

**Principles, Process and Responsibility: Exploring Ethics as a Meta-Regulatory
Framework for Evolving Governance Discourse**

by

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Abstract

This thesis proposes a new paradigm for understanding, developing and maintaining standards of corporate governance and conduct based on ethics as a meta-regulatory framework for governance discourse. It explores the possibility that, within such a framework, the explicit recognition of fundamental norms of ethical conduct and decision making such as honesty, fairness, consideration of others, responsibility and trustworthiness would precede and inform policy decisions relating to the objectives, structure and regulatory approaches of particular governance systems and practical considerations of how to implement and operationalize governance practices. It suggests that, despite the complex legal, institutional, normative and social dimensions of corporate governance standards and practice, these ethical norms are already implicit, and more recently explicit, in the formal systems of laws, rules and standards that seek to regulate corporate conduct. Alongside these traditional governance regulatory mechanisms, informal and soft law governance standards – codes, guidelines, international and multi-partite commitments – have emerged as an influential source of explicitly ethical, values based beliefs and expectations of what constitutes responsible business. There is an opportunity to use these ethical norms as a common point of departure for future governance discourse that is broad enough to support multiple approaches to governance yet flexible enough to accommodate complexity, diversity and change. Such discourse has the potential to alleviate some of the inherent interpretive and practical challenges to reconciling culturally diverse and pluralistic regulatory approaches in the pursuit of effective global corporate governance standards.

Table of Contents

Abstract	ii
Table of Contents	iii
List of Figures	vi
Acknowledgements	vii
Dedication	viii
1. Introduction	1
1.1 A Framework for Understanding Governance	1
1.2 Shared Core Values: A Foundation for Good Governance	4
1.3 Discourse and the Governance of Business	7
2. Approach	17
2.1 Research Objective	17
2.2 Structure	18
2.2 Objective	25
2.3 Method	27
2.4 Sample	29
2.4.1 Codes originated by public corporations	29
2.4.2 Codes originated by NGOs and civil society organizations	32
2.4.3 Codes originated by institutional investors and investor coalitions	33
2.4.4 Codes originated by or on behalf of corporations and business coalitions	34
2.4.5 Codes originated by or on behalf of state or multi-state entities	35
Part One – Systems Failures	36
3. Governance in the Spotlight, Again	37
3.1 The Latest in a Long History of Crises	37
3.2 A New Ingredient in the Old Formula	42
3.3 Unintended Consequences	48
4. The Expectations Gap	52
4.1 A Failure of Governance, Responsibility or Both? Diagnosing the Problem	52
4.2 Prescription Without Diagnosis: Incomplete Remedies	54
4.3 Different Approaches: Alternative Perspectives on Governance	59
Part Two – Corporate Governance Frameworks: An Overview of the United Kingdom, United States and Europe	67
5. Common Language, Distinct Paths: Corporate Governance in the United Kingdom, the United States and Europe	68
5.1 Form and Function	68
5.2 The ‘United Kingdom Approach’	70
5.3 The ‘United States Approach’	86
5.4 Corporate Governance in Western Europe	99
5.5 Beyond the ‘Either/Or’ Paradigm of Corporate Governance	112
Part Three – The Corporate Structure: Challenging Conventional Boundaries	114
6. Legal Limits and Moral Boundaries: the Corporate Challenge to Formal and Normative Conventions	115
6.1 The Root of the Problem	115
6.2 Corporate Responsibility – A Misnomer?	124
6.3 Geographically Unbounded	131
Part Four – Re-framing Regulatory Discourse	139

7.	From Debate to Innovation	140
7.1	Reconstructing the Regulatory Debate	140
7.2	Power Shifts	147
7.3	Achieving Regulatory Purpose in a Changing World.....	155
7.4	The Limits of Regulatory Responsibility.....	158
8.	A Matter of Form <i>and</i> Substance.....	164
8.1	Formal Boundaries.....	164
8.2	Regulating with Hindsight	169
8.3	The Importance of Informal or Normative Constraints	173
Part Five – The Changing Governance Landscape		180
9.	Re-Framing Corporate Governance	181
9.1	Reconstructing the Relationship Between Business and Society	181
9.2	The Significance of Stakeholders	189
9.3	Legitimacy and the Stakeholder Relationship	193
9.4	Ethics and Stakeholder Engagement.....	196
10.	Different Voices: Evolving Governance Discourse.....	198
10.1	Multiple Regulatory Paths	198
10.2	Market Forces for Change	202
10.3	Enabling Change Through Governance Disclosure.....	209
11.	Governance: Setting New Standards	222
11.1	The Problem of Definition	222
11.2	Values Based Standards of Conduct	224
12.	Global Institutionalization of Meaning.....	244
12.1	Language and Transformation in Governance Discourse.....	244
12.2	Contest or Constructive Dialogue.....	245
12.3	The Opportunities and Risks of Interdiscursivity in a Digital World.....	249
13.	Exploring Institutional Governance Discourse.....	260
13.1	Discourse and Institutions.....	260
13.2	The Corporate Voice.....	263
13.2.1	Voices in the boardroom and the ‘tone at the top’	263
13.2.2	Executive pay in the spotlight.....	271
13.2.3	Risk, responsibility and ethics	272
13.3	Investor/Shareholder Voice	275
13.3.1	Shareholder stewardship.....	275
13.3.2	Meeting investor expectations – more than the single bottom line	278
13.3.3	Ownership and beyond	282
Part Six – Closing		291
14.	Ethics as First Order Regulation: Principles, Process and Responsibility.....	292
14.1	A First Principles Approach.....	292
14.2	Deconstructing Governance.....	294
14.3	Establishing the ‘Good’ in Governance	296
14.4	Ethics and Governance: A Question of Problematization	297
15.	Conclusion	302
15.1	Commitment and Action.....	302
15.2	Ethics as a Meta Regulatory Framework for Governance Discourse	304
Bibliography		308

Appendix One – List of Notable Scandals..... 343

List of Figures

Figure 1 - Frequency of Code Types in Sample	29
Figure 2 - Codes Originated By Public Corporations	30
Figure 3 - Codes Originated by NGOs and Civil Society Organizations	32
Figure 4 - Codes Originated by Investors/Investor Coalitions	33
Figure 5 - Codes Originated by or on Behalf of Multiple Corporations/Business Coalitions	34
Figure 6 - Codes Originated by or on Behalf of State or Multi-State Entities.....	35
Figure 7 - Economy Coverage Over Time.....	47
Figure 8 - CR Index Companies versus FTSE All-Share Index - TSR by Year.....	206
Figure 9 - Percent Returns - World's Most Ethical Companies vs. S&P 500.....	208
Figure 10 - Voluntary Governance Mechanisms	232
Figure 11 - Corporate Governance Developmental Timeline.....	262
Figure 12 - % of Financial Post 500 Board Seats Held By Women in Canada.....	271
Figure 13 - Historical Support for Proxy Proposals on Social and Environmental Issues	282

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1. Introduction

1.1 A Framework for Understanding Governance

Governance is a complex, dynamic process. It depends on the coordination and cooperation of multiple elements, even in its most contained application of individual self-governance. In an ever more interconnected and interdependent world, governance at every level involves countless interactions that occur in a constantly changing context amidst myriad endogenous and exogenous factors.

The principles, processes and responsibilities that determine the governance of the smallest units to the largest potentially have implications and consequences far beyond the economically, physically, socially and temporally proximate. As such, each unit of governance is connected to other units, together comprising multiple, successively larger units of governance.

The relationship between separate parts that connect or cross in the context of a larger whole is the basis of any system. To approach governance from a systems-based perspective implies a conceptual whole: that the dynamic relationships among and between separate units of governance and within multiple frameworks can be considered in aggregate, as well as in terms of the constituent parts or governance sub-systems.

In the face of a degree of complexity and a scale that exceeds the capacity and reach of existing mechanisms of control, there is a tendency for governance discourse to become specialized and located within separate governance sub-systems – those of governments, institutions, corporations, organizations and individuals – and in doing so to weaken the connection with other parts and the larger system.

The systems-based approach necessitates an appreciation of the singular as well as the collective. Analysis of a single unit provides specific, detailed information and an opportunity to observe internal function, specialization and endogenous factors that, for

example, influence adaptation and change within the unit. However, conclusions drawn from such observations are limited and incomplete as a basis for a general theory or for the development of principles, best practices or standards for wider application in that they fail to take account of the myriad exogenous factors that permeate and influence the unit from outside its boundaries.

This thesis therefore focuses on the business sphere as a specific governance sub-system, and corporate governance in particular, in order to identify and engage with the many dimensions of a broader notion of governance in an applied context. That is, rather than examining the conduct and governance of business in isolation, it does so with a view to acquiring specific knowledge that may provide insight into other governance sub-systems and governance as a whole. This approach also supports an analytical framework broad enough to encompass examination of the roles played by diverse actors in the construction and recalibration of corporate governance both specifically and within a wider societal context.

Furthermore, situating the study of governance in the business sphere within a wider governance context transcends a narrow focus on compliance that has been dominant in recent corporate governance scholarship. There is a tendency to concentrate on the concrete and more static components of governance in preference to the more nebulous dimensions. That is, to focus on the formal agreements, rules, policies and procedures that seek to define, recommend or prescribe specific governance related activities and functions rather than to consider the role of broader cultural norms in influencing attitudes, behaviour and conduct choices.

This thesis proposes a new paradigm for understanding, developing and maintaining standards of ethical business conduct and good corporate governance.¹ The point of

¹ A paradigm is defined as a pattern of thinking, a set of background assumptions taken for granted. *Penguin Dictionary of Philosophy*, 2d, (Penguin Books, 2005). The term's usage in this sense is associated with the influence of Thomas Kuhn's 1962 *The Structure of Scientific Revolution*. (Thomas S. Kuhn, *The Structure of Scientific Revolutions*, Second Edition, Enlarged, (Chicago: The University of Chicago Press, 1970 (1962)). Kuhn used the term to refer to the theoretical frameworks within which scientific thinking and practice operate and which encompass the general theoretical assumptions, and laws and techniques for

departure is not a position along the diverse and divergent paths of corporate governance and regulatory theory and practice. Instead, it starts with the possibility of an overarching conceptual and regulatory framework that precedes the specific, instrumentalist questions of how to construct particular governance frameworks and institute, implement, and operationalize governance practices in any given context.

This ‘framework of frameworks’, or meta-framework, is a valuable concept in complex systems thinking.² Applied in the context of governance, it is an overarching conceptual framework that offers systemic integrity, shared referents and a common foundation broad enough to support multiple governance sub-systems. It also has the benefit of being flexible enough to accommodate complexity, diversity and change within those sub-systems while at the same time sufficiently robust to protect the integrity of the system as a whole.

From this starting point, the thesis explores the idea that within such a meta-framework it may be possible to locate a common source of the core values, norms and objectives that explicitly or implicitly inform the substance of governance policies and principles, the laws, rules, and standards *a priori* their particular form and function. In essence, it is an examination of the potential for ethics as a meta-regulatory framework for governance discourse, standards and practice.

their application that are assumed and standardized by members of a particular scientific community. The term has been generalized to refer to any intellectual perception or view that is accepted by an individual, community or society at large as a clear expression, model or pattern of how things work in the world

² In general terms, the basis of systems thinking is the proposition that the individual components of a network of relationships – or system – are best understood in terms of the connections, dependencies, hierarchies and interrelationships that exist with and between the separate components, rather than in isolation. Equally that a dynamic and complex system is best comprehended through the relationship and interactions of the component parts to the whole.

1.2 Shared Core Values: A Foundation for Good Governance

“A basic code of good business behaviour is a bit like oxygen: we take an interest in its presence only when it is absent.”

Amartya Sen.³

The search for transcendent norms and standards of good governance, conduct and responsibility – to apply to the activities of business, state and non-state institutions, civil society and the individuals that animate them – is all the more important in a global economy. For the questions of *whose rules* and *which boundaries* exist to constrain and guide behaviour become immeasurably more challenging when actions and consequences occur variously outside the specific geo-political limits of the law in a marketplace that is populated by a plurality of standards, interpretations, expectations and incentives articulated by numerous diverse constituencies.

In this thesis, I examine the proposition that the shared values, behavioural norms and sustainable objectives embodied in good governance practices are derived from fundamental norms of ethical conduct and decision making such as accountability, fairness, honesty, respect for others, responsibility and trustworthiness.⁴ These norms constitute ‘hyper-norms’ because they transcend regulatory debate and practice and endure over time as an essential part of the larger more intricate system of norms that govern social interactions throughout society.⁵

³ 1998 Nobel laureate in Economic Science, Amartya Sen in: Amartya Sen, *Development as Freedom* (New York: Anchor Books, 1999) 264.

⁴ There are numerous bases for identifying these specific values. For example, in 1994 The Institute of Global Ethics conducted surveys, interviews and established focus groups in 16 countries around the world with a view to identifying the existence of core values that transcend individual cultures. The list that emerged included, in addition to trust or trustworthiness: love, truthfulness, fairness, freedom, unity, tolerance, respect and responsibility. In 1996, the Institute with the Gallup Organization survey 272 participants representing 40 countries and more than 50 different faiths who were gathered at the State of the World Forum convened by Mikhail Gorbachev and other world leaders. The research found strong convergence around: truth; compassion and responsibility. In a later survey on 1,100 managers in major U.S. financial services firms the top values were: honesty, responsibility, respect and fairness. Source: Rushworth M. Kidder, “Trust: A Primer on Current Thinking”, Institute for Global Ethics, undated. www.globalethics.org.

⁵ Donaldson and Dunfee have described hyper-norms as “deep moral values” representing “a convergence of religious, political and philosophical thought”. Thomas Donaldson and Thomas W. Dunfee, *Ties that*

Part of this examination involves a search for expressions of shared values, behavioural norms, and sustainable objectives that inform a spectrum of established and emergent approaches to achieving *good* corporate governance. Such expressions may provide evidence of a shared provenance among structurally and operationally diverse regulatory models and approaches to governance. If such evidence is found, the common essential elements potentially can provide an explicit context for governance discourse that transcends the limits of law, state-based regulatory authority, and the public-private divide.

It is my contention that affirming these shared core values enables the establishment – or recognition – of a common, ethically based meta-framework for governance discourse. The scope of the governance discourse conducted within this meta-framework would be broad enough to encompass the combined strengths of the different regulatory approaches that have evolved from this common origin.

Furthermore, with explicit recognition of a common origin in ethical norms, principles and values, the meta-framework would also establish a stronger basis on which to engage with diverse perspectives than the continuously evolving regulatory landscape in which those values, principles and objectives can become obscured or lost in the translation from policy into practice and process. This engagement with diverse perspectives would, in turn, increase the likelihood that future governance discourse occurs and evolves informed and enriched by the multiple governance standards emanating from a plurality of ‘regulatory’ and ‘quasi regulatory’ voices, respecting rather than obscuring historical and cultural differences and finding similarities in existing legal, institutional, and normative governance paradigms.

Bind (Boston MA: Harvard Business School Press, 1999) at 27 and 44. Later, Wempe and Donaldson describe ‘hyper-norms’ as norms so fundamental that evaluation and judgment of ordinary norms is conducted by reference to these constant higher order norms – see, Johan Wempe and Thomas Donaldson, “The Practicality of Pluralism: Redrawing the Simple Picture of Bipolarism and Compliance in Business Ethics” in George G. Brenkert, (ed.) *Corporate Integrity and Accountability* (London: Sage Publications, 2004) 31. See also: Linda M. Sama and Victoria Shoal, “Reconciling Rules and Principles: An Ethics Based Approach to Corporate Governance” (2005) *Journal of Business Ethics* Vol. 58 (May 2005).

The potential of this higher level framework approach based on enduring ethical norms, principles and values is a greater ability to accommodate normative and societal change and to deliver broad based benefit than narrower frames of reference that emphasize and capitalize on the deficiencies, flaws and weaknesses of other systems and approaches in a form of regulatory imperialism.⁶

To focus on differences and to overlook the similarities in function, if not form, is to risk obscuring fundamentally shared goals: and it is on those fundamentally shared goals –situate within an ethical framework that transcends the limits of conventional geopolitical boundaries and different regulatory and approaches and philosophies – that constructive engagement can occur on the common pursuit of effective, globally recognized standards of *good* corporate governance.

There are those who argue that the specific activities of business and commercial enterprise are predominantly a matter of private law focus. More often the case in the United States, where corporate law is the exclusive jurisdiction of the individual States and matters of incorporation and conduct of affairs are protected by privacy and limited in terms of financial reporting requirements and other governance mechanisms, any study of the governance and conduct of market actors inevitably encounters the public – private debate.

Yet, whatever the private interactions and transactions and despite constitutional barriers to effective governance oversight, all business takes place within a wider social, political and economic framework and relies on public goods and social licence to operate. Its primary purpose is to satisfy human and material needs by efficiently producing and supplying good and services. As such, business activities – exploration, invention, research and development, production, trade, marketing, investment and finance among others – are inherently social acts between parties that take place, have implications and

⁶ On democratic governance, see: Christine Parker, *The Open Corporation – Effective Self-Regulation and Democracy* (Cambridge University Press, 2002); Douglas K. Smith, *On Value and Values* (New Jersey: Pearson Education Inc, publishing as Financial Times Prentice Hall, 2004).

consequences for and must be considered in light of the larger societal arena.⁷ It is for this reason that this thesis explores the social and normative as well as legal and institutional dimensions of business conduct and seeks fresh insight by viewing them through the window of governance discourse – formal and informal, established and emergent.

1.3 Discourse and the Governance of Business

The internet's accelerated ascendance in the last two decades has coincided with the emergence of a combination of forces for change in the nature, conduct and governance of business.

One is the sustained growth in developed economies of retail investor participation in capital markets, both directly and indirectly through mutual funds, insurance policies and pension investments. Another is the rise of the corporate social responsibility movement from mid last century, and the subsequent emergence of civil activism around corporate influence and the implications of global economic policies and trade practices. A third is the increased public attention to matters of corporate governance since the collapse of Enron and contemporaneous corporate bankruptcies and scandals through the close of the last and into this century.

⁷ M. Granovetter, "Economic Action and Social Structure: the Problem of Embeddedness" (1985) *American Journal of Sociology* 91: 481-93: a response to the under-socialization (rational economics) and over-socialization (sociological theory) of economic behaviour that markets and hierarchies should be understood as embedded in social networks. James Coleman, *Foundations of Social Theory* (New York: First Harvard University Press, 1994): regarding exchange relationships as derived from inherently social and cultural norms rather than purely rational calculus. Gary M. Woller, "Business Ethics, Society and Adam Smith: some observations on the liberal business ethics" (1996) *Journal of Socio Economics* vol. 25, issue 3: social norms underpin Adam Smith's market. Ken Morrison, *Marx, Durkheim, Weber Foundations of Modern Thought* 2d (London: Sage Publications, 2006) at 388: central to Marx's examination of the effects of the modern economy on human labour processes was the notion that labour served to connect individuals to themselves and to the community through the process of production. He identified four sources of alienation from the inherently social function of work due to changes to the labour process through industrial capitalism such as the commoditization of work, price competition and the pursuit of private gain.

For the traditional participants in governance discourse – businesses, investors, institutions, the wider market community and regulators – electronic information platforms have for some time served as efficient repositories, resources and outlets for information. Specifically, information about companies and capital markets, their constitution, activity and operation, performance and varied structures. Through the 1980s and 1990s, these participants had relatively exclusive access to detailed and sophisticated information through internal and proprietary information platforms, content and tools. Even web-based sites that emerged in the nineties with the growth of dotcoms were developed with a view to restricted accessibility and maintained barriers through subscription costs and the specialized presentation of information.

At this level, these proprietary and subscription based online resources operated as restricted information portals with limited contribution to make to the potential powers of communication, information and transparency as an indirect regulatory mechanism.

As Bardach and Kagan have observed, “[i]nformation is potential power” provided there are available resources for its useful consumption by “the citizen, the consumer or the worker”, otherwise “the information is beside the point”.⁸ Absent these resources, the distribution of information is incomplete or dependent on intermediaries, giving rise to information asymmetries that limit the efficiency and transparency of capital markets and arguably impede their proper function.

However, these specialized uses facilitated the development of mechanisms for achieving the greater transparency and information disclosure necessary for greater and more independent governance oversight. Such advances include: mandatory filings on publicly accessible repositories such as EDGAR in the United States and SEDAR in Canada; the introduction of XBRL to facilitate interaction with and analysis of corporate financial data; public access to corporate information and disclosure documents through official corporate websites; online communication with shareholders and electronic voting; and

⁸ E. Bardach and R.A. Kagan, *Going By The Book: the problem of unreasonableness*. (Philadelphia, PA: Temple University Press, 1982) at 248.

the availability of information and resources from independent sources that range from interactive finance and investing websites to those that monitor business' social, environmental and ethical practices, political influence and carbon footprint. In this regard, these public online functions and portals serve the potentially powerful 'information strategy'. Whereby, according to Bardach and Kagan, individuals are empowered "to be their own ubiquitous inspectors, tailor their own standards to particular risks, and invoke their own sanctions". In some cases this can be to powerful effect.⁹

The internet as a means of communication is thus distinct from previous information exchange media that facilitated communication between sophisticated capital market participants in that much of its vast information resource is potentially accessible to a much broader audience. Further, the ability to access information and verification from independent sources enables more complete monitoring of business activity than that which relies solely on corporate disclosure. As a result, the internet has enabled the growth of governance discourse beyond the elite spheres of traditional boardrooms and executive offices of corporations and institutions: serving as a platform for discussion and debate on wider issues concerning business and its economic, political and social influence within society.

In the context of governance and globalization, legal scholars such as Branson have argued that the technological and communications phenomenon of the information age will enable diversity and preserve governance styles particular to specific cultures and economies rather than facilitate the dominance and eventual formal convergence to an American style form of governance as has been suggested in United States governance convergence scholarship.¹⁰

⁹ Ibid. at 248.

¹⁰ See, John C. Coffee, Jr., "The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications" (1999) 93 *Nw. U. L. Rev.* 641; Henry Hansmann and Reinier Kraakman, "The End of History for Corporate Law", Social Sciences Research Network (SSRN) Electronic Paper Collection, http://papers.ssrn.com/paper.taf?abstract_id=204528 (2000) [UPDATE]. More recently, there is increasing recognition of the fundamental incompatibility of US style corporate governance with corporate governance regulation and practice in other parts of the world. For example, Tim Bush in *'Divided by Common Language' Where Economics Meets the Law: US Versus Non-US Financial Reporting Models* (Chartered Accountants in England and Wales, 2005). Web published at:

Certainly, a more open forum for governance discourse can help to dispel misperceptions and inaccurate assumptions that arise in comparative and competitive governance analysis dominated by particular perspectives. In *Divided by Common Language*, Bush writes that the common language of the United Kingdom and United States can at times create a superficial similarity in both governance and reporting matters when, beneath the surface, the law is quite different in form and substance, intent and effect.¹¹

As such, the internet as a platform for information exchange and a communication medium offers the promise of greater access, openness and transparency.¹² It signifies the potential for what a recent Arthur W. Page Society report described as “democratized access to information production, dissemination and consumption ... overturning the corporation’s traditional ability to segment audiences and messages and to manage how it wishes to be perceived.”¹³

Yet, the internet’s great weakness and the largest very real threat to achieving this potential is its vulnerability to anonymous transactions, hidden biases and influence, and criminal and socially disruptive activity. As much if not more than its potential for greater openness and transparency is the internet’s potential to provide a platform for the manipulation and misrepresentation of information and distortion of the truth on a mass scale. The reality is that communication technologies do not simply support a neutral platform or medium for the exchange of information and ideas and debate, but also

http://www.icaew.com/index.cfm/route/115933/icaew_ga/pdf web-published June 2005. (See also notes: 36, 136, 231.)

¹¹ “The US securities laws are trying to do something entirely different to the financial reporting regimes of other countries because of the constitutional limitations of the US federal system [b]ecause of anomalies within the US federal reporting system, introducing aspects of a US-style regulatory financial reporting and corporate governance regime into other countries where the laws are actually different and not constitutionally restricted, is conceptually unsound”. Ibid. at 2-3.

¹² James Bohman, “Expanding Dialogue: The Internet, the public sphere and prospects for transnational democracy”, in *Social Theory – Continuity and Confrontation 2nd ed*, Roberta Garner (ed.) (Broadview Press, Peterborough, 2007). Thomas S. Ulen, “Democracy and the Internet: Cass R. Sunstein, Republic.Com. Princeton, NJ. Princeton University Press, Pp. 224, 2001” (2001) *Journal of Law, Technology and Policy*, No. 2, Fall 2001. Available at SSRN: <http://ssrn.com/abstract=286293> or doi:10.2139/ssrn.286293

¹³ Arthur W. Page Society, *The Authentic Enterprise* (Arthur W. Page Society, 2007) at 6. Online at: http://www.apagesociety.com/site/resources/white_papers/.

operate as an instrument of commerce, and a vehicle for the exercise of power, exclusion and oppression.¹⁴

These contrasts – the democratic ideal and the reality – provide a rich canvas for examination of the evolution and formation of societal norms and standards of business and institutional conduct, and the communicative mechanisms and vocabulary used to express them within and between diverse dialogic communities.¹⁵ They also provide an opportunity to examine the evolving governance discourse after Habermas’ dialogic ideal, the influence of concealed power on the nature of that discourse following Foucault and others’ examinations of power relations in language, and the implications for an explicit ethics of engagement.

Some jurisdictions – notably the United Kingdom, other Member States of the European Union and the European Commission, Australia and South Africa – have advanced contemporary discourse on the interrelationship of economics, law, public policy and the public good, corporate governance and the responsible conduct of business.¹⁶

In the United Kingdom, a Committee on Financial Aspects of Corporate Governance was struck in 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession in response to business scandals that caused considerable damage to public and market confidence in the honesty, accountability and value of public

¹⁴ See for example: R.C. Holub, *Jurgen Habermas: Critic, in the Public Sphere* (London: Routledge, 1991); L. McLaughlin, “Feminism, the Public Sphere, Media and Democracy” (1993) *Media, Culture and Society* 15: 599-620; N. Fraser, “Rethinking the Public Sphere: A Contribution to the Critique of Actually Existing Democracy”, in C. Calhoun (ed.) *Habermas and the Public Sphere*, (Massachusetts: The MIT Press, 1992).

¹⁵ The concept of a dialogic community was first theorized in the work of philosopher Martin Buber. Buber states "Community is the overcoming of otherness in living unity...community is no union of the like-minded, but a genuine living together of men of similar or of complementary natures but of differing minds" (Martin Buber as cited in R.C. Arnett, *Communication and community: implications of Martin Buber's Dialogue* (Carbondale, IL: Southern Illinois University Press, 1986) xi.

¹⁶ These relationships have been the subject of thought and discussion for centuries. In 1699, for example, English political economist Charles Davenent wrote that “Trade, without doubt is in its nature a pernicious thing; it brings wealth which introduces luxury; it gives rise to fraud and avarice Lycurgus in the most perfect model of government that was ever framed, did banish it from his commonwealth”. Charles Davenent, “Essay upon the Probable Methods of Making a People Gainers in the Balance of Trade” (1699) in Works II, 275 quoted in Jerry Z. Muller, *Adam Smith in His Time and Ours: Designing the Decent Society* (New York: Free Press, 1993).

companies.¹⁷ In the opinion of the Committee Chairman Sir Adrian Cadbury, the former Chairman of Cadbury Schweppes with its storied 170 year history of conducting business according to the high ethical standards of nineteenth century ‘Quaker capitalism’,¹⁸ “[T]he proper governance of companies was becoming as crucial to the world economy as the proper governing of countries”.¹⁹

The Committee issued its findings in 1992²⁰ following extensive consultation and consideration of more than 200 written submissions during the public comment process.²¹ The report – which came to be known as *The Cadbury Report* – its findings, recommendations and Code of Best Practice based on the principles of openness,²² integrity,²³ and accountability²⁴ is generally considered to be the genesis of modern

¹⁷ In particular, the sudden financial collapses of two companies, wallpaper group Coloroll and the Polly Peck consortium. Subsequent to the Committee’s establishment, continuing controversy over director and executive compensation levels, and two further scandals that shook the financial world heightened the significance and profile of the work of the Cadbury Committee during a particularly difficult economic period: the collapse of the Bank of Credit and Commerce International (BCCI) and exposure of its widespread criminal practices, and the posthumous discovery of Robert Maxwell’s appropriation of £440m from his companies’ pension funds as the Maxwell Group filed for bankruptcy in 1992. Source: “The Cadbury Report”, *The Cadbury Archive*, University of Cambridge Judge School of Business. Online at: <http://www.jbs.cam.ac.uk/cadbury/report/index.html>.

¹⁸ The ‘Quaker capitalists’ of nineteenth century Britain believed that business should be conducted according to strict principles of hard work, austerity and watchful restraints, with wealth creation not as an end in itself but as a means to benefit workers, local communities and society at large as well as the entrepreneurs. The notion of personal advantage and gain as a distinct aim of business offended such principles. Cadbury, Deborah, *Chocolate Wars* (Vancouver, Canada: Douglas and McIntyre, 2010) at xi.

¹⁹ As quoted *ibid.* at 278.

²⁰ The Cadbury Committee, *The Report of the Committee on the Financial Aspects of Corporate Governance*, (London: Gee, 2002) (“*The Cadbury Report*”). The draft report was issued in May 1992 and the final report in December 1992. Online at: <http://www.jbs.cam.ac.uk/cadbury/report/index.html>

²¹ The Committee’s draft report, issued for public comment on 27 May 1992, drew on a number of reports on different aspects of corporate governance which had either been published or were in preparation at the time the Committee convened as well as a wide range of submissions from interested parties. Reports considered included “Business Ethics and Company Codes – Current Best Practice in the United Kingdom”, (1992) from the Institute of Business Ethics, an influential non-profit organization established in 1986 to encourage high standards of business behaviour based on ethical values. The public comment process yielded over 200 written responses to the Committee’s proposals, the great majority of which broadly support the Committee’s approach. *The Cadbury Report* supra note 20 at par. 2.2-2.4

²² *The Cadbury Report* supra note 20, Introduction at par. 3.1: “An open approach to the disclosure of information contributes to the efficient working of the market economy, prompts boards to take effective action and allows shareholders and others to scrutinize companies more thoroughly.”

²³ *The Cadbury Report* supra note 20, Introduction at par 3.3. The Committee regards integrity as encompassing “straightforward dealing and completeness” such that financial reports “should be honest ... should present a balanced picture of the state of the company’s affairs ... [and] depends on the integrity of those who prepare and present them”.

corporate governance having influenced governance in more than twenty-eight countries and in institutions such as the World Bank.²⁵

While the Quaker values that influenced Sir Adrian's understanding of how a company best operates, and that were evident in the governance best practices developed within Cadbury under his family's leadership, were not mentioned explicitly in the Cadbury Code, their influence was crucial. In Sir Adrian's view the aim of the code was to bring "greater transparency, honesty, simplicity and integrity to the process of running a company".²⁶

In Australia, The Bosch Committee, comprising representatives from business and the professions and chaired by Henry Bosch past Chairman of the National Companies and Securities Commission, the predecessor of the Australian Securities and Investments Committee, was established in 1990 at least partly in response to damaging publicity arising out of the malpractices of a small number of prominent companies in the 1980s.²⁷ The formation of the committee reflected a genuine desire to restore the reputation of the business community and to prevent a repetition of past excesses.²⁸ Its publication, *Corporate Practices and Conduct*, set out guidelines for directors of Australian companies with the main objective to "improve the performance and reputation of Australian business by encouraging and assisting the general adoption of the highest standards of corporate conduct".²⁹

²⁴ *The Cadbury Report* supra note 20, Introduction at par 3.4. The Commission held that boards of directors were "accountable to their shareholders and both had to play their part in making accountability effective." The board's provision of quality information to the shareholders could achieve this objective.

²⁵ Cadbury, Deborah, *The Chocolate Wars*, (Vancouver, Canada: Douglas and McIntyre, 2010) at 278.

²⁶ As quoted *ibid.* at 278.

²⁷ Two of the most notable, that inspired intense public backlash and provoked significant law reform activity, were the corporate collapses of HIH and One.Tel. HIH is the largest collapse in Australian corporate history, and the subject of an A\$40 million Royal Commission (HIH Royal Commission). The Commission's findings were published in April 2003 HIH Royal Commission, Commonwealth of Australia, *The Failure of HIH Insurance* (2003), <http://www.hihroyalcom.gov.au/finalreport/index.htm>

²⁸ Jean Jacques du Plessis, Anil Hargovan, Mirko Bagaric, *Principles of Contemporary Corporate Governance* 2d, (Cambridge University Press, 2011) at 137.

²⁹ Henry Bosch, *Corporate Practices and Conduct* (3rd ed) (Woodslane Pty Ltd, 1995), Foreward.

The South African government in 1992 asked former South African Supreme Court Judge Mervyn King S.C. to chair a private sector committee to draft corporate governance guidelines in keeping with the country's move toward democratic government. The King Committee on Corporate Governance issued its first report in 1994. The report – *The King Report on Corporate Governance for South Africa* (“King I”, as it came to be known) – incorporated a Code of Corporate Practices and Conduct, the first of its kind in the country, aimed at promoting the highest standards of corporate governance in South Africa.³⁰ These highest standards went beyond the financial and regulatory aspects of corporate governance, taking an integrated and inclusive approach to good governance in the interests of a wide range of stakeholders beyond shareholders that was groundbreaking and to this day regarded as ahead of its time.³¹

In Canada, an independent national commission – the Canadian Democracy and Accountability Commission – conducted cross-country hearings throughout 2001 as part of its year-long investigation of corporate accountability. Its report issued in January 2002, *The New Balance Sheet: Corporate Profits and Responsibility in the 21st Century*, contained 24 recommendations to significantly broaden the concept of corporate accountability beyond the narrow focus on profit.³² Specifically, the Commission recommended that corporate accountability include accountability to employees, customers, communities, the environment, the country and the global community. According to a national survey conducted on behalf of the Commission to supplement the hearings and separate submissions³³ to the Committee, 74 percent of shareholders surveyed agreed that “business executives have a responsibility to take into account the

³⁰ King Committee on Corporate Governance, *King Report on Corporate Governance for South Africa*, 1994 (South Africa: Institute of Corporate Directors, 1994) (“King I”).

³¹ The evolving global economic environment together with recent legislative developments, have necessitated updates to King I, *The King Report on Corporate Governance for South Africa*, 2002 (South Africa: Institute of Corporate Directors, 2002) (“King II”) and the *King Code of Corporate Governance for South Africa*, 2009 (South Africa: Institute of Corporate Directors, 2009) (“King III”).

³² Canadian Democracy and Accountability Commission, *The New Balance Sheet: Corporate Profits and Responsibility in the 21st Century* (Canadian Democracy and Accountability Commission, 2002).

³³ In addition to the hearings, the Commission met or received submissions from 157 organizations and individuals from government, the corporate sector, organized labour, nongovernmental organizations, *ibid.* at Appendix B.

impact their decisions have on employees, local communities and the country as well as making profits [sic]”.³⁴

A recent communication by the European Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions, *Towards a Single Market Act* carries forward to the present these same concerns, in stating that,

[I]t is of paramount importance that European businesses demonstrate the utmost responsibility not only towards their employees and shareholders but also towards society at large.³⁵

Other jurisdictions are broadening business discourse to address wider socio-economic implications. Such shifts are evident even in the United States, where the long-established view of many academics, policy makers and market participants – that economies have a separate and superior existence to the rest of society – fundamentally differs from the majority view in the rest of the world.³⁶

My thesis proposes that this form of governance discourse – if conducted within an explicitly ethical framework – is essential in a global economy. The need for ethically-based and inclusive governance discourse is particularly the case where the economy is dominated by the capitalist model, where the boundaries between public and private sectors, individual and community interests are constantly challenged and where the notions of what is ‘ethical’, ‘fair’, ‘just’ and ‘right’ in a free market system elude legal definition and, consequently, formal regulation.

³⁴ Vector Research poll conducted from September 28 to October 8, 2001 with 2006 adults across Canada, *ibid.* at Appendix C.

³⁵ Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions, *Towards a Single Market Act – for a highly competitive social market economy*, COM(2010) 608 final/2, 27.

³⁶ Douglas Branson in “The Very Uncertain Prospect of ‘Global’ Convergence in Corporate Governance” (2001) 34 *Cornell International Law Journal* 321 elaborates on how other models of capitalism such as family capitalism, bamboo capitalism, crony capitalism, guided capitalism, managed capitalism and even gangster capitalism in developing and newly industrializing economic regions, are grounded in cultural norms and social institutions that have at least equally significant existence to the economy.

Through this lens, I consider the limits of formal regulation and the inter-relationship between laws, norms and ethical standards in market based and public policy approaches to directing, regulating and judging the conduct and governance (broadly construed) of business institutions.

This examination, in turn, will shed some light on the role that ethical norms play in ordering society and social groups beyond the realm of formal rules. In particular, the ways in which society at large organizes as normative governance sub-cultures with distinct voices – such as communities, industry groups, and non profit organizations – that achieve cooperation in order to pursue common as well as individual goals.

In this cooperation there is an intangible, morally, socially and behaviourally complex element that goes beyond a merely rational economic calculus toward something that is suggestive of an appreciation for shared rather than narrow self interests.

2. Approach

“While narrowing the focus of any enterprise is necessary in order to say anything meaningful about anything, the scope of an inquiry into a subject as sweeping as norms must be broad ... The broader the starting inquiry, the greater the understanding. [T]o opt for simplicity in the hope of achieving clarity [means that] clarity is achieved at the expense of a realistic understanding of norms”.

Lawrence Mitchell³⁷

2.1 Research Objective

One of the central issues facing governments, civil society, individuals and corporations with respect to standards of business conduct and governance is whether expectations for corporations and like entities to be responsible for social, environmental and ethical issues arising from their operations are amenable to prescriptive, formal regulation and adjudication, or whether such expectations are, by their nature, more appropriately situated in the ethically and normatively regulated domain, subject to certain minimum standards prescribed in law.

One of the objectives of this research is to gain insight into the existence, or not, of observable functional or substantive as well as formal congruence between normative public discourse regarding ethical corporate conduct on the one hand and formal (legal and regulatory) and institutionalized governance rhetoric on the other. Evidence of such congruence could be found in an emergent dominant lexicon, or normalized and institutionalized expressions of governance standards, or both, relating to ethical considerations³⁸ within and across different ‘regulatory’ dialogic communities. It could also be found in the advent of a common or shared vocabulary for explicit, formal

³⁷ Lawrence E. Mitchell, “Understanding Norms” [1999] *University of Toronto Law Journal*, April 1999. Available at SSRN: <http://ssrn.com/abstract=142432>.

³⁸ ‘Ethical considerations’ in this regard is a broad phrase encompassing environmental and social as well as economically responsible considerations.

recognition via disclosure of ethical issues as material ‘non-financial’ considerations and risks.

It is a truism that language in common does not necessarily lead to common meaning or shared understanding. In this exercise, therefore, it is necessary to confront a variety of interpretive challenges. These include: issues of source, representation and contested legitimacy; the appearance or illusion of commonality or congruence; and the dominant or hegemonic influences of authority and power embedded in institutionalized legal and normative governance discourse and the dominant governance lexicon.

The existence of formal, functional or substantive congruence, if found, leads to further exploration of the possibility that ethics – as a meta-regulatory framework – may have the potential to alleviate some of the inherent interpretive and practical challenges to reconciling culturally diverse and pluralistic regulatory approaches in the pursuit of effective global corporate governance standards.

By embarking on this project, I hope to demonstrate the application of institutional discourse and the dialogic dimension of regulatory theory and practice to emergent legal and normative regulation of corporate governance and conduct. The findings also relate institutionalization and normalization processes to emergent standards of responsibility and accountability that extend beyond those required for strictly instrumental and/or narrow rational economic purposes.

2.2 Structure

Governance generally, and corporate governance specifically, is a complex, many layered and multidimensional subject. So too is the discourse that variously creates, defines, influences, implements and shapes it.

In exploring ethics as a meta-regulatory framework for governance discourse I have chosen to explore legal, institutional, normative and social dimensions of governance standards and practice.

The scope of this project encompasses:

- the study of traditional, formal sources of corporate governance standards and practices – state-based legal and regulatory measures – and a range of emergent, non-traditional and informal sources – voluntary codes, guidelines, standards and values-based expectations – all of which fulfill a regulatory function whether it be the so-called ‘command and control’ at one extreme to enlightened self-restraint at the other;
- an exploration of the conjunction, intersection, and inter-relationship of these established and emergent sources of corporate accountability, conduct, and governance norms and standards; and
- a consideration of the evolving roles and interactions of established and newer participants in the ongoing discourse of corporate governance – governments, business, investors, stakeholders, and the public.

The structure and approach in this thesis reflects a series of choices including: where to situate and how to lay the foundations; how to frame the discussion; and how to progress from one aspect to another and in what sequence so that each part advances or deepens the preceding discussion.

In this regard, Chapter Three situates the discussion within the context of a long-standing dynamic between business, government and society by providing an overview of recent and past crises in governance and successive responses. It examines the pattern of regulatory response to crisis evident from the recent history of corporate and market failures, and considers whether the fact that this cycle is played out on an increasingly public stage has any significance to the nature of response.

Chapter Four begins to lay the foundations of the central themes of this thesis by taking the variable success of policy responses to recent governance failures as an opportunity to introduce alternative perspectives on the nature, source and expectations of corporate governance and to provide examples of how consideration of alternative perspectives can serve to advance the discourse of governance and the achievement of public policy

objectives. The consideration of alternative perspectives as a means to broaden, enrich and legitimate governance discourse is a recurring element of this thesis and an essential ingredient of an ethical framework for governance discourse.

Chapter Five develops the preceding chapter's consideration of alternative perspectives on corporate conduct and governance by way of an overview of the formal basis of corporate governance standard-setting in the United Kingdom, United States and the European Union. Each of these systems' approaches to corporate governance is the product of their particular historical, constitutional, legal, political, institutional and cultural influences. In the case of the United Kingdom and the United States the shared language and the central role of capital markets in their respective economies may suggest greater concordance than in fact exists, In this regard, the chapter highlights some of the foundational differences that distinguish the approach to corporate governance in the United Kingdom and the United States. By contrast, the chapter also highlights the functional similarities among member states of the European Union (including the United Kingdom) on the principles of governance notwithstanding their diversity of formal legal and political structures and different cultural and historical roots. It also invokes two central ideas on which this thesis is based. One, that similar goals can be pursued by different means and two, that there is potential for constructive engagement to take place on issues of accountable, ethical, and effective governance that transcend the limitations of conventional boundaries.

Chapter Six juxtaposes the ideas for pursuing common goals within a framework of constructive engagement advanced in the preceding chapter with the object of such efforts – the corporate entity. Modern corporations have considerable influence in developing and under-developed, as well as developed, nations and virtual omnipresence in mainstream society. As a consequence they play a powerful normative role in shaping standards and expectations of business conduct and governance alongside and in some respects well beyond the formal role of state institutions. The chapter draws attention to particular attributes of corporate entities that are the source of, or that exacerbate, contemporary challenges to ensuring that businesses conduct and govern themselves

responsibly with due attention to reducing or ameliorating adverse impacts and consequences of their operations wherever they may occur. While these challenges are not insurmountable, any framework for effective governance discourse must include corporate decision makers, recognizing the inherent challenges but also the opportunities for constructive engagement on – and solutions to – issues that transcend the regulatory capacity of governments.

Chapter Seven embarks on a closer examination of the limits of the law and formal regulation as a sole source of corporate conduct, governance and accountability standards in an open economy and global marketplace that has empowered businesses to operate beyond traditional geo-politically defined boundaries of control. Specifically, it considers the implications of an increasingly global marketplace for the authority and effectiveness of state-based law and regulation that only prescribes and enforces minimum legal thresholds and that have little or no formal extraterritorial effectiveness. Furthermore, while markets are increasingly interconnected and interdependent there are and arguably will remain significant cultural, economic, institutional, legal and normative barriers to formal regulatory convergence. Given this, a central consideration is whether the collective efforts of many to promote regulatory harmonization might be better aimed at the potential for achieving higher level normative consensus on the fundamental principles that shape and inform the regulation and self-regulation of corporate conduct and on the desired outcomes, both proactive and preventative.

Chapter Eight advances the discussion toward a consideration of the expressive and normative functions of formal and informal sources of governance standards based on the early insights of Emile Durkheim on the relevance of systems of normative regulation, and of others who have considered complex systems and networks based perspectives in the regulation of conduct.³⁹ These theories provide important insight into the relationship

³⁹ Andrew Dunsire, “Modes of Governance”, in: J. Kooiman (ed.), *Modern Governance: new government-society interactions* (London: Sage, 1993) 21-34 at 29. J. Kirkbride and S. Letza, “Regulation, Governance and Regulatory Collibration: achieving an ‘holistic’ approach” (2004) *An International Review* Volume 12, No. 1, January, 2004. W. W. Powell, “Neither Market nor Hierarchy: Network Forms of Organization” (1990) *Research in Organizational Behaviour* ,12:295-336. Villiers and Boyle “Corporate Governance and

between, mutual constitution and evolving co-existence of normative, principles-based, and prescriptive approaches to regulating corporate conduct and governance standards on a transnational level.⁴⁰ These themes – the synergies of ethical, normative and legal domain, the limits of traditional regulatory mechanisms, the role of socially and contextually constructed meaning, and the possibility of institutionalization and normalization of a culture of accountability, good governance and responsibility beyond instrumentalist compliance – are the common thread in the ensuing chapters.

Chapter Nine considers the changing nature of the relationship of business to society and in this regard explores the relatively recent formal recognition of stakeholders in general and civil society in particular, as a legitimate source of expectations of and normative influence on standards of corporate conduct and governance.

Chapter Ten examines some of the agents and catalysts for change in the nature of, and forum for, governance discourse and recent innovations in disclosure relating to the ethical dimensions of governance. They also manifest as the normative influences of economic and social stakeholders that are altering the nature and expectations of business. This influence is particularly evident with respect to accountability, engagement, transparency and changing contextual referents such as the recognition of social costs and ‘non-financial’ risks in the assessment of corporate value, and values.

The engagement of these different stakeholders on issues of corporate governance and conduct also provides a window into the ordering function of norms within social groups. That is, illuminating how communities and organizations construct norms and accompanying narratives based on common interests or shared ideologies that enable

the Approach to Regulation”, in L. MacGregor, T. Prosser, and C. Villiers (eds.) *Regulation and Markets Beyond 2000*. (London, UK: Ashgate, 2000).

⁴⁰ Emile Durkheim, *The Division of Labour in Society* (New York: The Free Press, 1984 (1893)). Emile Durkheim, *Professional Ethics and Civic Morals* (London: Routledge, 1992 (1900)). Villiers and Boyle emphasize that it is the interrelationship between different parts of the whole system that are determinative of effective corporate governance. That is, the interactions, tensions and balances between internal mechanisms of control supported through self-regulatory codes of conduct and a framework of formal legal rules in “Corporate Governance and the Approach to Regulation” in L. MacGregor, T. Prosser and C. Villiers (eds.) *Regulation and Markets Beyond 2000*. (London, UK: Ashgate, 2000).

individual and collective cooperation⁴¹ in pursuit of common goals that goes beyond the narrow self interest of instrumentalist justification of cooperation. In this connection, I also explore the appearance in the last two decades of explicit ‘public good’ policy objectives relating to the ethical, environmental and social dimensions of corporate behaviour – that is, corporate governance broadly defined – in legislation and formal regulation of business conduct.

Chapter Eleven considers the advent of values and values based standards in corporate governance discourse over the last three decades and their influence in informal and institutionalized change, and in both internalized and shared notions of corporate governance, standards of conduct and responsibility. Influence that is evident, for example, in the increased incidence of corporate entities, institutions and governmental authorities employing the language of governance, ethics and accountability in an interpretation of corporate responsibility that goes beyond legal and economic duties to shareholders, to encompass ethical, social and environmental accountability. The public texts of these values based standards range from so-called ‘soft law’ codes of conduct⁴², best practice guidelines, statements of principles, and formal commitments related to ethical corporate conduct and good governance. Here, as in previous chapters my exploration considers the dialogic dimension of these normative sources of corporate conduct and governance standards, in this case the choice of language used by constituents of the different ‘regulatory communities’⁴³, and the challenges inherent in

⁴¹ Influential writing on the topic of inter-organizational collaboration and cooperation include: E. Trist, “Referent Organizations and the Development of Inter-Organizational Domains” (1983) *Human Relations* 36.3: 269-84; Barbara Gray, “Conditions Facilitating Inter-organizational Collaboration” (1985) *Human Relations* 38:10: 911-36; F. Westley H. Vredenburg, “Strategic Bridging: The Collaboration between Environmentalists and Business in the Marketing of Green Products” (1991) *Journal of Applied Behavioural Science* 27.1: 65-90; S. Sharma, H. Vredenburg and F. Westley “Strategic Bridging: A Role for the Multinational Corporation in Third World Development” (1994) *Journal of Applied Behavioural Science* 30.4: 458-76; V. Lowndes and C. Skelcher “The Dynamics of Multi-Organizational Partnerships: An Analysis of Changing Modes of Governance” (1998) *Public Administration* 76: 313-33; H. Vredenburg and F. Westley “Sustainable Development Leadership in Three Contexts: Managing for Global Competitiveness” (2002) *Journal of Business Administration* Special Issues: ‘Bridging Business on Board: Sustainable Development and the B-School Curriculum’, 239-59.

⁴² Douglas M. Branson, “Teaching Comparative Corporate Governance: The Significance of “Soft Law” and International Institutions” (2000) 34 *GA. Law Review* 669, 682-84.

⁴³ The concept and terminology of ‘regulatory community’ has been used by numerous scholars including: E. Meidinger “Regulatory Culture: A Theoretical Outline” (1987) *Law and Policy* 9: 355-86; Julia Black, *Rules and Regulators*, (Oxford: Clarendon Press, 1997); Christine Parker, “Compliance Professionals and

what is an essentially open and unregulated forum where the interpretation and meaning of even the most central concepts are fluid and contested.

Chapter Twelve considers the role of discourse in light of modern advances in communication technologies, and the opportunities as well as the inherent risks that these advances pose to the ideal of ethical dialogue and the socially legitimate construction of meaning in general and in relation to governance and corporate conduct specifically. It seeks insight from the work of Bourdieu, Habermas and others into whether a shared understanding can be achieved through dialogue, or if interpretation is ultimately imposed unilaterally through an exercise of power including, but not limited to, regulatory authority.

Chapter Thirteen carries the theme of governance discourse into the institutional domain. Starting with an explanation of the specific characteristics of institutional discourse, it explores the nature of governance discourse occurring within the corporate and shareholder spheres by considering the particular aspects of corporate governance in which these institutions have chosen to engage and formally articulate positions that reflect standards of governance, conduct and practice that go beyond those necessary to comply with legal minimum or threshold requirements.

Each of the preceding chapters have contributed to, and advanced, the central exploration of this thesis: ethics as a meta-regulatory framework for governance discourse. Ethical standards – their observance or their breach – have formed part of the governance narrative whether in the context of corporate transgressions, regulatory shortcomings, terms of engagement between business and their stakeholders or as one of the measures of performance used by investors in constructing their equity portfolios. Ethics comes from the Greek (he)ethike(tekhne) ‘(the science of) morals with its base in the Greek ethos meaning ‘nature, disposition’.⁴⁴ Nature and disposition are the essence of conduct,

Regulatory Community: The Australian Trade Practices Regime” (1999) *Journal of Law and Society* Vol. 26, Number 2, 215-39 (June 1999); Ian Ayers and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, (New York: Oxford University Press, 1992).

⁴⁴ *The Oxford Dictionary of Word Histories* (Oxford University Press, 2004).

and a moral nature or disposition is the foundation of good conduct that is in turn the basis of good governance.

In Chapter Fourteen I consider ethics as a constitutive, or first order, governance resource – one that ensures that those whose decisions and actions shape the governance landscape, whether by formal or informal means, conduct themselves according to fundamental norms of ethical conduct such as fairness and honesty, inclusiveness, and integrity embodied in principles that will guide processes, identify responsibilities and ultimately inform choices that take account of the implications and consequences for those affected.

Lastly, in Chapter Fifteen, I reflect on the possibility of situating governance discourse within an explicitly ethical meta-regulatory framework in light of the theoretical, practical, and conceptual challenges and opportunities considered in this thesis. The expression of overarching statements of ethical principles and the underlying norms, or values, creates an explicit, shared frame of reference. This common referent can guide and inform the nature, process, terms and standards of engagement that enable the pursuit of shared understanding and informed discourse, as well as help to achieve consistency and common standards of accountability that constitute a safeguard against dishonest and unethical behaviour. Such processes and standards are core to the establishment of the trust necessary for constructive dialogue and effective engagement that can ultimately lead to good governance.

2.2 Objective

The central issue facing governments, civil society, individuals and corporations is whether business values and standards of corporate conduct with respect to social, environmental and ethical issues are amenable to prescriptive, formal regulation and adjudication or whether they are, by their nature, more appropriately situate in the ethically and normatively regulated domain, subject to certain minimum standards prescribed in law.

One of the objectives of this research is to gain insight into the existence, or not, of observable functional or substantive as well as formal congruence between normative public discourse regarding ethical corporate conduct on the one hand and formal (legal and regulatory) and institutionalized governance rhetoric on the other. Evidence of such congruence could be found in an emergent dominant lexicon, or normalized and institutionalized expressions of governance standards, or both, relating to ethical considerations⁴⁵ within and across different ‘regulatory’ dialogic communities. It could also be found in the advent of a common or shared vocabulary for explicit, formal recognition via disclosure of ethical issues as material ‘non-financial’ considerations and risks.

It is a truism that language in common does not necessarily lead to common meaning or shared understanding. In this exercise, therefore, it is necessary to confront a variety of interpretive challenges. These include: issues of source, representation and contested legitimacy; the appearance or illusion of commonality or congruence; and the dominant or hegemonic influences of authority and power embedded in institutionalized legal and normative governance discourse and the dominant governance lexicon.

The existence of formal, functional or substantive congruence, if found, leads to further exploration of the possibility that ethics – as a meta-regulatory framework – may have the potential to alleviate some of the inherent interpretive and practical challenges to reconciling culturally diverse and pluralistic regulatory approaches in the pursuit of effective global corporate governance standards.

By embarking on this project, I hope to demonstrate the application of institutional discourse and the dialogic dimension of regulatory theory and practice to emergent legal and normative regulation of corporate governance and conduct. The findings also relate institutionalization and normalization processes to emergent standards of responsibility

⁴⁵ ‘Ethical considerations’ in this regard is a broad phrase encompassing environmental and social as well as economically responsible considerations.

and accountability that extend beyond those required for strictly instrumental and/or narrow rational economic purposes.

2.3 Method

This dissertation draws from three methodological approaches: primary, secondary and firsthand or quasi-primary research methods.

I conducted primary research and analysis of, and constructed a database of information from a sample of 67 codes, guidelines, and standards relating to business conduct and governance originated by corporate, institutional, government (including multi-state) and stakeholder entities. A full list of these documents and their origins is contained in section 2.5. This primary data was collected directly from the websites of the originating sources.

I conducted textual analysis of a representative body of: ethics, business, legal and sociology literature; scholarly work originating in the academic and non-profit sector; institutional and government reports, guidelines, standards and policy statements; primary legislation, rules and regulation; and business journalism addressing the legal, ethical (encompassing social and environmental), normative and practical dimension of governance generally, and corporate governance in particular. This secondary data was mainly sourced from published texts, peer reviewed studies and articles published in print, in electronic journals and online and from corporate, government and institutional websites. These materials were subjected to critical review and analysis.

This dissertation also draws on firsthand experience, knowledge and observations amassed in the private, nonprofit and public sectors that can be characterized as quasi primary research. Specifically, I have practiced law for 20 years, focusing in the areas of governance, ethics, securities regulation, corporate law, executive compensation, and comparative regulatory policy and practice for more than fifteen years. I have worked in multiple jurisdictions and have extensive international business experience providing

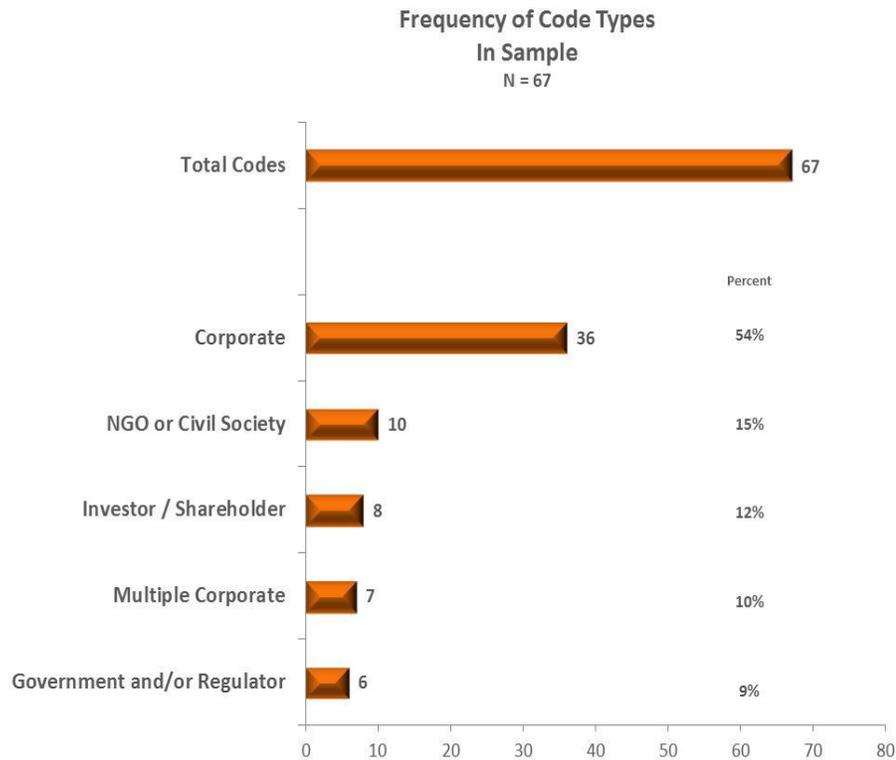
strategic, design and operational advice to boards of directors and executives of multinational, British and European companies on: executive and employee performance and values linked remuneration; corporate governance; multi-jurisdictional legal and regulatory compliance: and best practice policies and practices for sustaining positive, accountable relationships with shareholders, regulators, stakeholders and the wider community.

Additionally, I directed programs and project development for over 2 ½ years at a non-profit foundation focused on ethics, accountability and integrity-based leadership, with particular emphasis on the relevance, value and practical application of ethical principles in fostering high standards of governance and accountability, and responsible decision-making. Lastly, prior to commencing this dissertation, I spent three years as senior legal counsel at a provincial government securities commission developing policy, drafting and implementing new regulatory instruments and amendments to existing rules, and applying and interpreting securities law and regulatory requirements.

2.4 Sample

The following chart describes the composition of the primary research sample.

Figure 1 - Frequency of Code Types in Sample



2.4.1 Codes originated by public corporations

The corporate sample comprises company-specific codes of ethics and conduct issued by 36 publicly listed companies. All of the companies are domiciled in democratic, ‘rule of law’ countries with developed free market economies and established legal and institutional frameworks for corporate and securities regulation. In all, thirteen different countries are represented in the sample a range of industry sectors from automobile manufacturing to technology. Their common feature is a published, general code of ethics or conduct. Regarding the latter, some but not all directly or indirectly references to ethics as a guiding principle. The codes are sorted chronologically in the following table.

Figure 2 - Codes Originated By Public Corporations

Codes Originated by Public Corporations (n=36)		
Official Name	Year of Origin⁴⁶	Location or Source
Unilever - Code of Business Principles	1880s	United Kingdom
Novo Nordisk - The Novo Nordisk Way	1920s	Denmark
Johnson and Johnson - Credo and Principles of Corporate Governance	1943	United States
IBM - Business Conduct Guidelines	1969	United States
Shell International - Code of Conduct	1976	Netherlands/United Kingdom
RBC - Our Code of Conduct	1980	Canada
Toyota Code of Conduct	1992	Japan
Nike Inc. - 'Inside the Lines': The Nike Inc. Code of Ethics	1992	United States
Rio Tinto - 'The Way We Work': Global Code of Conduct	1997	Australia
Nokia - Code of Conduct	1997	Finland
Nestle - Code of Business Conduct	1998	Switzerland
ING Group N.V. - Business Principles	1999	Netherlands
Merck - Code of Conduct	1999	United States
BASF - Vision, Values, Principles and Code of Conduct	2000	Germany
Sony Group Code of Conduct	2003	Japan
Ackzo Nobel - Code of Conduct	2003	Netherlands
Kraft Foods - 'Our Way of Doing Business: The Kraft Food Code of Conduct	2004	United States
Alliance Boots - Code of Conduct and Business Ethics	2006	United Kingdom/Switzerland
A.P. Moller-Maersk - Group Principles of Conduct	2007	Denmark
BHP Billiton - 'Working with Integrity': Code of Business Conduct	2008	Australia

⁴⁶ The term 'Year of Origin' in this table refers to the date provided for the first code, whether or not subsequently revised. In this respect, it is not possible in all circumstance to identify the date of origin of some corporate codes in particular those that exist in electronic form where previous version are subsumed within currently accessible versions.

Codes Originated by Public Corporations (n=36)		
Official Name	Year of Origin⁴⁶	Location or Source
Imerys – ‘Ethics and Values’: Code of Business Conduct	2009	France
Henkel – ‘Vision and Values’: Code of Conduct	2009	Germany
Nexen Inc. - How we work: Our integrity guide	2010	Canada
PepsiCo - Worldwide Code of Conduct	Not stated	United States
Motorola Mobility - Code of Business Conduct	Not stated	United States
ANZ - Code of Conduct	Not stated	Australia
Barrick Gold - Code of Business Conduct and Ethics	Not stated	Canada
EnCana - Corporate Responsibility Policy and Business Conduct and Ethics Practices	Not stated	Canada
Alstom – ‘Our Code of Ethics’	Not stated	France
Statoil - Ethics Code of Conduct	Not stated	Norway
ABB - Code of Conduct	Not stated	Switzerland
Marks and Spencer - Code of Ethics and Behaviours	Not stated	United Kingdom
BT plc - A Statement of Business Practice: ‘The Way We Work’	Not stated	United Kingdom
WPP - Code of Business Conduct	Not stated	United Kingdom
The Cooperative Group - Values and Principles	Not stated	United Kingdom
Coca-Cola - Code of Business Conduct	Not stated	United States

2.4.2 Codes originated by NGOs and civil society organizations

This sample comprises a sample of the foremost internationally recognized codes addressing the conduct and governance of business, generally issued by international non-governmental (NGO) and civil society organizations. The codes are sorted chronologically in the following table.

Figure 3 - Codes Originated by NGOs and Civil Society Organizations

Codes Originated by NGOs and Civil Society (n=10)		
Official Name	Year of Origin⁴⁷	Location or Source
ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy	1977	International
Bench Marks Foundation Principles for Global Corporate Responsibility	1995	Canada, United Kingdom, South Africa
Commonwealth Association for Corporate Governance CACG Guidelines: Principles for Corporate Governance in the Commonwealth	1999	British Commonwealth
Social Venture Network Standards of Corporate Social Responsibility	1999	United States
Accountability AA 1000 Accountability Principles Standard	1999	NA
The Global Sullivan Principles	1999	South Africa
United Nations Global Compact	2000	international
ISO 2600 Social Responsibility Standard	2010	international
Clarkson Principles of Stakeholder Management	1993	Canada
ICGN - Global Corporate Governance Principles	2004	international

⁴⁷ The term ‘Year of Origin’ in this table refers to the date provided for the first code, whether or not subsequently revised.

2.4.3 Codes originated by institutional investors and investor coalitions

The institutional investor sample comprises codes of ethics, conduct, or more generally governance, for business issued by prominent individual institutional investors and entities representing multiple institutional investors. The codes are sorted chronologically in the following table.

Figure 4 - Codes Originated by Investors/Investor Coalitions

Codes originated by investors/investor coalitions (n=8)		
Official Name	Year of Origin⁴⁸	Location or Source
The Hermes Responsible Ownership Principles	1999	United Kingdom
London Principles of Sustainable Finance	2002	United Kingdom
Canadian Coalition for Good Governance Building High Performance Boards	2010	Canada
UNPRI Principles for Responsible Investment	2006	N/A
Association of British Insurers Guidelines on Responsible Investment Disclosure	2007	United Kingdom
California Public Employees Retirement System (CALPERS) Global Principles of Accountable Corporate Governance	Not stated	United States
TIAA - CREF Policy Statement on Corporate Governance	Not stated	United States
Council of Institutional Investors Corporate Governance Policies	Not stated	United States

⁴⁸ The term ‘Year of Origin’ in this table refers to the date provided for the first code, whether or not subsequently revised. In some circumstances, the date of origin of some codes is not disclosed, particularly those that subsume previous versions.

2.4.4 Codes originated by or on behalf of corporations and business coalitions

The multi-corporate sample comprises codes of ethics, conduct, or more generally governance, for business issued by bodies representing multiple corporate interests. The codes are sorted chronologically in the following table.

Figure 5 - Codes Originated by or on Behalf of Multiple Corporations/Business Coalitions

Codes originated by or on behalf of multiple corporations/business coalitions (n=7)		
Official Name	Year of Origin⁴⁹	Location or Source
Keidanren Charter for Good Corporate Behaviour	1991	Japan
King Codes of Governance for South Africa (King I, II, III)	1994	South Africa
Commonwealth Business Council Business Principles	2007	British Commonwealth
National Association of Corporate Directors (NACD) Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies	2008	United States
Caux Round Table Principles for Responsible Business	1994	Multi-national
BITC Responsible Business and The Marketplace Responsibility Principles	2008	United Kingdom
Equator Principles	2006	Multi-national

⁴⁹ The term ‘Year of Origin’ in this table refers to the date provided for the first code, whether or not subsequently revised.

2.4.5 Codes originated by or on behalf of state or multi-state entities

The government and regulatory sample comprises codes of ethics, conduct, or more generally governance, for business issued by state, multi-state and regulatory entities. The codes are sorted chronologically in the following table.

Figure 6 - Codes Originated by or on Behalf of State or Multi-State Entities

Codes originated by or on behalf of State or Multi-State Entities (n=6)		
Official Name	Year of Origin⁵⁰	Location or Source
OECD Guidelines for Multinational Enterprises	1976	Multi-state
U.S. Model Business Principles	1996	United States
OECD Principles of Corporate Governance	1999	Multi-state
Australia Stock Exchange Corporate Governance Council: Corporate Governance Principles and recommendations	1999	Australia
New York Stock Exchange Commission on Corporate Governance Corporate Governance Principles)	2010	United States
UK Financial Reporting Council (FRC) - UK Corporate Governance Code 2010	2010	United Kingdom

⁵⁰ The term ‘Year of Origin’ in this table refers to the date provided for the first code, whether or not subsequently revised.

Part One – Systems Failures

3. Governance in the Spotlight, Again

*“Publicity is justly commended as a remedy for social and industrial disease. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”*⁵¹

L. Brandeis

3.1 The Latest in a Long History of Crises

From late 2007 through 2009 the world witnessed the unfolding of arguably the most far-reaching financial crisis in the history of modern markets. The impacts were felt around the globe and caused virtually incalculable economic and social damage.

Analysis of the circumstances prior to the collapse and subsequent unfolding of events has exposed failures of governance, culture and ethics in business and especially financial sector institutions. It has also identified shortcomings in the parties responsible for overseeing the governance of market actors and the instruments and methods employed to generate profit on financial markets – governments, regulatory authorities, gatekeepers and shareholders – and revealed gaps and weaknesses in the oversight architecture.⁵²

The aftermath brought forth a maelstrom of commentary from all spheres on the lack of ethics and integrity in all aspects of economic and public life, public and private denouncement of damaging and reckless behaviours induced by distorted incentives, and

⁵¹ Louis D. Brandeis, American jurist (1856 – 1941) in *Harper's Weekly*, December 20, 1913.

⁵² Deficiencies in corporate governance practices have been highlighted as one of the contributing factors to the 2007-09 financial market crisis. See for example: OECD, *Corporate Governance and the Financial Crisis: Key Findings and Main Messages*, (OECD, 2009). Online at: www.oecd.org/dataoecd/3/10/43056196.pdf; International Corporate Governance Network (ICGN), *Second Statement on the Global Financial Crisis* (ICGN, March 23rd, 2009). Online at: http://www.icgn.org/files/icgn_main/pdfs/news/icgn_statement_on_the_financial_crisis_23_march_09.pdf. See also: Hector Sants, “The Crisis: the role of investors”, speech the NAPF Investment Conference 2009, March 11, 2009 (UK Financial Services Authority, March 2009). Online at: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0311_hs.shtml

an accompanying demand for more transparent decision-making, greater accountability, and more responsible leadership.⁵³

In most advanced economies, political response took the form of fast track government interventions and broad condemnation of abusive market practices. This response fits an oft-repeated pattern, or sequence of events. In the initial phase, crisis prompts a rush to take emergency action usually in the form of hastily developed and instituted measures to contain damage and to manage, or at least appear to manage, the situation.

The next phase involves a hunt to find fault – or at least lay the initial blame – and search for a credible culprit, or culprits that overlaps with, or ensues shortly after, the initial phase. This leads into a third phase, a period of closer analysis accompanying the development of detailed legislative and regulatory responses, when commentators and experts – armed with the wisdom of hindsight – put forward competing views on who and what was responsible and the measures needed to prevent recurrence. Richard Reid of the International Centre for Financial Regulation (ICFR) has applied this pattern of initial and ensuing reaction to crisis events to the regulatory response to the most recent financial crisis.⁵⁴

History has borne witness to the impotence of the repeated attempts by policy makers to end the cycle with the regulatory solutions developed to deal with the last crisis. As J.K. Galbraith presciently observed in 1954, writing about the 1929 stock market crash, “[T]here will surely be another crisis. It will be different, and whatever regulation we put in place today, it isn’t going to stop it.”⁵⁵ Two decades later, Charles Kindleberger’s

⁵³ OECD Secretary-General Angel Gurría, welcoming the decision by G7 Finance Ministers to work towards establishing a set of common principles on integrity, transparency and propriety in global financial and business transactions, said the financial crisis had exposed the need for both more effective international regulation and a greater ethical dimension to global business. OECD, “OECD’s Gurría welcomes G7 move to establish set of ethical principles on global business”, Press Release 16/02/2009.

⁵⁴ Richard Reid from “The G20 and the Financial Regulatory Cycle” – speech delivered at ICFR-UCL-PRMIA conference on 17 June 2010.

⁵⁵ J.K. Galbraith, *The Great Crash 1929* (Houghton Mifflin Company: New York, 1954)

comment “*financial crisis – a hardy perennial*” similarly counters the idea of a policy based solution to ensuring crises never happen again.⁵⁶

The history of capital markets is punctuated with the damaging consequences of unchecked greed and the reckless pursuit of profit.⁵⁷ One of the earliest such instances occurred in Europe with the South Sea bubble collapse of 1720. In the United States, the Mississippi Company bubble of 1719 was the first large scale instance of financial speculation leading to a financial collapse to be repeated two centuries later in the decade of corrupt finance leading to the United States stock market crash of 1929 and The Great Depression. The 1980’s and early 1990’s witnessed scandals such as those associated with the United States Savings and Loans, HIH and One.Tel in Australia, and in the United Kingdom the Maxwell Group bankruptcy and associated Mirror Group pension fund scandal and the collapses of Bank of Credit and Commerce International (BCCI) and Barings Bank.

The late 1990’s were mired by the accounting scandals leading to the Enron Corporation’s bankruptcy amid allegations of accounting fraud in 2001 and the related demise of then big-five accounting firm Arthur Andersen, accounting scandals at Tyco International, Adelphia, WorldCom Inc. (now MCI) and Global Crossing in 2002, and a catalogue of other incidents along the way.⁵⁸

The stock market collapse in the United States in September 1929 and the ensuing years of the Great Depression were considered to be the result of extensive market manipulation by corporate officers and investment bankers. According to the Senate Committee on Banking and Currency in its 1934 report, the ‘Fletcher Report’, it was

⁵⁶ CP Kindleberger, *Manias, Panics and Crashes* 5th edition (Wiley, 2005 (1978))

⁵⁷ For example: in the United Kingdom, the Maxwell pensions scandal, BCCI and Barings Bank; in the US, the Railway privatizations and stock market crash of 1873, the junk bonds of Drexel Burnham Lambert, Adelphia, Global Crossing, WorldCom, Tyco; in Canada, The Principal Group in 1980, Bre-X in 1990 and Nortel in ; In Italy, Parmalat. For a survey of corporate scandals throughout history, see Kenneth R. Gray, Larry A. Frieder, George W. Clark, Jr. *Corporate Scandals - The Many Faces of Greed* (Paragon House, St. Paul, 2005); Joel Seligman, *The Transformation of Wall Street* 3d ed. (New York: Aspen Publishers, 2003).

⁵⁸ See Appendix 1 – List of Notable scandals.

“excessive and unrestrained speculation which dominated the securities markets, disrupted the flow of credit, dislocated industry and trade, impeded the flow of interstate commerce, and brought in its train social consequences inimical to the public welfare”.⁵⁹

Discouragingly for those interested in stable and sustainable economies, generally, and financial markets, specifically, the circumstances of the 2007 - 2009 global financial crisis appear to reaffirm the old adage that ‘the more things change the more they stay the same’. Once again it appears the roots of the crisis are to be found in speculative finance, distorted incentives, the risks and instability associated with the focus on short term gains, and insufficient or misplaced oversight.⁶⁰

The response to the 1929 market collapse was the passage by the United States Congress of *The Securities Act of 1933* and the *Securities Exchange Act, 1934* and the creation of the Securities Exchange Commission (SEC).⁶¹ The Acts were intended to address the social impacts of the financial malfeasance and market manipulation and to reassert social control over capital that Congress considered to have been misappropriated to the detriment of millions and the benefit of an elite few.

When President Roosevelt signed *The Securities Act of 1933* into law he stated, “[T]he Act is thus intended to correct some of the evils which have been so glaringly revealed in

⁵⁹ United States Congress Senate Committee on Banking and Currency, *Stock Exchange Practices: Report of the Committee on Banking and Currency Pursuant to S.Res. 84 and S.Res. 56 and S.Res. 97* (June 6, 1934) 1-394 at 5.

⁶⁰ Note that there are those who profit from the periods prior to, during, and following financial instability, crisis and upheaval.

⁶¹ *The Securities Act of 1933* (May 27, 1933, Ch. 38, title I, Sec. 1, 48 Stat. 74.) was created with two core objectives: to require that investors receive financial and other significant information concerning securities being offered for public sale; and to prohibit deceit, misrepresentations, and other fraud in the sale of securities. The *Securities Exchange Act of 1934* (June 6, 1934, ch. 404, title I, Sec. 1, 48 Stat. 881.) created the Securities Exchange Commission and empowered it with broad authority over all aspects of the securities industry. This broad authority includes the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's securities self regulatory organizations (SROs) such as the New York Stock Exchange, American Stock Exchange, and The National Association of Securities Dealers, which operates the NASDAQ system. The 1934 Act also identifies and prohibits certain types of conduct in the markets and provides the Commission with disciplinary powers over regulated entities and persons associated with them. The Act also empowers the SEC to require periodic reporting of information by companies with publicly traded securities. Excerpted from: “The Laws that Govern the Securities Industry”, United States Securities and Exchange Commission, <http://www.sec.gov/about/laws.shtml>

the private exploitation of the public's money".⁶² The subsequent *Securities Exchange Act*, 1934, empowered the SEC in the specific statutory wording of section 14(a) with public interest disclosure power alongside investor protection providing that the SEC may require anything in the proxy statement disclosure "as necessary or appropriate in the public interest or for the protection of investors".⁶³

In the new legislation, Congress chose disclosure as the primary method for deterring the legal, but socially unacceptable, practices of market participants. As well, the legislation contained measures to address issues of board related dysfunction, such as the conflicts arising from interlocking boards and weaknesses in the oversight function attributed to delinquent directors. It also sought to increase shareholders' powers *vis a vis* management by introducing requirements to furnish shareholders with information about management policies and practices that would enable informed voting and thus effective corporate suffrage.⁶⁴

More than 75 years on, Congress' intentions for the two Acts have yet to be realized notwithstanding continued efforts and further interventions by successive legislators. Furthermore, the intervening years have added many more problems and obstacles to the fulfillment of the legislation's original purpose, as is the case for legislative authorities around the globe as to their own responses to successive crises.

However, notwithstanding the historical backdrop, there are circumstances of this most recent crisis that suggest the possibility of different forces at work in the dynamic of crisis and response that may alter the patterns of the past.

⁶² *The Public Papers and Addresses of Franklin D. Roosevelt*, vol.2, pp.213-214, as quoted in Joel Seligman, *The Transformation of Wall Street*, 3d, (New York: Aspen Publishers, 2003).

⁶³ For a discussion of the explicit public interest policy behind the creation of the SEC, see Cynthia, A. Williams, "The Securities and Exchange Commission and Corporate Social Transparency" (1999) *Harvard Law Review* vol. 112, no.6.

⁶⁴ Cynthia, A. Williams, "The Securities and Exchange Commission and Corporate Social Transparency" (1999) *Harvard Law Review* vol. 112 no.6.

3.2 A New Ingredient in the Old Formula

The advent of television, the internet, globalization (as the term is generally understood), and the 24 hour news cycle are alternately credited and blamed for many of the societal transformations of the last three decades.⁶⁵ Undeniably, all four of these 20th century changes to the way that we interact with the world around us have played a role in ensuring that each new crisis, scandal or transgression in the corporate and public sphere is subject to more media exposure, commentary and public opinion, than would have seemed possible prior to the advent of these technology enabled advances in communication.

Although some would argue that the intense media coverage and sensationalism of these repeated misdeeds and transgressions have inured the public to declining standards, there are clear indications of a shift in public mores toward expectations of greater scrutiny and lower tolerance of bad behaviour, whether by politicians, celebrities or senior executives of major corporations.⁶⁶

The political and mainstream public reaction to the sequence of events that began unfolding in 2007 was extensive and swift. New communication technologies and the internet enabled access to and sharing of information without the spatial, structural and temporal boundaries that would previously have impeded such direct and open

⁶⁵ Regarding the use of the term 'globalization', as explained by Crane and Matten (in Andy Crane and Dirk Matten, *Business Ethics: A European Perspective Managing Corporate Citizenship and Sustainability in the Age of Globalization*, 2d (Oxford: Oxford University Press, 2004)), "frequent misuse of this term has contributed to a lack of clarity and definition" such that the distinctions in Schlote's classification are subsumed within a generalized use of the term. For early discussion of these technological phenomena as change agents, see: Chris Moon and Clive Bonny, *Business Ethics: Facing up to the Issues* (London: The Economist in Association with Profile Books Ltd., 2001) at 7.

⁶⁶ As to the decline of public standards, see for example: Chris Hedges, *The Empire of Illusion: The End of Literacy and the Triumph of Spectacle* (Vintage Canada, 2009). Regarding high profile scandals that attracted intense public interest and considerable public debate about public and private morality, space permits only a few examples from different areas of public life. From public office: William J. Clinton, President of the United States; Elliot Spitzer, former New York District Attorney. From entertainment: Tiger Woods, professional athlete; Mel Gibson, actor. From Business: Lord John Browne, former chairman British Petroleum; Mark Hurd, former CEO of Hewlett Packard.

communication.⁶⁷ As a consequence, it was an informed and watchful global audience that witnessed in real time the domino collapse of an arcane structure based on unethical lending practices, complex derivatives and debt securitization that wiped out almost half of stock market value and nearly the global financial system.⁶⁸

While much of the direct and collateral damage is attributed to this toxic mix, the very fact of its existence is evidence of deeper systemic problems of governance. There are some who would argue that the 2007– 2009 crisis is a special case because it revolved around regulated commercial and retail banks as well financial institutions such as investment banks and hedge funds. However, whether it is abuse of off-balance sheet accounting, regulatory loopholes and special purpose vehicles to conceal billions of dollars in corporate debt, or the creation, securitization and placement of high risk debt obligations without appropriate transparency or financial safeguards, these are the symptoms and the core issues are substantially the same. That is, the culture that fostered such practices; the failures of governance that enabled such culture and allowed such activity to go unchecked; and most fundamentally the absence or disregard for ethical norms of conduct.

The Financial Crisis Inquiry Commission (FCIC) appointed by the United States government to investigate the causes of the 2007 – 2009 financial crisis released its findings in January 2011. It concluded that "the crisis was avoidable and was caused by:

⁶⁷ For a discussion of the unbounded nature of internet as a communication medium, see: James Bohman, "Expanding Dialogue: The Internet, the public sphere and prospects for transnational democracy", in *Social Theory – Continuity and Confrontation 2nd ed.*, Roberta Garner, (ed.) (Peterborough: Broadview Press, 2007).

⁶⁸ While the underpinnings of the crisis are widely acknowledged to be the extension of unsecured credit through subprime mortgages to lower-middle class America, the domino collapse that spread through the global financial markets and left few unscathed was caused by the pooling, packaging and reselling of these high risk mortgages in the form of increasingly complex bundles of debt securities (mortgage derivatives, collateralized debt obligations CDOs, synthetics CDOs), and the rampant speculation and leveraging (through CDSs) that went along with them. For extensive and comprehensive analysis of these issues, see: United States Senate Permanent Subcommittee on Investigations - Committee on Homeland Security and Governmental Affairs Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Majority and Minority Staff Report Permanent Subcommittee on Investigations, United States Senate, April 13, 2011.

Widespread failures in financial regulation, including the Federal Reserve's failure to stem the tide of toxic mortgages; *Dramatic breakdowns in corporate governance including too many financial firms acting recklessly and taking on too much risk*; An explosive mix of excessive borrowing and risk by households and Wall Street that put the financial system on a collision course with crisis; Key policy makers ill prepared for the crisis, lacking a full understanding of the financial system they oversaw; and *systemic breaches in accountability and ethics at all levels*".⁶⁹(emphasis added)

On the corporate governance implications of the financial crisis, the OECD observed that:

[I]t is important to take a wider corporate governance view since banks are not fundamentally different from other companies with respect to corporate governance, even though there are important differences of degree and failures will have economy-wide ramifications.⁷⁰

In general, poor corporate governance is a major factor in almost all known cases of distress of financial institutions. Specifically in the case of the 2007 – 2009 financial crisis the problems included: failings of the primary governance mechanisms of board and shareholder monitoring and oversight, failure to fulfill fiduciary responsibility, and lack of management accountability. These shortcomings were made all the more egregious when combined with inadequate understanding and supervision of the tools and practices employed in the pursuit of short term profits, inappropriate incentives that fostered unethical conduct, and a disregard (whether willful or not) to the inherent risks and potential consequences.⁷¹

Some have argued that in exposing investors to excessive risk leading to huge losses, and in some cases the collapse, of firm equity and shareholder value, management violated

⁶⁹ "Financial Crisis Inquiry Commission Releases Report on the Causes of the Financial Crisis", Press Release, January 27, 2011; FCIC, Conclusions of the Financial Crisis Inquiry – Excerpt, <http://fcic.law.stanford.edu/report/conclusions>

⁷⁰ OECD, *Corporate Governance and the Financial Crisis: Key Findings and Main Messages* (OECD, June 2009) at 13. www.oecd.com

⁷¹ For extensive and comprehensive analysis of these issues, see United States Senate Permanent Subcommittee on Investigations - Committee on Homeland Security and Governmental Affairs Carl Levin, Chairman, Tom Coburn, Ranking Minority Member, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Majority and Minority Staff Report Permanent Subcommittee on Investigations, United States Senate, April 13, 2011. Remarks by retired Federal Reserve Chairman Alan Greenspan to

their fundamental duty to act in shareholders' best interests. Former Chairman of the Federal Reserve and champion of free market theory, Alan Greenspan, admitted to the United States House of Representatives oversight committee that he "made a mistake in presuming that the self-interests of organisations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms". He went on to say that "[t]hose of us who have looked to the self-interest of lending institutions to protect shareholders' equity (myself especially) are in a state of shocked disbelief."⁷²

New and traditional media also provided platforms for the expression of widespread outrage at the violation of values integral to the proper functioning of the markets and society as a whole: ethical conduct, fair dealing, honesty, integrity, responsibility, and transparency.⁷³ The threads of the initial response to the Bear Stearns sub-prime mortgage hedge funds collapse in late 2007 multiplied and spread across the worldwide web, allowing experts and lay person alike to make the connections with the demise of Lehman Brothers and the 2008 market crash when the full extent of the crisis became public knowledge.

It appears that this outpouring of public sentiment may have helped to mobilize and unite governments around the world in rapid and unprecedented condemnation of the market manipulation and unethical practices at the heart of the crisis. Almost certainly, the widespread public reaction that kept the inescapable social impact of the crisis⁷⁴ at the

United States House of Representatives oversight committee October 23, 2008 as quoted in Andrew Clark and Jill Treanor, "Greenspan: I was wrong about the economy", *The Guardian*, Friday, 24 October 2008. <http://www.guardian.co.uk/business/2008/oct/24/economics-creditchunch-federal-reserve-greenspan>.

⁷³ This condemnation of the 'Wall Street culture' is by no means new. The collapse of the savings and loan industry, the rise of hostile takeovers and leveraged buyouts, fraud, insider trading and stock manipulation in the 1980s led to the public condemnation of Michael Milliken and Salomon Brothers CEO John Gutfreund, and the prevailing trading culture generally (likened to a 'den of thieves' by J. Stewart in his 1991 best-selling book of the same name). Joel Seligman, *The Transformation of Wall Street* 3 ed. (New York: Aspen Publishers, 2003). The impact was superficial and merely masked the growing misalignment of interests (fuelled by distorted incentives and the drive for financial innovation) between those engaged in the business of financial risk and the wider culture. Michael Lewis, *The Big Short* (New York: W.W. Norton & Company, 2010) 254

⁷⁴ When the G-20 Leaders adopted their Global Plan for Recovery and Reform in April 2009 at the London Summit on Growth, Stability and Jobs, their announcement at paragraph 26 included the statement that "[W]e recognize the human dimension to the crisis. We commit to support those affected by the crisis...",

forefront also contributed to the pressure on governments to act quickly with coordinated intervention simultaneous with their investigations into the exact nature of the legal and technical violations and the market actors that perpetrated them.⁷⁵

While the politicization of the issues inevitably served partisan political agendas at a domestic level, the commitment to action at an international level bridged borders and ideological divides to affirm fundamental shared values. In the opening paragraphs of their statement the leaders of the G-20 affirmed that:

We start from the belief that prosperity is indivisible; that growth, to be sustained, has to be shared; and that our global plan for recovery must have at its heart the needs and jobs of hard-working families, not just in developed countries but in emerging markets and the poorest countries of the world too; and must reflect the interests, not just of today's population, but of future generations too. We believe that the only sure foundation for sustainable globalisation and rising prosperity for all is an open world economy based on market principles, effective regulation, and strong global institutions.⁷⁶

The legacy of these events is an unprecedented level of broad-based public, as well as expert, debate on and discussion of the crisis, its causes and future implications throughout and continuing since the crisis.

For example, through 2008 the financial story in the United States (including everything from energy costs and the troubled auto industry to the Wall Street bailout), accounted for 15% of the overall 'newshole' – almost as much coverage as the Iraq war generated in 2007 (16%) and about six times more coverage than the economy generated in 2007.⁷⁷

G20, "London Summit Leaders Statement 2 April, 2009", www.g20.org/Documents/G20_communique_020409.pdf

⁷⁵ To tackle the financial and economic crisis that spread across the globe in 2008, the G20 members were called upon to further strengthen international cooperation. G20 Summits were held in Washington in 2008, in London and Pittsburgh in 2009, and in Toronto and Seoul in 2010. Source: www.G20.org. However, the impetus for high level action has not carried forward to meaningful developments in redressing the harms caused or holding those responsible to account.

⁷⁶ G20, "London Summit Leaders Statement 2 April, 2009", www.g20.org/Documents/G20_communique_020409.pdf

⁷⁷ Pew Project for Excellence in Journalism, "The State of the Media – Annual Report on American Journalism", 2009.

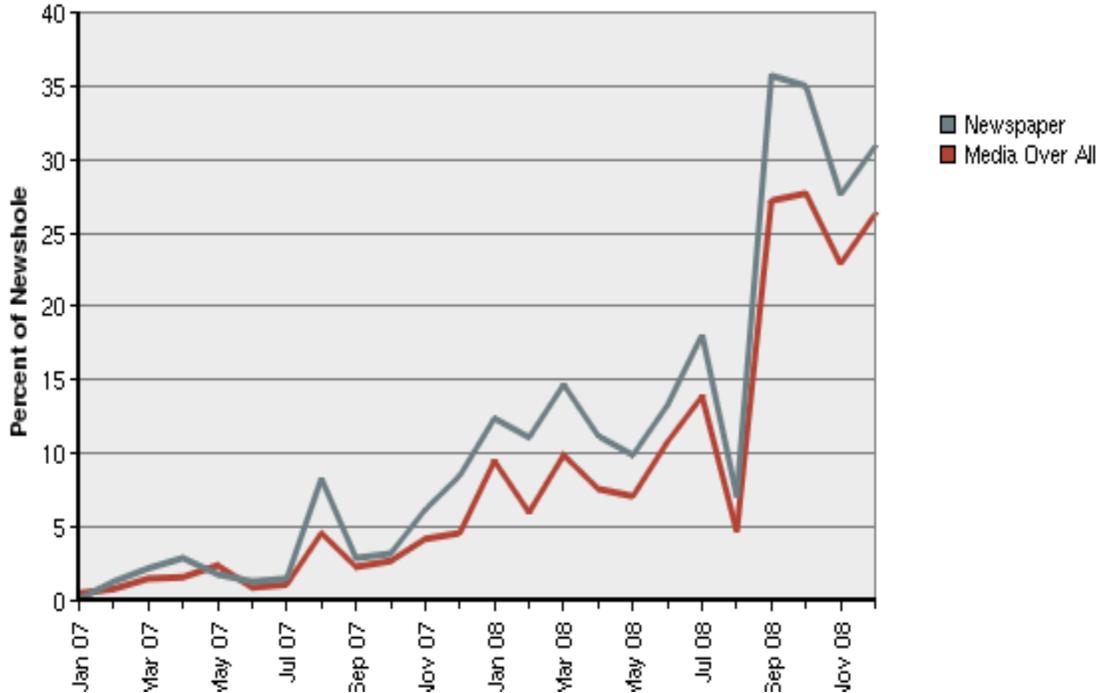
http://www.stateofthedia.org/2009/narrative_newspapers_contentanalysis.php?cat=1&media=4

The level of discussion is reflected in statistics on the extent of economic coverage in mainstream media channels throughout 2008 that in turn represent only a portion of overall discussion taking place through alternative media and communication channels as well as in direct interpersonal communications.⁷⁸ See Figure 7, below.

Figure 7 - Economy Coverage Over Time

Economy Coverage Over Time: Newspaper vs. Media Over All

2007 through 2008



Source: Pew Research Center’s Project for Excellence in Journalism, “The State of the Media – Annual Report on American Journalism”, 2009, www.stateofthemedi.org. By permission.

⁷⁸ Mainstream media includes: Network TV News, Newspapers, Online News Sites, Cable News, and Radio News. Through 2008 the financial story in the United States (including everything from energy costs and the troubled auto industry to the Wall Street bailout), accounted for 15% of the over all newshole – almost as much coverage as the Iraq war generated in 2007 (16%) and about six times more coverage than the economy generated in 2007.
http://www.stateofthemedi.org/2009/narrative_newspapers_contentanalysis.php?cat=1&media=4

3.3 Unintended Consequences

Through 2008 and 2009, the unprecedented level of awareness added its own momentum to the market contagion as the institutional and retail investment community and general public alike became prey to the rising anxiety and risk aversion⁷⁹ that led to what eventually manifested as full-scale market panic.⁸⁰

Heightened levels of engagement in the public sphere have both positive and negative dimensions as will be explored further in Chapter 12. To the extent that the discourse is informed and objective, there are many benefits to increased knowledge, greater understanding of risk – particularly those associated with high investment returns – and the recognition of the need for personal vigilance, notwithstanding the appearance of systemic and institutional controls.

However, the spread of reliable information and the influence of informed and objective discourse is often diluted or displaced in times of crisis, particularly when the issues are complex, far reaching and challenging to vested interests, and the immediate and potential implications are highly politicized.⁸¹ Such circumstances can lead to deflection, inaccurate generalizations, over-simplification and self-serving analysis, particularly in hindsight.⁸²

⁷⁹. There are a number of studies on the vulnerabilities of investors to human attitudes and behavioural tendencies that undermine fully objective, informed rational decision making. For a comprehensive overview of the behavioural and cognitive factors that are at play in the market and have implications for regulatory strategies to prevent fraud and market abuse, see: Robert Prentice, “Whither Securities Regulation? Some Behavioural Observations Regarding Proposals for its Future” (2002) *Duke Law Journal*, Vol. 51 No.5, March 2002. Robert Shiller contends that the primary emotions that determine risk taking behaviour are not greed and fear, but hope and fear. Robert Shiller, *Irrational Exuberance*, paperback edition, (Broadway Books, 2001).

⁸⁰ Associated Press article: ‘Snowballing sell off spreads worldwide’ October 10, 2008. http://www.mlive.com/business/index.ssf/2008/10/snowballing_selloff_spreads_wo.htm. In the period between October 9, 2007 and March 6, 2009 the DJIA had dropped 54% from its peak of 14164 to 6469 (before beginning to recover). Source: <http://finance.yahoo.com/q/hp?s=%5EDJI+Historical+Prices>

⁸¹ As Posner has observed, media attention can be arbitrary, disproportionate and unpredictable – E. A. Posner, *Law and Social Norms* (Harvard University Press, 2000).

⁸² An example of the potential distortion from media coverage: ‘Tracking the Economic Slowdown’ Journalism.org, August 18, 2008: “While public attention to economic news does not always translate into more coverage, more coverage of the economy can be correlated to deepening public worries. After press coverage of the economy jumped in the first quarter of 2008, the number of Americans who considered the

The perception of corporate governance is a case in point. As Kenneth Daly, National Association of Corporate Directors (NACD) President & CEO stated in his introduction to the NACD Key Agreed Principles to Strengthen Corporate Governance for US Publicly Traded Companies launched in October 2008, “[T]he current economic crisis has eroded public and investor confidence in corporate governance. American corporations must take action to restore the public trust.”

It is generally held that the majority of companies – large and small, public and private – seek to willfully comply with their legal obligations, embody sound governance principles, and maintain corporate cultures of integrity and candour. Yet, the actions of the minority of companies that do not, fuel a widely held public perception that all companies value the bottom line more than the truth, and pursue short term profit regardless of medium and longer term consequence. A perception that is reinforced by a regulatory approach that, in Bush’s words, “seeks to regulate all companies as if they were all run by crooks”.⁸³

There are many examples of the misconduct of the few tainting the reputation of the many: circumstances where an entire group is caught in a ‘reputational web’ whereby the choices of particular individuals or groups of individuals regarding conduct and decisions to cut corners, disregard or actively avoid rules, and breach ethical standards result in general condemnation.

In a survey conducted in July 2002, the month that the *Sarbanes-Oxley Act* became law and a year after the Enron scandal first emerged, 46 percent of the general public believed “every company does this kind of thing [i.e., fraud], but only a few more will get caught.”⁸⁴ Another poll that year revealed that 79 percent of the general public said

economy to be ailing doubled. The economic picture improved slightly during that period.” (Pew Research Centre’s Project for Excellence in Journalism).

⁸³ Tim Bush, ‘*Divided by Common Language*’ *Where Economics Meets the Law: US Versus Non-US Financial Reporting Models* (Institute of Chartered Accountants in England and Wales, June 2005) 28. Web-published http://www.icaew.com/index.cfm/route/115933/icaew_ga/pdf.

⁸⁴ The American Survey, (July 2002) as quoted in Arthur W. Page Society and Business Roundtable Institute for Corporate Ethics, *Special Report: The Dynamics of Public Trust in Business* (Business

improper actions among top executives are “very” or “somewhat” widespread.⁸⁵ The Business Roundtable Institute for Ethics refers to this as the ‘negative contagion effect’, whereby all businesses are associated with the scandals of a few.⁸⁶

The effect is often not readily contained to any one sector or segment, as demonstrated when the entire accounting profession suffered significant industry-wide and international damage to reputation in the aftermath of the Enron scandal and the exposure of the role of then big-five accounting firm Arthur Andersen principals in the fraudulent transactions and accounting practices.

Similarly, the issue of excessive compensation to some executives in the face of mediocre or unsustainable performance and growing discrepancies between median and executive salaries through the nineties prompted regulators in Great Britain, Australia, Europe, and North America to implement extensive disclosure requirements on all corporate boards of directors in respect of executive remuneration.⁸⁷

These regulatory interventions have proved limited in curbing excessive pay or reducing the distorting effect of inappropriate incentives on management behaviour such that executive ‘fat cats’ and the boards that approve the remuneration packages continue to be vilified by the public and in mainstream media.⁸⁸ More recently, the issue has prompted

Roundtable Institute for Corporate Ethics, 2009) 13. http://www.darden.virginia.edu/corporate-ethics/pdf/public_trust_in_business.pdf

⁸⁵ CNN/USA Today/Gallup Poll (July 2002) as quoted in Arthur W. Page Society and Business Roundtable Institute for Corporate Ethics, *Special Report: The Dynamics of Public Trust in Business* (Arthur W. Page Society and Business Roundtable Institute for Corporate Ethics, 2009), 13.

http://www.darden.virginia.edu/corporate-ethics/pdf/public_trust_in_business.pdf

⁸⁶ *Ibid.* at 13.

⁸⁷ Examples of measures introduced requirements with respect to the detailed disclosure of executive compensation include: In the United Kingdom, the *Companies Act 1985*, The UK *Listing Rules* and *The Combined Code*; in Australia *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act, 2004* (Australia) (‘CLERP 9’); in Germany, the German Commercial Code and the Cromme Commission’s Corporate Governance Code; in the United States, *Item 402, Regulation S-K*; in Canada National Instrument 51-102 F6 *Statement of Executive Compensation*.

⁸⁸ One of the earliest cases occurred in Great Britain in 1994, when shareholders of British Gas protested the pay package of then chief executive Cedric Brown starting a nearly three decade heated debate in the United Kingdom over the remuneration paid to executive directors and management executives. See for example: Nick Isles, *The Risk Myth: CEOs and labour market risk* (The Work Foundation, December 2006). Online at: www.theworkfoundation.com; and The High Pay Commission, *More for Less: what has*

policy makers in some jurisdictions to facilitate, and shareholders to demand, greater say on compensation levels and structures in an effort to contain an issue that is no longer isolated to particular companies or sectors but a matter considered to be symptomatic of widespread governance shortcomings.⁸⁹

The challenge and the risk is that of a self-perpetuating circle of transgression and regulatory response.⁹⁰ Such that failures by the corporate community and other market participants to police their own and others' conduct and an absence of an explicit ethical standard for business behaviour will continue to fuel the demand for more laws and regulation in an inevitably failed effort to "force the missing moral choices".⁹¹

happened to pay at the top and does it matter (Interim Report of The High Pay Commission, May 2011). Online at <http://highpaycommission.co.uk>. The discussion has spread to other European countries that historically have had limited transparency with respect to executive pay, Italy is the latest European country to see mandatory executive compensation disclosure under rules introduced by ConSob the Italian stock market regulator in February 2011 with immediate effect. In the last decade outrage over pay levels has even spread to the United States with its history of vastly inflated executive compensation, seeing high profile executives Chuck Price of Citigroup, Stanley O'Neil of Merrill Lynch and Angelo Mazilo of Countrywide Financial in March 2008 appearing before the United States House Oversight and Government Reform Committee in Washington accused of excessive pay packages at the time of shareholder losses. "CEO Pay and the Mortgage Crisis" Hearing before the Committee on Oversight and Government Reform House of Representatives One Hundred Tenth Congress Second Session, March 7, 2008, Serial No. 110-81. <https://house.resource.org/110/org.c-span.204328-1.raw.txt>

⁸⁹ Say-on-Pay has been implemented in various forms in a number of different countries. The U.K. in 2003 and Australia in 2005 enacted legislation requiring that listed companies give shareholders a *non-binding advisory* vote on the prior year's executive compensation. The Netherlands in 2004, Sweden in 2006 and Norway in 2007 require that shareholders have a *binding* vote on the future compensation policies of the company. In 2010, the United States introduced advisory say on pay votes under the *Dodd Frank Act*. Legislative changes introduced in February 2011 in Australia pursuant to *The Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill*, give shareholders in listed Australian companies new powers over executive remuneration. Shareholders will be able to remove directors if a company's remuneration report receives a "no" vote of 25 per cent or more at two consecutive annual meetings. The Bill also provides that directors, executives and "closely related parties" are prohibited from voting on executive pay, and from hedging their incentive remuneration.

⁹⁰ For a pre-*Sarbanes-Oxley Act* review of the last three hundred years of this pattern of corporate scandal and regulatory response, see: Stuart Banner, "What Causes New Securities Regulation? 300 Years of Evidence" (1997) 75 *Wash. U. L. Q.* 849. See also: Jennifer Hill, "Regulatory Responses to Global Corporate Scandals" (2001) *Wisconsin International Law Journal* Vol 23, No.3. For a post-Enron comparison of corporate governance regulatory reforms, see: Luca Enriques, "Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms" (2003) *Wake Forest Law Review*, Vol. 38. Available at SSRN: <http://ssrn.com/abstract=464241> or doi:10.2139/ssrn.464241

⁹¹ R. Arnott, 'Why poor moral ethics prove costly', *Financial Times*, January 24, 2010. <http://www.ft.com/intl/cms/s/0/fcc3e1fe-0785-11df-915f-00144feabdc0.html#axzz1TFX47wpv>.

4. The Expectations Gap

As protection against financial illusion or insanity, memory is far better than law. When the memory of the 1929 disaster failed, law and regulation no longer sufficed. For protecting people from the cupidity of others and their own, history is highly utilitarian. It sustains memory and memory serves the same purpose as the SEC and, on the record, is far more effective.

John Kenneth Galbraith⁹²

4.1 A Failure of Governance, Responsibility or Both? Diagnosing the Problem

There is every reason to be discouraged by the seeming impotence of state institutions to curb the worst excesses of greed and opportunism, particularly in the face of the 2007–2009 global financial crisis, following so soon after the corporate accounting scandals and internet debacle of the previous decade, and the revelations of stock analyst fraud, mutual fund market timing, and stock option back dating in the intervening years.

Similarly, the healthy skepticism that greets many of the traditional governmental responses to the latest financial crisis is understandable. Informed by past experience, there is a general expectation that, regardless of rhetoric, the primary focus of legislators inevitably will be on reactive measures or prescriptions to treat and prevent recurrence of the most visibly acute symptoms rather than on diagnosis and measures to address the underlying conditions that caused them.

According to the Organization for Economic Co-operation and Development (OECD) diagnosis, the crisis of 2007 – 2009 resulted from widespread failures to properly and fully implement governance mechanisms and practices. These failures ranged from purely formal observance, also known as box-ticking, and ‘creative compliance’ where compliance is with the letter not the spirit of requirements, to unclear roles and

⁹²J.K. Galbraith, *The Great Crash*, 3rd ed. (Boston: Houghton Mifflin, 1972).

responsibilities. It concluded that these failures undermined the effectiveness of established principles of governance such as set out in the OECD principles of corporate governance, the Basel Committee recommendations, and national legislation that would otherwise have covered problems revealed by the financial crisis.⁹³

What this diagnosis and characterization fails to acknowledge is the role and culpability of individual actors in the decisions and conduct that led to such failures of governance mechanisms and their implementation. Boards of Directors were ultimately responsible for the lack of effective oversight. Together with senior management they failed to provide the kind of organizational leadership that would have deterred excessive risk taking and unethical behaviour. In many instances employees were active and knowing participants, choosing to be risk takers without due regard to the consequences if not to themselves then to others.

Boards of directors, executives and senior management admitted to being ignorant of the activities of employees, and acknowledged widespread lack of understanding of the nature and implications of complex financial structures and transactions including by those working with them.⁹⁴ These last being indicative of weak or compromised internal controls, and employees working to inappropriate incentives that fostered dangerously short-term perspectives, and excessively risky behaviour within and between financial institutions and other market actors.

These circumstances serve as stark reminders that a system cannot rely on mechanisms and procedures to maintain it, if there is no integrity at its core and nothing to provide stability and determine orientation. The *Cadbury Report* emphasized this point, stating that: “[R]aising standards of corporate governance cannot be achieved by structures and

⁹³ OECD’s public consultation ‘Corporate Governance and the Financial Crisis’, 18 March, 2009 and ensuing report entitled *Corporate Governance and the Financial Crisis: Key Findings and Main Messages* (OECD, June 2009). Online at: www.oecd.org/dataoecd/3/10/43056196.pdf.

⁹⁴ Grant Kirkpatrick, “The Corporate Governance Lessons from the Financial Crisis”, *Financial Market Trends*, Vol. 2009/1 at p.8, 11. OECD 2009 IISN 1995-2864.

rules alone. ... compliance itself is a matter for everyone concerned with corporate governance.”⁹⁵

On this basis, diagnoses that focus on failures of implementation as the source of the problems rather than as symptoms of individual and collective choices leading to the abdication of governance responsibility, cannot achieve a cure.

Business organizations operate through human agency and as such are the product of human decision making processes. These are fallible, and subject to biases and interests not necessarily coincident or aligned with the interests of organizations, their shareholders and stakeholders, or society in general. It is essential that this not be forgotten in the rush to new rules and regulations, systems and procedures as a response to past problems.

4.2 Prescription Without Diagnosis: Incomplete Remedies

In the United States, the circumstances of the 2007-2009 global financial crisis were not as immediately or as obviously linked to failures and weaknesses in governance practices and of the existing governance regime, as for example they were in the case of the accounting scandals that led to the adoption of *The Sarbanes-Oxley Act of 2002* (the *Sarbanes Oxley Act*)⁹⁶ at the beginning of the decade.

Part of the reason for this, at least initially, was that the immediate focus of attention was not on diagnosis but on stemming the precipitous financial decline and unravelling the abusive sub-prime lending practices, market manipulation through complex derivatives, hedging and excessive leveraging at the heart of the crisis. The urgent need to respond to the immediate crisis in the short term drew attention away from more fundamental

⁹⁵ *The Cadbury Report* supra note 20 at pars. 3.14-15.

⁹⁶ *The Sarbanes–Oxley Act of 2002* (Pub.L. 107-204, 116 Stat. 745, enacted July 30, 2002), also known as the *Public Company Accounting Reform and Investor Protection Act* (in the Senate) and *Corporate and Auditing Accountability and Responsibility Act* (in the House) and commonly referred to as the *Sarbanes Oxley Act*, *Sarbanes–Oxley* or *SOX*.

questions of conduct, governance and responsibility. Other factors, such as the culture of secrecy, opaque practices, the highly specialized nature of the financial industry, and the connection with the banks involving additional regulatory complexities, impeded investigation into the activities, the actors and, most fundamentally, the business culture and environment that enabled them.⁹⁷

From a conceptual standpoint, this delay in linking the consequences of misconduct and unduly risky behaviour to failures of governance is a function of the structural and philosophical bias in the United States toward governance narrowly conceived. That is, governance effected through the formalistic observance of compliance mechanisms and prescribed audit processes that, in effect, serve as proxies for individual and collective responsibility.

As in the case of Enron, the appearance of governance mechanisms and processes can conceal the reality of a toxic business culture and malfunctioning oversight that fails to rein in behaviour that is unacceptable by, in Friedman's words, "the basic rules of society, both those embodied in law and those embodied in ethical customs".⁹⁸ Yet the response to Enron, and the catalogue of contemporaneous corporate governance lapses and instances of financial misconduct, was for the then government to hastily create and impose the burden of detailed, extensive, onerous and costly new audit, governance and compliance measures and processes pursuant to the *Sarbanes Oxley Act*. The Act was passed July 30, 2002, just over nine months from the complete collapse of Enron in late 2001.⁹⁹

⁹⁷ See supra notes 67, 68 and 70.

⁹⁸ Milton Friedman, "The Social Responsibility of Business is to Increase its Profits", *The New York Times Magazine*, September 13, 1970.

⁹⁹ For an analysis of the substantive shortcomings of the Sarbanes Oxley governance measures and the politicization of the policy process that led to them, see: Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (2004) Yale University International Centre for Finance Working Paper No. 04-37. Available at: <http://ssrn.com/abstract=596101>. For another perspective, see for example, Lawrence Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)* (2003) 35 Conn. L. Rev. 915, 917 ("Pressured by a parade of accounting and corporate governance scandals from Enron Corp. to WorldCom Inc. at the dawn of the new millennium, Congress possessed that rare political and institutional capacity to address deep causes and systemic dysfunction. Congress used this episodic power opportunity to pass the Sarbanes-Oxley Act." (citations omitted)).

Demonstrating the law of unintended consequences, perpetuating this linear, mechanical approach to governance has been found to have the effect of predisposing individuals to a compliance mindset that limits the capacity for considered action, responsibility and accountability.¹⁰⁰ Furthermore, building layers of governance mechanisms in the hope of channeling behaviour often serves to frustrate meaningful stewardship on the part of corporate directors and management and sends a message of distrust throughout the workplace that alienates the very employees who are essential to maintaining standards and safeguarding organizational integrity.¹⁰¹

Proper diagnosis and appropriate remedy requires diligent investigation and thoughtful analysis of the root cause of the problem and its systemic as well as specific implications. As Romano and others have argued, the process prior to and the regime introduced pursuant to the *Sarbanes Oxley Act*, lacked these key ingredients.¹⁰²

Furthermore, in order to grasp the nature and full extent of the issues as well as the implications and consequences for all of those affected, the process for diagnosis and the development of remedies must include informed dialogue that occurs in multiple fora, is accessible to and engages diverse perspectives and seeks input from a range of stakeholders to reduce the risk of capture, groupthink and self-serving solutions. In practice however, the pressure for regulatory solutions to acute business challenges can lead to action – in the form of a new set of prescriptions – taking precedence over a longer diagnostic process.

Furthermore, such solutions are developed in formal consultation with, and therefore influenced by, interested parties representing a relatively narrow set of sophisticated

¹⁰⁰ Command and control types of regulation combined with legal sanctions can, according to Braithewaite, offer the wrong incentives by putting a price on non-compliance rather than a value on willful compliance. Ian Braithewaite, *Crime, shame and reintegration* (Cambridge University Press, 1989) 142. The short term 'regulatory reflex' can be counterproductive, undermining rather than addressing issues of trust, see: Ed Smith and Richard Reeve "Papering over the cracks? Rules, regulations and real trust", Provocation Series, Vol. 2, No.1, January 2006. Online at: www.theworkfoundation.org.

¹⁰¹ Roderick M. Kramer, "Trust and Distrust in Organizations: Emerging Perspectives, Enduring Questions" (1990) *Annual Review of Psychology* 50: 591.

¹⁰² Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (2004) Yale University International Centre for Finance Working Paper No. 04-37.

business stakeholders. While such consultation has the potential to enrich the debate, test the proposed content and build acceptance of the ensuing regulatory changes or interventions, it also opens the door to powerful participants whose aim is to protect vested interests, alter or limit the substance, scope and impact of changes or interventions.¹⁰³ The outcome is often a compromise and, as in the case of the *Sarbanes Oxley Act* reforms, imposed costly measures that effected largely formal rather than substantive change.¹⁰⁴

On this basis, the events that followed would come as no surprise. With less than a decade elapsed since the last crisis of corporate financial misconduct, and notwithstanding legislation that at the time was billed by then President George W. Bush as “the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt”,¹⁰⁵ the United States again faced the consequences of a deeply compromised business culture that seems to have thrived behind the appearance of oversight mechanisms and in spite of, and in some cases as a result of, a myriad of rules.

Systems remain at risk when the integrity of the individual parts is in question. By failing to take the time to address head on the deeply embedded cultural roots that nurtured the scandals at Enron, Tyco International and WorldCom (now MCI) and Adelphia among others – deception, greed, excessive risk, inappropriate incentives, and irresponsibility to

¹⁰³ A case in point was the SEC’s introduction of new rules for the executive compensation disclosure that became effective in 2006 (Regulation S-K Item 402 and 404. In response to the initial draft published for comment the market, and especially the accounting profession, lobbied heavily and forcefully to change the valuation of equity based compensation for disclosure purposes from grant date fair value to mark to market – a less transparent method. The SEC did a late stage u-turn and the final published form adopted the industry lobbied approach. Disclosure under the new rules produced some aberrant results such as negative compensation numbers and generally established a less transparent regime. In Canada, the Canadian Securities Administrators initial proposal for new disclosure rules (National Instrument 51-102F6) followed the US approach, including the u-turn on valuation. However, in response to the initial CSA publication in early 2007, the market and stakeholders responded forcefully to change the proposed valuation method back to the more transparent method (i.e. the original approach prior to the US’s u-turn) benefiting the market with better information. The CSA second publication for comment and final rules returned to a grant date fair value basis. The SEC subsequently replaced the mark to market valuation with a requirement to value equity based compensation on a grant date fair value basis.

¹⁰⁴ Roberta Romano, “The Sarbanes-Oxley Act and the Making of Quack Corporate Governance” (2004) Yale University International Centre for Finance Working Paper No. 04-37.

¹⁰⁵ U.S Securities and Exchange Commission, *The Laws that Govern the Securities Industry*. Online at: <http://www.sec.gov/about/laws.shtml>.

name a few – the prescription at best masked a wider systemic problem that has infected market capitalism.

Hector Sant, former Chief Executive of the United Kingdom’s Financial Regulatory Authority, stated it thus: “[S]ome of the causes of the [2007-2009] crisis were deeply rooted in behavioral issues that resulted in actions or decisions that with the benefit of hindsight were not the ‘right’ ones ... we need a fuller understanding of the linkages between culture and inappropriate behaviour”.¹⁰⁶

Focusing primarily on ways to uncover transgressions and find the perpetrators is a limited strategy. As recent events suggest, it risks falling short of addressing the more profound need and arguably the greater challenge – to create and reinforce a culture in which unethical behaviour, wrongdoing, and those involved, simply have no place.

As discussed earlier¹⁰⁷, the pattern of regulatory response to crisis is a hard one to break. Within a year of the near collapse of the global economic system precipitated by a confluence of events stemming from abusive and unethical lending practices in the United States, the Obama administration saw its financial reform bill passed by Congress as the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the Dodd-Frank Act).¹⁰⁸

The legislation focuses foremost on restructuring the financial regulatory framework and will have the most impact on the financial services industry. However, the Act extends the federal regulation of matters relating to corporate governance practices and distinct governance linked areas such as executive compensation and shareholder proxy access to all United States public companies – this reaching well beyond the specific problems in the financial industry where the crisis took hold.

¹⁰⁶ Hector Sants, “Do regulators have a role to play in judging culture and ethics”, June 2010, Speech to the Chartered Institute of Securities and Investment Conference (Financial Services Authority, 2010). FSA/PN/101/2010.

¹⁰⁷ See discussion in part 3.1.

¹⁰⁸ *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Pub.L. 111-203, H.R. 4173)

Only experience and time will tell if these measures, once implemented, will serve the stated purpose and give effect to real systemic change or, as with past United States regulatory interventions, merely find limited success by curtailing particular activities or eliminating specific transgressions leaving open the possibility of new ones emerging to take their place.

Even before the full complement of regulations to be issued under the *Dodd-Frank Act* by the relevant regulatory authorities, there is growing skepticism as to whether more regulation is the answer to the failures of such governance fundamentals as accountability, transparency that were at the root of this latest crisis and those that preceded it.

According to a recent poll of 377 senior level executives in the United States, there is little confidence among key stakeholders that the Act will bring meaningful improvements to transparency and accountability. In a 2011 poll of 377 senior executives carried out by accounting firm Grant Thornton only 36 percent responded positively to the question “Do you believe Dodd-Frank will improve transparency and accountability?”

4.3 Different Approaches: Alternative Perspectives on Governance

In the European Union and the United Kingdom a more direct association was made between the events in the period from 2007 to 2009, and the absence or failures of governance that enabled a culture of reckless behaviour to develop and take hold for years unchecked.¹⁰⁹

This difference is consistent with their traditions of corporate governance wherein governance is constitutive rather than additive, encompasses accountability and

¹⁰⁹ See for example, United Kingdom House of Commons, Treasury Committee, *Banking Crisis: Reforming corporate governance and pay in the City*, Ninth Report of Session 2008-09, (15 May 2009) 8. <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf>

responsibility beyond corporate boundaries, and serves purposes beyond increasing shareholder value and protecting the efficiency of capital markets.

Part of the distinction lies in the differences in how company law in the United Kingdom and countries with an English corporate law tradition or continental European tradition address corporate governance as compared to the approach in the United States.¹¹⁰

In the latter, prior to the *Sarbanes-Oxley Act*, the governance of corporate entities was a matter primarily dealt with at the state level.¹¹¹ Corporate law statutes set out basic requirements concerning shareholders rights and the functions of the board and management. In Delaware, the jurisdiction of choice for incorporation for much of the last century and consequently the most influential, state corporate law statutes historically contained minimal intrusion into the governance of corporations beyond the basic elements. Beyond the statutory baseline, governance norms have developed through private litigation of director fiduciary duties on a case specific basis before the State judiciary from which are derived precedent and best practices that rely in large part on private ordering and good faith self-governance for influence and effect.¹¹²

In the United Kingdom, the common law duty of directors was to act in good faith in the company's interests. This duty was considered and developed over the years through case law and, as with similar requirements in other jurisdictions the manner in which this duty is to be fulfilled is contestable. It requires that directors discern what the company's

¹¹⁰ Douglas M. Branson, "Teaching Comparative Corporate Governance: The Significance of "Soft Law" and International Institutions" (2000) 34 *GA. Law Review* 669, 682-84. In note 48 on page 22 of the paper, Branson details the spread of the English company law tradition to the Pacific Rim and Africa including countries that were not former colonies and including countries with civil law or mixed legal systems as well as those with common law systems.

¹¹¹ With the enactment of the *Sarbanes-Oxley Act*, Congress introduced a series of corporate governance initiatives into the federal securities laws which previously only consisted of disclosure requirements, rather than substantive corporate governance mandates – the traditional purview of state corporate law. Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (2004) Yale University International Centre for Finance Working Paper No. 04-37, p.4

¹¹² For a firsthand account of the evolution of the role of the state judiciary in corporate law and governance, see: The Honourable E. Norman Veasey, Former Chief Justice of Delaware, "The Role of the Judiciary in Corporate Law, Corporate Governance and Economic Goals", Presentation to Conference on Company Law Reform in OECD Countries: A Comparative Outlook on Current Trends, Stockholm Sweden, December 2000. Online at: www.oecd.org.

interests are. If the interests of the company are interpreted to be the interests of its members, the shareholders, the challenge becomes one of how to determine the interests of a dispersed share ownership. Taken literally, the duty would be impossible to fulfill since the interests of dispersed shareowners are never fully aligned. It raises questions as to whether the duty is to be fulfilled within temporal restrictions, that is, to prefer short term interests over longer term interests, a choice that could have the practical effect of dislocating these economic interests from the fundamental constitution and purpose of the company as a going concern.¹¹³

With the introduction of the *Companies Act, 2006*, c.46 (the *Companies Act, 2006*) the common law and equitable principles gained statutory expression in section 170¹¹⁴ while at the same time remaining the basis for application and interpretation of the statutory duties. The Act affirms that the statutory duties are owed to the company and only the company can directly enforce them.¹¹⁵ The new Section 172 of the *Companies Act 2006* introduces a duty to promote the success of the company which in effect states that directors are expected to pursue “enlightened shareholder value”¹¹⁶ in order to promote the long term success of the company. Pursuant to Section 172, directors must continue to act in a way that benefits the shareholders as a whole, but there is now an additional list of non-exhaustive factors to which the directors must have regard.¹¹⁷

This codification of factors to be considered was one of the most controversial aspects of the new legislation at the drafting stage. However, in practice, the factors are no more than those which the principles of good governance would require directors to consider: the long term consequences of decisions; the interests of employees; the need to foster the

¹¹³ For an example, refer to the discussion of the hostile takeover of Cadbury by Kraft in section 7.2.

¹¹⁴ Section 170, *Companies Act 2006*, c.46. Section 170 sets out the scope and nature of directors’ general duties.

¹¹⁵ Section 170, *Companies Act 2006*, c.46. It is important to note that company shareholders have certain statutory means whereby they can sue directors in the name of, and for the benefit of, the company in respect of an actual or proposed act or omission of a director or directors involving negligence, default, breach of duty (including of the general statutory duties) or breach of trust. Shareholders also have certain rights as to the election (s. 160) and removal (s. 168) of members of the board of directors.

¹¹⁶ Financial Reporting Council, *Consultation on a Stewardship Code for Institutional Investors*, January 2010, p.3

¹¹⁷ Section 172, *Companies Act 2006*, c.46. Section 172 sets out the directors’ duty to promote the success of the company.

company's business relationships with suppliers, customers and others; the impact on the community and the environment; the desire to maintain a reputation for high standards of business conduct; and the need to act fairly as between members.¹¹⁸ Similarly, the main governance principle addressing the role of the board in the *UK Corporate Governance Code, 2010* (Principle A.1) was amended and now states that “the board is responsible for the *long-term* success of the company” (emphasis added).¹¹⁹

The continental model of cooperative governance associated with traditional corporate governance regimes of western European countries is based on the so-called insider system of corporate governance. In this system, controlling shareholders and banks, as the primary sources of finance and resources rather than the equity markets, have an influential governance role.¹²⁰ This traditional approach in continental Europe, and also in Asia, has historically shielded companies from much of the excessive short-termism¹²¹ of equity investors by enabling longer investment horizons.

Coffee has observed that no corresponding wave of financial scandals involving a similar level of companies to that in the United States in the period culminating in the *Sarbanes Oxley Act* broke out in Europe and those that did arise in Europe often had American

¹¹⁸ The Department of Trade and Industry's introduction to the Ministerial statements relating to directors' duties under the *Companies Act 2006* stated that "There was a time when business success in the interests of shareholders was thought to be in conflict with society's aspirations for people who work in the company or in supply chain companies, for the long-term well-being of the community and for the protection of the environment. The law is now based on a new approach. Pursuing the interests of shareholders and embracing wider responsibilities are complementary purposes, not contradictory ones... The new expression of the duties is part of the wider recognition and encouragement of change in the Act. The enhanced business review, which for quoted companies must now include information on environmental, employee, social and community issues, is another key example that builds on the growing consensus that it is good business sense for companies to embrace wider social responsibilities." Department of Trade and Industry, "Companies Act 2006, Duties of company directors: Ministerial statements" (DTI, June 2007). Online at: <http://www.berr.gov.uk/files/file40139.pdf>.

¹¹⁹ The UK corporate governance regime combines a statutory framework pursuant to the *Companies Act 2006* c. 46 and codified set of principles and standards of good governance practice pursuant to the UK Corporate Governance Code established by the UK Financial Reporting Council the independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The UK regime is considered in detail in section 5.2.

¹²⁰ R. Kraakman et al., *The Anatomy of Corporate Law* 2 ed. (Oxford: Oxford University Press, 2009) at 30.

¹²¹ "Short-Termism"—corporate and investment decision-making based on short-term earnings expectations versus long-term value creation for all stakeholders. Source: CFA Centre for Financial Market Integrity and Business Roundtable Institute for Corporate Ethics, *Breaking the Short-Term Cycle*, (CFA Institute, 2006).

roots. Other than Parmalat, the emblematic European scandal, the financial irregularities at Adecco, Royal Ahold, Skandia and Vivendi Universal were all, at least initially, centred on accounting at U.S. subsidiaries.¹²² However, while such large scale fraud on shareholders of this kind is less common, the concentrated shareholding structure in Europe does create the potential for self-interested behaviour and the appropriation of the private benefits of control at the expense of minority interests.

That said the continental model, as an inherently more cooperative system of governance, is also associated with a greater orientation towards the interests of a broader group of stakeholders, including the participation of stakeholders on oversight boards.¹²³ In addition to the banks and controlling shareholders, the insider system consciously relies on the recognition and in some cases representation of a range of interests that are closely connected to the local community – workers, customers, other businesses.¹²⁴ This accommodation of a broader constituency of interests in the continental governance model fosters a wider conception of the purpose of the economy generally, and corporate entities specifically, as something more than solely the means for profit maximization in the neoclassical tradition of individualist free markets and American style capitalism.

In this conception of corporate entities as inherently socially situated rather than autonomous organizations, governance is not primarily viewed as a means to constrain or control an organization's ability to compete freely in the marketplace. Nor is it considered additive or supplemental – something that can be achieved merely by grafting on a set of formal mechanisms and processes.

Instead, governance is constitutive of the organization's fundamental *raison d'être*. It is at the very essence of how organizations animate and conduct themselves through the

¹²² John C. Coffee, "A Theory of Corporate Scandals: Why the U.S. and Europe Differ" (March 2005) Columbia Law and Economics Working Paper No. 274. Available at SSRN: <http://ssrn.com/abstract=694581> or doi:10.2139/ssrn.694581.

¹²³ Thomas S. Clarke, "The Stakeholder Corporation: A Business Philosophy for the Information Age", (1998) *Long Range Planning* 31: 182–194.

¹²⁴ In Germany, for example, employees have a right to half minus one of the seats on the supervisory board as well as numerous safeguards against dismissal and an array of statutory benefits. Thomas C. Clarke, *International Corporate Governance: A Comparative Approach*, (Routledge, 2007) 170.

agency of their management and workforce – from defining purpose, setting objectives and developing policy to the nature of their activities and interactions, internally and externally. Beyond that, as the United Kingdom’s Financial Reporting Council affirmed in 2006, “[G]ood corporate governance is essential to the effective operation of a free market, which enables wealth creation and freedom from poverty”.¹²⁵

This conception has parallels in institutionalist theory applied in the context of the sociological perspectives of law. The sociological lens conceives of law as encompassing formally enacted law and the breadth of its application, interpretation, observance and enforcement, and thus as culturally constituted and evolving.¹²⁶

Institutional perspectives in organizational theory similarly posit organizations as culturally constituted – the products of exogenous social and environmental influences including but not limited to external regulatory structures such as the law – and not solely as vehicles rationally created for the sole purpose of productive efficiency and profit maximization. In combination, these illuminate the complex, dynamic and ultimately irreducible relationship between organizations and their societal contexts.¹²⁷

The proposition that governance is central and constitutive to the internal and external functioning of connected and interdependent entities can also be approached according to the principles of systems-based thinking.

A fundamental concept in general systems theory is that the properties, or behaviour, of a system as a whole emerge out of the interaction of the components comprising the system such that a system is essentially defined by the interaction and relationships among its

¹²⁵ UK Financial Reporting Council, *The UK Approach to Corporate Governance*, November 2006, Foreward.

¹²⁶ Mathieu Deflem, *Sociology of Law: Visions of a Scholarly Tradition* (Cambridge: Cambridge University Press, 2008) 150.

¹²⁷ *Ibid* at 151. W. R. Scott, *Institutions and Organizations*, 2d. (Thousand Oaks, CA: Sage Publications, 2001).

constituent units.¹²⁸ Systems principles therefore focus on the whole of a system and the interactions with other systems as well as the interrelationship and interdependencies among the parts.¹²⁹ They provide a theoretical construct that enables the study of the role of dynamic equilibrium – the process of maintaining stability in the process of change; the developmental movement from simple to complex structures and relationships; and the importance of balance and harmony in each individual or subjective world system.¹³⁰

Capitalism as a system involves the entire institutional environment in which economic transactions of a society take place as defined by the roles of and interrelationship between the economic, political, social, and cultural organizations of that society.¹³¹

A systems-based approach can thus facilitate an understanding of corporate entities as inherently socially situated rather than autonomous organizations. It captures the complex, dynamic and multi-interactive nature as well as the fundamental dependence on guiding principles, their effective implementation and the responsible oversight by independent boards and external stakeholders. As such it provides an alternative theoretical basis for the important conceptualization of corporate governance as much more than a series of formal, internal mechanisms and processes that serve as proxies for individual and corporate responsibility.

¹²⁸ Elaine Parent, “The Living Systems Theory of James Grier Miller”, undated web document. www.newciv.org.

¹²⁹ The classical versions of systems theory are based on the accounts in biological science of how living organisms self-regulate while forming part of and interacting with a larger ecosystem. These classical accounts of systems theory focus on the dynamics and interactions within and between the ‘legal system’, the ‘economic system’ and the ‘political system’. See for example: M. Brans and S. Rossbach, “The autopoiesis of administrative systems: Niklas Luhman on public administration and public policy” (1997) *Public Administration* 75: 417-439; and G. Teubner, “After legal instrumentalism? Strategic models of post-regulatory law” in G. Teubner (ed.) *Dilemmas of Law in the welfare state* (Berlin: De Gruyter, 1986). Later applications perceive the boundaries between systems as porous causing the systems to evolve through interaction and the interactions to change in future iterations. For discussion of the application of systems theory to effecting holistic change in governance systems, see: A. Dunsire, “Modes of Governance” in J. Kooiman (ed.), *Modern Governance: new government-society interactions*. (London: Sage, 1993) 21-34; J. Kirkbride, and S. Letza, “Regulation, Governance and Regulatory Collibration: achieving an “holistic” approach” (2004) *An International Review* Volume 12, No. 1, January, 2004.

¹³⁰ Elaine Parent, “A Living Systems Perspective as a Meta-framework for Viewing the dynamics of Human Experience”, 2000. Document at <http://weber.ucsd.edu/~eparent/part1/paper1.html>

¹³¹ J. Rogers Hollingsworth and Karl Muller in *Advancing Socio-Economics: An Institutional Perspective*, J. Rogers Hollingsworth, Karl Muller, Ellen Jane Hollingsworth eds. (Lanham, Maryland: Rowan and Littlefields, 2002) 235.

The diagnosis of failures from a systems-based perspective follows a similarly holistic approach. Specific problems are not to be treated separately and in isolation but considered as symptomatic of a wider systemic concern. From this, the potential connections and interrelationships between the problems become the focus of the diagnostic process which is aimed at a systemic solution.

Such systems principles have increased in utility with the ascendance of globalization that has made coordination between independent corporate entities and organizations, state and non-state actors at national, transnational and supranational levels increasingly important.¹³² The G-20 response to the global financial crisis is a case in point, where traditional, domestic market and hierarchy mechanisms were harnessed in order to organize a coordinated implementation of measures on an international scale.¹³³

¹³² Wolfgang Meyer, "Regulation, Responsibility and Representation: Challenges for Intra-Organizational Communication", in Istemi Demirag (ed.) *Corporate Social Responsibility, Accountability and Governance: Global Perspectives* (Sheffield UK: Greenleaf Publishing, 2005) 43.

¹³³ For further discussion on hybrid and network forms of coordination, see: W.W. Powell, "Neither Market nor Hierarchy: Network Forms of Organization" (1990) *Research in Organizational Behaviour* 12:295-336.

Part Two – Corporate Governance Frameworks: An Overview of the United Kingdom, United States and Europe

5. Common Language, Distinct Paths: Corporate Governance in the United Kingdom, the United States and Europe

5.1 Form and Function

Governance practices arise in the context of, and are affected by, systems of law and regulation, norms and values, and socio-economic traditions. In every governance subsystem, these combinations of influences lead to subtle and not so subtle differences in the path of governance development.¹³⁴

In the business sphere, effective governance is supported by and dependent on framework conditions specific to the jurisdiction of incorporation. These include foundational elements such as established rule of law and legal institutions, respect for and protection of property rights, an independent judiciary and functioning courts.¹³⁵ These support, in developed economies, the operation of the legal, regulatory and accountability regime comprised of company law, accounting and auditing standards, securities regulation, supervision and oversight structures, bankruptcy laws, judicial enforcement and the nature of the market for corporate control.

The features of each governance model, the operationalization, and requirements of each country's approach are reflections of their particular, historical, constitutional, legal, political and institutional structures, as well as diverse cultures, values, economic influences, financing traditions, and ownership structures.¹³⁶

To gain insight into the range and interplay of influences engaged in determining the nature and function of governance, it is worthwhile considering some of the main

¹³⁴ Amir N. Licht, "The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems" (2001) 26 *Delaware Journal of Corporate Law* 147.

¹³⁵ R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R.W. Vishny, "Law and Finance" (1998) 106 *Journal of Political Economy* 1113.

¹³⁶ For an analysis of the complex of institutions, institutional frameworks, practices and norms that enable and support effective securities markets, see: Bernard S. Black, "The Legal and Institutional Pre-conditions for Strong Securities Markets" (2001) 48 *UCLA Law Review* 781.

attributes that characterize different governance regimes.¹³⁷ Studying corporate governance in the United Kingdom, the United States and the European Union reveals that, despite obvious formal and institutional differences and more subtle but distinct customs and practices, there are also observable similarities between the different regimes.

Many of the similarities are functional rather than formal and to be found in the influential, but not directly binding, recommendations of governance codes. The evolution of these codes took place alongside the accelerated integration of capital markets throughout the latter decades of the last century, a period also dominated by the United States approach to corporate governance. As such, they are shaped by and responsive to a difficult balancing task. On the one hand, there is pressure to meet the expectations of foreign investors with their ever more mobile capital as a consequence of increasingly interconnected and international capital markets. On the other there is need to ensure, on the domestic front, that the necessary safeguards are in place for the protection of fundamental interests, respect for shareholder and stakeholder rights, and the fundamental precepts of fair, honest and transparent conduct of business.

Each of the three jurisdictions – the United Kingdom, the United States and the European Union – represents a different approach to finding this balance, not only in the written

¹³⁷ There have been numerous comparative studies and evaluations that focus specifically on the nature of capital market, securities regulatory systems and corporate governance regimes around the world, including: Lucian A. Bebchuk and Mark J. Roe, “A Theory of Path Dependence in Corporate Ownership and Governance” (1999) 52 *Stanford Law Review* 127; Bernard S. Black, “The Legal and Institutional Preconditions for Strong Securities Markets” (2001) 48 *UCLA L. Rev.* 781; Douglas A. Branson, “The Very Uncertain Prospect of ‘Global’ Convergence in Corporate Governance” (2001) 34 *Cornell International Law Journal* 321; William M. Bratton and Joseph A. McCahery, “Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference” (1999) 38 *Columbia Journal of Transnational Law* 213; John C. Coffee, “The Future As History: The Prospects for Global Convergence in Corporate Governance and its Significance” (1999) 93 *Northwestern University Law Review* 641; John C. Coffee, “Privatization and Corporate Governance: Lessons from Securities Market Failures” (1999) 25 *The Journal of Corporate Law*, No.1, Fall 1999; Ronald J. Gilson, “Globalizing Corporate Governance: A Convergence of Form or Function” (2001) 49 *American Journal of Comparative Law* 329; R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R.W. Vishny, “Law and Finance” (1998) 106 *Journal of Political Economy* 1113; Amir N. Licht, “The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems” (2001) 26 *Delaware Journal of Corporate Law* 147; Mark J. Roe, “Political Determinants of Corporate Governance: Political Context, Corporate Impact”, Discussion Paper No. 451, 12/2003 Harvard Law School, Cambridge MA 02138. Available at SSRN: http://papers.ssrn.com/abstract_id=472366.

laws, rules and standards, but also in the extent that voices other than that of the regulator are heard in the regulatory discourse.

5.2 The ‘United Kingdom Approach’

The United Kingdom has been most commonly associated with a principles based approach (or ‘light touch’ as it is referred to in political spheres) to corporate governance, and the establishment and regulation of standards of business conduct. Although this tends to over-simplification, it is an approach that is perceived as less prescriptive than other jurisdictions following the Anglo-American model of the corporation, particularly the United States post *Sarbanes Oxley* and, to a lesser extent, Canada and Australia.¹³⁸

The origins of the United Kingdom’s corporate governance regime are also found in response to fraud and financial scandal – in this case a series of corporate collapses and scandals in the late 1980s and early 1990s, including in 1991 the collapse of the BCCI bank and the Robert Maxwell pension funds scandal – that led to a fall in investor confidence in the quality of companies’ financial reporting and by extension the integrity of the companies and the market for their shares.¹³⁹

The series of reports and codes that eventually constituted the United Kingdom’s *Combined Code on Corporate Governance (The Combined Code)* – and are now consolidated, with revisions, in the *United Kingdom Corporate Governance Code 2010* – established the principles based system of corporate governance in the United Kingdom.

The Combined Code consolidated the substance and recommendations of the 1992 *Cadbury Report*, the 1995 *Greenbury Report of the Study Group on Directors Remuneration*, and the 1998 *Committee on Corporate Governance Final Report* (the

¹³⁸ In Australia, companies listed on the Australian Stock Exchange (ASX) must provide a corporate governance statement in their annual reports which must address the ASX Corporate Governance Council’s Principles of Good Corporate Governance and Best Practice Recommendations and disclose non compliance on an ‘if not, why not’ basis.

¹³⁹ UK Financial Reporting Council, “The UK Approach to Corporate Governance” (UK FRC, November, 2006) 3.

Hampel Report).¹⁴⁰ It was formulated in 1998, and annexed to the United Kingdom's Financial Services Authority Listing Rules (*The Listing Rules*).¹⁴¹ It was subsequently revised with additional guidance and recommendations following the publication of the 2003 *Review of the Role and Effectiveness of Non-Executive Directors* (the *Higgs Report*) reviewing the role and effectiveness of non-executive directors and the 2003 *Audit Committees: Combined Code Guidance* (the *Smith Report*) on audit committees.

Consistent with the reports that preceded it, *The Combined Code* (and its successor the *UK Corporate Governance Code 2010*) emphasizes the *principles* of good governance rather than setting out explicit rules, with the aim of alleviating the regulatory burden on companies, avoiding 'box-ticking' and being flexible enough to be applicable to all companies. These principles, from the Cadbury Committee's first articulation are enduring and, following reviews in 2005, 2007 and 2009 that included extensive consultation with practitioners and stakeholders, remain the core principles of the *UK Corporate Governance Code 2010*.¹⁴²

¹⁴⁰ *The Cadbury Report*, formally entitled *The Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee, 1992) was published in December 1992, following the recommendations of the Cadbury Committee. The Committee, established in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession addressed the financial aspects of corporate governance and subsequently produced a Code of Best Practice with which, in their belief, all boards of United Kingdom listed companies should comply. (See also earlier discussion of the Cadbury Committee and Report in section 1.3). The 1995 *Greenbury Report of the Study Group on Directors Remuneration* (the "Greenbury Report") documented the findings of the Greenbury Committee established to address the corporate governance issues relating to director's remuneration which in the 1990s was becoming a primary concern for investors and the public at large. The Greenbury Report incorporated a *Code of Best Practice on Director's Remuneration*. The Hampel Committee was established in 1996 to review and revise the earlier recommendations of the Cadbury and Greenbury Committees. The 1998 *Committee on Corporate Governance Final Report* emphasized principles of good governance rather than explicit rules to alleviate the regulatory burden on companies, avoid 'box-ticking' and to be flexible enough to be applicable to all companies. Various sources, including: UK Financial Reporting Council and Manifest Proxy Voting Agency, *Milestones in UK Corporate Governance*. www.manifest.co.uk/reports/governance/UK%20Corporate%20Governance%20Milestones.pdf

¹⁴¹ In practice, the objectives of *The Combined Code* were realized through its linkage with the UK *Listing Rules* establishing the model for self-regulation and reported compliance regime, now commonly referred to as the 'comply or explain' method. See further discussion of the *Listing Rules* infra p. 72. Regarding the origins of the UK Financial Service Authority, see infra note 175.

¹⁴² The UK Financial Reporting Council, *UK Corporate Governance Code 2010*, Preface.

Administered pursuant to the authority of The Financial Reporting Council¹⁴³, the *UK Corporate Governance Code 2010*, as its predecessors, promotes high standards of corporate governance. While mandatory reporting against the code is required only of listed companies under the Listing Rules, the code's influence extends beyond the listed sector, and the United Kingdom. Other sectors in the United Kingdom have adopted the code as the governance standard, for example building societies and mutual insurers, and its high-level principles have been the basis of many other codes of practice.

The relative strength of corporate governance in the United Kingdom since the introduction of the first code of governance, following the Cadbury Report, and the findings and recommendations of the Cadbury, Greenbury, Turnbull, Higgs and Smith Committees¹⁴⁴ that informed its subsequent iterations, is widely considered a testament to the codes' success as well as the spirit with which the majority of UK companies have endeavoured to fulfill their governance responsibilities. There have been and continue to be detractors, but few offer any demonstrably more effective alternatives to the current system.

Paul Myners, Chair of the 2001 Review of Institutional Investment in the United Kingdom, put it this way:

Such codes can be (and have been) criticized, for lacking teeth. In fact, I believe history suggests otherwise. The voluntarist approach, allied with transparency, may not appeal to the purist. It cannot deliver perfection. Nevertheless, corporate governance practices [in the United Kingdom] are unrecognizable from the pre-Cadbury world. On any reasonable analysis the codes have done their job.¹⁴⁵

¹⁴³ The Financial Reporting Council has regulatory oversight of corporate governance, investor engagement, reporting audit and accounting, fulfilling the market regulation role until recently the domain of the United Kingdom Financial Services Authority. See *infra* note 175.

¹⁴⁴ *The Turnbull Report* (1999) – provided guidance on proper internal controls; *The Higgs Report* (2003) addressed the critical role of non-executive directors; *The Smith Report* (2003) made recommendations on the role, responsibilities and composition of audit committees. Two subsequent reviews in 2005 and 2007 to assess the Codes continued fitness for purpose were conducted prior to the 2009 review that followed the global financial crisis and led to the *UK Corporate Governance Code 2010*.

¹⁴⁵ *Institutional Investment in the United Kingdom: A Review* (HM Treasury, 2001) (“The Myners Review”) Summary. Accessible at: http://archive.treasury.gov.uk/pdf/2001/myners_report.pdf.

It is important to distinguish between the governance principles and requirements apparatus of the corporate governance code, the statutory governance framework – successive company law statutes, now the *Companies Act 2006* c. 46 (the *Companies Act, 2006*) – and the common law.¹⁴⁶ The distinction and its implications for understanding the corporate governance regime is one that has often been overlooked by the United States comparative governance scholarship which has, in its analysis of convergence trends, tended to treat the regimes in the United States and the United Kingdom as highly aligned.¹⁴⁷

The United Kingdom was one of the first nations to establish rules for the operation of companies and a legal framework within which business operates.¹⁴⁸ The British model of corporate governance refers to the model established in Great Britain and continuing to operate in the United Kingdom and jurisdictions outside the United Kingdom that base their systems on that model. In the British model, the components of corporate governance are constituted by company law statute and incorporation – financial reporting, audit, and governance are framed in Company law, and the duty to deliver an annual accounting to shareholders is a basic requirement of incorporation.

Under UK company law, shareholders have comparatively extensive voting rights. These include the rights to appoint and dismiss individual directors and, in certain circumstances, to call an extraordinary general meeting of the company. Other statutory requirements relate to the annual general meeting, including the provision of information to shareholders and arrangements for voting on resolutions, to the information to be disclosed in the annual report and accounts. This information requirement includes a business review in which the board details the principal risks and uncertainties facing the

¹⁴⁶ The *Companies Act 2006* codified the common law and equitable principles that previously governed directors' duties. The new statutory statement of directors' duties which are owed to the company, and only enforceable by the company, includes seven general duties.

¹⁴⁷ See: Douglas, A. Branson, "The Very Uncertain Prospect of 'Global' Convergence in Corporate Governance" (2001) 34 *Cornell Int'l L. J.* 321.

¹⁴⁸ United Kingdom Department of Trade and Industry, "Explanatory Notes on the Companies Act 2006" (UK Department of Trade and Industry). Online at: <http://www.legislation.gov.uk/ukpga/2006/46/notes/division/2>

company and a report on directors' remuneration, on which shareholders have an advisory vote.

The statutory framework is reinforced by the Listing Rules that must be followed by companies listed on the principal market of the London Stock Exchange. The Listing Rules provide further rights to shareholders (for example, by requiring that major transactions are put to a vote), and require certain information to be disclosed to the market. This includes the requirement to provide a 'comply or explain' statement in the annual report explaining how the company has applied the *UK Corporate Governance Code 2010* or, in the case of companies incorporated outside the UK, to describe how the companies' governance practices differ from those set out in the Code.

A different model exists in the United States. Unlike the British Model, much of what is considered to be regulation of the corporate governance of corporate entities in the United States is effected indirectly through the regulation of securities markets pursuant to federal securities law. This distinction is important in terms of locating the appropriate authority for matters of corporate governance when considering and comparing different jurisdictional practices.

It is also critical to understanding the fundamental distinction between corporate governance as constitutive and relatively uncontested, as in the British Model, and corporate governance as additive and consequently contested as it is in the United States. The departure from the British Model resulted from a constitutional divide between federal and State law that prevented Congress in 1930 from adopting a federal model of incorporation that reflected in full the *British Companies Act, 1929* despite the desire and intention to do so. The United States Supreme Court confirmed the original legislators' intention to follow the British model in its judgment in *Gustafson v. Alloyd Co.* 513 U.S. 561 (1995). Kennedy J., regarding the proper basis for interpreting the civil liability provisions of the *Securities Act 1933*, ss. 11 and 12, stated "... [F]ar from suggesting an

intent [sic] to depart in a dramatic way from the balance struck in the British Companies Act, the legislative history suggests an intent to maintain it”¹⁴⁹

Instead, Congress proceeded with an accommodation of federal and state constitutional jurisdiction in the form of the 1933 *Securities Act* that seeks to regulate the governance of companies indirectly by means of direct regulation of the sale of securities. That is, using the federal jurisdiction over the market for the sale and exchange of securities, as a means to attach corporate governance requirements as between offeror and purchaser of shares.

This contrast in the location of the constitutional and legal foundations of corporate governance – company law in the United Kingdom, securities law in the United States – highlights the inherent dangers in extracting regulatory approaches from their original context, the legal and operational framework for the purpose of distilling theory.¹⁵⁰

Company law in the United Kingdom has become increasingly prescriptive over the last few decades, with hundreds of substantive commands and statutory minimum requirements. The *Companies Act 2006* heralded significant reforms and interventions with respect to the operation and oversight of United Kingdom listed companies and the most significant changes to company law in over 20 years.¹⁵¹

¹⁴⁹ *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995) at 582. In this conclusion, Supreme Court Justice Kennedy referred to the House Report issue by Congress during its deliberations on the *Securities Act 1933*, where it stated “[T]he committee is fortified in these sections by similar safeguards in the English Companies Act of 1929. What is deemed necessary for sound financing in conservative England ought not to be unnecessary for the more feverish pace which American finance has developed.” (H. R. Rep. No.85, 73d Cong., 1st Sess., 5 (1933), at 9). Later he stated, at 599 that “[T]he drafters of the Securities Act modeled this federal legislation on the British Companies Act, 19 & 20 Geo. 5, ch. 23 (1929). See Landis, “The Legislative History of the Securities Act of 1933” (1959) 28 *Geo. Wash. L. Rev.* 29, 34 (Landis and the other drafters “determined to take as the base of [their] work the English Companies Act”); see also *SEC v. Ralston Purina Co.*, 346 U. S. 119, 123 (1953) (characterizing the *Companies Act* as a “statutory antecedent[t]” of federal securities laws).”

¹⁵⁰ For a discussion of different origins and prescriptions for corporate misconduct see: John C. Coffee, “A Theory of Corporate Scandals: Why the U.S. and Europe Differ” (March 2005) Columbia Law and Economics Working Paper No. 274. Available at: SSRN: <http://ssrn.com/abstract=694581> or doi:10.2139/ssrn.694581

¹⁵¹ The 2006 Act which superseded the *Companies Act 1985* is the primary source of UK company law. It amends or restates almost all of the 1985 Act making changes to almost every aspect of the law in relation to companies, including the codification of the principal common law and equitable duties of directors, enshrining the notion of corporate social responsibility within the directors’ duties to promote the success of the company (s. 172), and implementing the European Union’s *Takeover and Transparency Obligations*

In the specific context of corporate governance, however, the *UK Corporate Governance Code 2010* (the recent consolidation of its predecessor *The Combined Code*) rather than statute is the authoritative guide. Unlike prescriptive ‘one-size-fits-all’ regulatory approaches such as the post *Sarbanes Oxley Act* system in the United States, the UK’s Code operates through a combination of general principles (main and supporting) which are “the core of the code”¹⁵² accompanied by a limited number of specific provisions and a flexible, ‘comply or explain’ approach that permits corporations to explain divergences from the best practice enshrined in the Code. As mentioned, the requirement for companies to apply the main principles and report to shareholders on how they have done so is contained in *The Listing Rules*.

Much of the effectiveness of the UK approach to corporate governance is based on the premise that the market will assess the company’s governance practices – compliant and non-compliant – in its overall quality assessment and valuation of the company from an investment perspective. According to the United Kingdom’s National Association of Pension Funds (NAPF)

‘Comply or explain’ confers a dual responsibility: it is the company’s duty to avoid ‘boiler-plate’ explanations, providing instead a thoughtful explanation for areas of non-compliance. Conversely, investors should evaluate explanations, taking care not to adopt a mechanistic approach and should make companies aware of the reasoning behind their votes on contentious issues. An effective ‘comply or explain’ regime must be based on regular and open dialogue between companies and shareholders, which should extend beyond the voting season.¹⁵³

While this implicit reliance on an active, responsible and willing investment community with medium to long term investment horizons might seem intrinsically flawed in the

Directives. Implementation of the 2006 Act took place in phases with certain provisions coming into force on 1 October 2007, on 6 April 2008 and on 1 October 2008, with final implementation on 10 October 2009. United Kingdom Department of Trade and Industry, “Explanatory Notes on the Companies Act 2006” (Companies House – United Kingdom Department of Trade and Industry). Online at: <http://www.legislation.gov.uk/ukpga/2006/46/notes/division/2>

¹⁵² UK Financial Reporting Council, *UK Corporate Governance Code 2010*. The Main Principles of the Code address the five core dimensions of board-led corporate governance: leadership; effectiveness; accountability; remuneration; and relations with shareholders.

¹⁵³ National Association of Pension Funds, *Corporate Governance Policy and Voting Guidelines* (NAPF, November 2010). Online at: http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/_media/Documents/NAPF%20Policy%20Documents/0154_Corporate_governance_policy_and_voting_guidelines_2010.ashx

context of the widely dispersed, transient share ownership in the United States, it has firm grounding in the traditionally active oversight role played by the United Kingdom institutional investor community.¹⁵⁴

Distinct from other Anglo American jurisdictions, shareholders – specifically institutional and other large investors in the United Kingdom – have had a long established, active and widely acknowledged role in articulating, monitoring and stewarding governance standards.¹⁵⁵

In the 1992 *Cadbury Report*, corporate governance is defined as “the system by which organizations are directed and controlled” and is the responsibility of boards of directors.¹⁵⁶ This responsibility includes “setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship.” According to this model of corporate governance,

[T]he governance role is not concerned with running the business of the company per se, but with giving overall direction to the enterprise, with overseeing and controlling executive actions of management and with satisfying legitimate expectations for accountability and regulation *by the interests beyond the corporate boundaries* ... All companies need governing as well as managing. (emphasis added)¹⁵⁷

In 2001, Paul Myners published the findings of his committees’ review of institutional investment, the Myners Review. The review was commissioned by the Office of the Treasury in response to the growth and complexity of the investment environment and risks facing those tasked with the investment decisions of institutional investment funds,

¹⁵⁴ According to a 2011 report published by UK Investment Managers Association, “Adherence to the FRC’s Stewardship Code”, almost 8 in 10 institutional investors exercise their voting rights in all the companies in which they own shares. This finding, based on a survey of 50 institutional investment management firms with respect to the extent of shareholder involvement in the period following the introduction of the *UK Stewardship Code* in July 2010, confirms the United Kingdom as the market where shareholders are most likely to engage with companies through voting, ahead of markets such as the United States, Canada, and Japan. <http://www.investmentfunds.org.uk/research/stewardship-survey>.

¹⁵⁵ E. Wymeersch, “The Enforcement of Corporate Governance Codes” (2006) 6 *Journal of Corporate Law Studies* 113.

¹⁵⁶ *The Cadbury Report* supra note 20 at 15.

¹⁵⁷ R.I. Tricker, *International Corporate Governance* (Englewood Cliffs, New Jersey: Prentice Hall, 1984) 6-7.

particularly pension and life funds. In the 2001 report, Myners observed that “[i]nstitutional investors – in particular, pension and life funds – manage the savings of millions of people. They also ‘own’ and control most of British industry. They have come to play a central – if low-key – part in British economic life.”¹⁵⁸

Following the 2007 – 2009 global financial crisis, the Financial Reporting Council affirmed this central role stating that the concept of active share ownership is central to the regulatory framework for the governance of listed companies in the United Kingdom.¹⁵⁹ In 2010, the Financial Reporting Council released the updated *UK Corporate Governance Code 2010* within months of the financial crisis. Its specific aim, in the light of the crisis, was to strengthen the accountability of company boards to their shareholders, to emphasize the need to follow the spirit as well as the letter of the governance principles and provisions within the Code, and to connect the newly introduced *UK Stewardship Code* with its complementary objective of fostering more and more effective engagement between companies and institutional investors.

The United Kingdom, with its dispersed share ownership system¹⁶⁰, shares with all such systems the potential for high incidence of the ‘collective action problem’. That is, where there is no incentive for individual shareholders to engage due to the high costs of monitoring and the ability of other investors to share in the benefits without contribution, otherwise known as the problem of free ridership. However, the historically high-level of institutional ownership of the UK equity market has helped to overcome the collective action problem in two ways: the large and diversified investors have in the past been willing to incur the costs of engagement on the basis that it will generate ‘positive externalities’ by sending the right message to other companies: second, institutional

¹⁵⁸ Paul Myners: *Institutional Investment in the United Kingdom: A Review* (HM Treasury, 2001) (“The Myners Review”) 1. Accessible at: http://archive.treasury.gov.uk/pdf/2001/myners_report.pdf.

¹⁵⁹ Financial Reporting Council, “Consultation on a Stewardship Code for Institutional Investors” (FRC, January 2010) 3.

¹⁶⁰ A system has ‘dispersed share ownership’ where a relatively few companies have controlling or block shareownership. See: R. La Porta, F. Lopes de Silanes and A. Schleifer, “Corporate Ownership Around the World” (1999) 54 *Journal of Finance* No.2, 471: 492-3; Marra Faccio and Larry H.P. Lang, “The Ultimate Ownership of Western European Corporations” (2002) 65 *Journal of Financial Economics* 365, 379-80.

shareholders have engaged in various forms of collective action to protect and advance their interests.¹⁶¹

In this regard, the Association of British Insurers (ABI) has long taken an active role in executive compensation through its regular publication of guidelines relating to executive and equity-based remuneration.¹⁶² The NAPF similarly plays a longstanding active role in corporate governance and responsible investment. It has published policy on corporate governance since 1996 and regularly updates its Corporate Governance and Voting Guidance aimed at assisting institutional and other investors in exercising their shareholder and voting rights responsibly.¹⁶³

In 2009, the NAPF published guidance on responsible investing updating the 2005 corporate social responsibility paper.¹⁶⁴ The guidance focuses on the close link between the more established principles of corporate governance and responsible investing (by both companies and investors) and expectations that best practice will develop further in this area, especially as pension funds and their investment managers take steps to implement the requirements of the new *UK Stewardship Code* that came into effect July, 2010.

The system was generally considered to be most effective while the investor community was concerned with a relatively small basket of companies and had a broad commonality of interest. However, recent years have seen a significant shift in share ownership in the United Kingdom: a 2008 survey for the Office of National Statistics reported that individual ownership of UK listed shares fell to 10.2 per cent at the end of 2008. As

¹⁶¹ Geof P. Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford: Clarendon Press, 1996); Ian MacNeil, "Activism and Collaboration Among Shareholders in UK Listed Companies" (2010) *Capital Markets Law Journal* 5(4) 419.

¹⁶² Association of British Insurers, *ABI Principles of Remuneration* (ABI, September 2011). Online at: www.abi.co.uk

¹⁶³ National Association of Pension Funds, *Good Corporate Governance* (NAPF, 1996). Online at: <http://www.napf.co.uk>

¹⁶⁴ National Association of Pension Funds, *Responsible Investment Guide* (NAPF, 2009). Online at: http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0098_Responsible_investment_guide_March_2009_0309.aspx. According to the NAPF, "responsible investment" is: The incorporation of client-specified non-financial corporate or societal behaviours into the investment decision process. These tend to be grouped under environmental, social and corporate governance ('ESG') issues.

recently as 1994 that figure was above 20 per cent.¹⁶⁵ Investors from outside the UK owned 41.5 per cent of UK listed shares at the end of 2008.

At the same time, the growth of rapid turnover share trading or transient ownership and the increasing separation of legal from economic interest in shares through share lending, has further altered the investment landscape. All of these factors undermine the ability of the investment community to identify and engage, let alone act collaboratively, on the basis of common or shared interests.

Further, the massive increase in the domestic and, with globalization, international markets over the past three decades¹⁶⁶, heightened competitiveness and attendant investment risks, along with distorting incentives and investment horizons far outpaced the capacity to perform anything more than a general formulaic review of corporate disclosures, passivity, and reliance on investment advisors and ratings agencies. Even then the costs of doing so are a significant burden. Respondents to a survey of institutional investors in the United Kingdom conducted by the Investment Management Association reportedly identified the main obstacles to stewardship as too few resources to be effective and stakes too small to be influential.¹⁶⁷

The sheer size of the capital markets creates the risk that the inventory of listed companies is too large for the investment community to have a credible proactive presence, let alone a coordinated one and, as with traditional law-based regulators, they lack the resources to ‘police’ companies effectively. Quite simply, the scale of the global

¹⁶⁵ See United Kingdom Office for National Statistics, “Share Ownership Statistical Bulletin 2010”. <http://www.statistics.gov.uk/StatBase/Product.asp?vlnk=930>

¹⁶⁶ In the period end 1990 to end 2010, the total number of listed companies (excluding investment funds) on main and parallel markets around the world grew from 19,968 to 45,508. Source: World Federation of Exchanges. www.world-exchanges.org/statistics/key_market_figures

¹⁶⁷ The “Adherence to the FRC’s Stewardship Code” survey covers the period to 30 September 2010. It is the first survey conducted since the launch of the Financial Reporting Council’s *UK Stewardship Code* in July 2010 and focuses on the activities that support institutional investors’ commitment to the Code. Respondents to the survey represented 50 of the 80 firms who had adopted the *UK Stewardship Code* by 26 November 2010, of which 41 were asset management firms, seven asset owners and two service providers. <http://www.investmentfunds.org.uk/research/stewardship-survey>. Note that as at 19 May 2011, there were 124 asset managers, 26 asset owners and 11 service providers signed up and on the FRC’s web site – 161 in total.

investment market, the volume of filings and corporate disclosures overwhelms its market recipients just as it does the regulators tasked with reviewing them.

These problems of scale have the practical effect of placing investors, along with regulators, generally in a reactive role – taking an active interest only when things start to go wrong. Furthermore, in cases where investors’ analysis does identify a potential or burgeoning problem, arguably they have no incentive to disclose the issue to the wider market since doing so poses a risk to their investment. If the issue prompts the ultimate investor recourse – exit – the interest in the companies practices, like the position, disappears. The *UK Stewardship Code* indirectly addresses these issues through its emphasis on active monitoring, dialogue, engagement, intervention alone or with other investors, and active exercise of shareholder rights such as voting and meeting requisition.¹⁶⁸

In his 2001 report, Paul Myners the Chair of the Myners Review stated, rather presciently as it turned out, that:

[W]e need to be clear that the savings industry, and the decision-taking structures we have evolved over the years, face forbidding challenges. We need to be certain that our structures are up to the current environment.¹⁶⁹

In particular, the review identified a number of distortions in the investment decisions underlying the vast flows of capital. It also identified that key decision-makers did not always have the skills, expertise and information to carry out their responsibilities effectively. The review also highlighted that “a lack of clarity about decision-making structures and incentives” could cause “the misalignment of the objectives of the ultimate investors – the millions of consumers and pension fund members – and the agents investing on their behalf.”¹⁷⁰

¹⁶⁸ The Financial Reporting Council, *UK Stewardship Code, 2010* (FRC, 2010). Online at: <http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf>

¹⁶⁹ P. Myners, *Institutional Investment in the United Kingdom: A Review* (HM Treasury, 2001) (the “Myners Review”) 1. Online at: http://archive.treasury.gov.uk/pdf/2001/myners_report.pdf.

¹⁷⁰ *Ibid.* at 20.

The increasingly challenging institutional oversight function also magnifies the inherent risks in the ‘comply and explain’ system and fuels questions about its effectiveness.¹⁷¹ Among those identified, perhaps the most problematic is the necessary reliance on corporate self-assessment and reporting of its governance practices with all the subjective bias, opportunity to distort and misrepresent (whether intentionally or otherwise) and the moral hazards present whenever the risk and consequences of noncompliance are perceived to be insignificant. The companies make their own determination based on a subjective interpretation of what constitutes compliance, what is justifiable divergence, and what the market needs to know, without an outside arbiter.¹⁷²

That said, this effectively shared oversight approach in the United Kingdom is attributed with relative success when compared to other developed nations in terms of establishing and maintaining high standards of business governance and conduct in United Kingdom listed companies.¹⁷³ In practical terms, it appears to have played a role in limiting if not completely avoiding incidences in the United Kingdom of the kind of ethical breaches, misconduct and fraud in United States listed companies that led to the collapse of Enron Corporation, the bankruptcies of Adelphia, WorldCom (now MCI Inc.), Global Crossing, Tyco and others, and in recent years the stock option backdating, mutual fund market timing and analyst reporting scandals.¹⁷⁴

However, the United Kingdom has not escaped corporate scandals in the past and did not escape the impact of this most recent financial crisis and the ensuing market contagion. The pension scandals of the late 1980’s and early 1990’s, including The Mirror Group pensions collapse and the pensions miss-selling scandal, prompted reforms to legislation

¹⁷¹ The Financial Reporting Council, “Consultation on a Stewardship Code for Institutional Investors” (FRC, January 2010) 4. The European Commission also recently expressed the view that the financial crisis “raises questions about the effectiveness of corporate governance rules based on the presumption of effective control by shareholders”, Commission (EC), Corporate Governance in Financial Institutions and Remuneration Policy (Green Paper) COM 284 final, 2 June 2010.

¹⁷² For the United Kingdom see: S. Arcot, V. Bruno and A. Faure-Grimaud, “Corporate Governance in the UK: Is the Comply or Explain Approach Working?” (2010) *International Review of Law & Economics* Vol. 30, no.2, 193-201; and Arcot and Bruno’s earlier, “In Letter but not in Spirit: An Analysis of Corporate Governance in the UK” (May 2006). Available at SSRN: <http://ssrn.com/abstract=819784>.

¹⁷³ In a recent GovernanceMetrics Global Corporate Governance Country Rankings the UK scored the highest average overall rating 7.60 out of 10.

¹⁷⁴ See earlier discussion in section 3.1 and Appendix 1 – List of Notable Scandals

governing pension arrangements and pension plan fiduciaries and the creation of the Financial Services Authority (FSA) in the 1990's. Similarly, the accounting scandals at Polly Peck and BCCI in the 1990's raised concerns about the integrity of corporate reporting.¹⁷⁵

In response to the latest market crisis, the United Kingdom government and its regulatory authorities embarked on another course to add to the existing corpus of rules and regulatory requirements in specific areas associated with the greatest level of risk.¹⁷⁶ It is important to note that, in this regard, the government is focused primarily on the financial institutions arena, as distinct from the regulations pertaining to the financial markets and the conduct and governance of its constituents.

In the latter regard it has turned to the codification of its expectations. In the *UK Stewardship Code*, the United Kingdom government took the step to officially codify a set of standards and expectations for large shareholders and institutional actors.¹⁷⁷ It did so in recognition of the fact that members of this investment community, contrary to their traditional stewardship role, were engaged in activity inconsistent or damaging to the integrity and long-term sustainability of capital markets and thus ultimately contributed (like their counterparts worldwide) to the global scale of economic loss and de-stabilization following the crisis in the United States.¹⁷⁸

¹⁷⁵ See Appendix 1 – List of Notable Scandals

¹⁷⁶ The Labour government set up the United Kingdom Financial Services Authority (FSA) in 1998 with four statutory objectives: market confidence, public awareness, consumer protection and reduction of financial crime. A commission-driven system had led to a massive scandal where people with good, solid final salary pensions were urged to exchange them for risky personal pensions with no guarantees. The FSA was charged with, among its other mandates, the task of ensuring that the three million people who had been mis-sold personal pensions received the compensation that was their due – more than £10bn in total. The same industry was also involved in mis-selling endowment mortgages necessitating that the FSA set up another major compensation scheme.

¹⁷⁷ The *UK Stewardship Code* is based on the Code on Responsibilities of Institutional Investors issued by the Institutional Shareholders' Committee ("ISC"). Following consultation, the FRC adopted the ISC code with minor amendments and in July 2010 published the resulting document as the *UK Stewardship Code*. While similar to its predecessor, a notable change in the *UK Stewardship Code* is the requirement for increased disclosure from institutional investment managers. Mirroring the approach used in the *UK Corporate Governance Code* and its predecessors, investment managers are required to provide disclosure on a "comply or explain" basis via their websites; the FRC will monitor this disclosure on a regular basis.

¹⁷⁸ Sir David Walker in the 2009 *Walker Review of Corporate Governance of UK Banks and other Financial Industry Entities* concluded that: "...there is a need for better engagement between fund

The government also embarked on a wholesale re-examination of the architecture of the regulatory structure.¹⁷⁹ Under the government's proposed new regulatory architecture and system of regulation to be in place by the end of 2012, the Financial Policy Committee of the Bank of England will be responsible for macro-prudential regulation with a new Prudential Regulation Authority created as a subsidiary of the Bank of England to supervise deposit takers, insurers and significant investment firms. An independent consumer protection and markets authority, the new Financial Conduct Authority (FCA), will be responsible for regulating conduct in relation to all organized retail and wholesale trading markets (including exchanges and multi-lateral trading facilities) and significant over-the-counter (OTC) dealing of financial instruments, capital and risk; for supervising the trading infrastructure that supports those markets; and for the prudential regulation of firms not already prudentially regulated by the new Prudential Regulation Authority.

According to the government's proposals set out in *The Financial Conduct Authority – Approach to Regulation*¹⁸⁰, the FCA will have the single strategic objective of protecting and enhancing confidence in and the integrity of the UK financial system and the firms and markets it will regulate. In pursuing this objective, the FCA's focus of attention will include: the soundness and resilience of the trading infrastructure; the integrity of the financial markets, including the reliability of their price formation process, adequate

managers acting on behalf of their clients as beneficial owners, and the boards of investee companies. Experience in the recent crisis phase has forcefully illustrated that while shareholders enjoy limited liability in respect of their investee companies, in the case of major banks the taxpayer has been obliged to assume effectively unlimited liability. This further underlines the importance of discharge of the responsibility of shareholders as owners, which has been inadequately acknowledged in the past... there should be clear disclosure of the fund manager's business model, so that the beneficial shareholder is able to make an informed choice when placing a fund management mandate".

http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf

¹⁷⁹ On June 16, 2010, the United Kingdom government announced fundamental changes to the United Kingdom's tripartite financial authorities – the Financial Services Authority, the Bank of England and Treasury. The proposals include changes to the financial oversight structure that would reconfigure the Financial Services Authority's prudential bank and financial company oversight, market regulation and consumer protection function within four new authorities, along with merging the United Kingdom Listing Authority with the Financial Reporting Council. (At time of writing these proposals for reform are out for public consultation). See commentary in: "Putting regulators in their right place", Comment, 16 November, 2010, *The Financial Times*. FT.com at: <http://www.ft.com/intl/cms/s/0/f87088fe-f1b9-11df-bb5a-00144feab49a.html#axzz1PI6GyJG6>; Baroness Hogg, "A Way to Cook Our Regulatory Soup", 11 November, 2010, *The Financial Times*. FT.com at: <http://www.ft.com/intl/cms/s/0/a04a470e-edd2-11df-9612-00144feab49a.html#axzz15UIWpwRt>.

¹⁸⁰ Financial Services Authority, *The Financial Conduct Authority – Approach to Regulation* (FSA, June 2011). Accessible at: http://www.fsa.gov.uk/pubs/events/fca_approach.pdf

disclosure of information, and suitability of listing rules; combating market abuse; and addressing the extent to which the UK financial system may be exploited for the purposes of financial crime. In this latter regard, the FCA will retain the FSA's criminal enforcement powers in relation to market conduct.

A key element of this remit is for the FCA to continue to ensure that the conduct of market participants is compatible with fair and safe markets. This means not only working to deter market abuse and pursuing it effectively where it does occur but also to prevent other behaviour which would harm confidence in the integrity of markets. In this regard, the FCA "will base its regulatory interventions on a deeper understanding of underlying commercial and behavioural drivers and the often multiple causes of poor outcomes" for consumers, the wider economy or society in general.¹⁸¹

According to the government's proposals, the FCA's approach will have "significant continuity" with the approach of its predecessor, the FSA, as to the regulation of markets for capital-raising and trading.¹⁸² In particular, in performing the functions of the UK Listing Authority, it will continue to have responsibility for the maintenance of standards beyond European norms in certain areas, but within the overall EU legislative framework.¹⁸³

While far from abandoning its established regulatory philosophy, the United Kingdom's turn to prescription, codification and enhanced regulatory structure before principle in this instance has been interpreted by some commentators as an indication of lessened

¹⁸¹ Ibid at 24.

¹⁸² Ibid. at 34.

¹⁸³ In this regard, the FCA will continue to be responsible for reviewing and approving prospectuses and circulars, determining eligibility for listing and maintaining the Official List. The FCA will also police the ongoing compliance of issuers and major shareholders with the ad hoc and periodic disclosures required under the Disclosure and Transparency and Listing Rules. The FCA will authorise and monitor the performance of sponsors and, if proposed reforms are enacted, primary information providers. The major regulatory tool in this area will remain ensuring that disclosures made by issuers, both in key documents such as prospectuses, and on a continuing basis, provide the information required to protect investors.

confidence in the effectiveness of existing principles based regulatory approaches to protect against wide scale systemic risk and its potentially devastating consequences.¹⁸⁴ This interpretation reflects a limited analysis that fails to separate the political from the policy response to the 2007 – 2009 crises and to take into account the international dimension of G20 governments coordinated action.¹⁸⁵ It is also based on the conventional characterization of governance regulatory approaches as either principles based or rules based: a characterization that overlooks the nuances within regulatory practice.¹⁸⁶

As the Financial Reporting Council has recently stated in its December 2011 report “Developments in Corporate Governance 2011: The Impact of the Implementation of the UK Corporate Governance and Stewardship Codes”:

while all regulatory frameworks need a combination of legal duties on companies and directors, shareholder rights and ‘comply or explain’ codes – the right combination will depend on a number of national considerations, including the structure and functioning of the market in each country. In this regard ... the ‘comply or explain’ approach, backed up by reporting obligations on companies and effective rights for investors, is the right model for the UK.¹⁸⁷

5.3 The ‘United States Approach’

In the United States, the governance of corporations has largely resided in the private law sphere – a market based combination of self-regulation, federally regulated earnings disclosure¹⁸⁸ and corporate board of director oversight of management, internal and external controls, institutional investor activism, and independent audit directed to the

¹⁸⁴ Jean Eaglesham, ‘FSA needs overhaul, says Tory funded review’, 8 March, 2009, FT.com at <http://www.ft.com/intl/cms/s/0/bd92b6b0-0bfd-11de-b87d-0000779fd2ac.html#axzz1PI6GyJG6>; James Sassoon, ‘Britain deserves better financial regulation’ 8 March 2008, FT.com at <http://www.ft.com/intl/cms/s/0/3decd86c-0c13-11de-b87d-0000779fd2ac.html#axzz1PI6GyJG6>

¹⁸⁵ See notes 74 and 476.

¹⁸⁶ This issue is discussed further in section 7.1.

¹⁸⁷ Financial Reporting Council, “Developments in Corporate Governance 2011: The Impact of the Implementation of the UK Corporate Governance and Stewardship Codes”, December 2011 at 7 and 9. www.frc.org.uk/publications/pub2672.html.

¹⁸⁸ Tim Bush, ‘*Divided by Common Language*’ *Where Economics Meets the Law: US Versus Non-US Financial Reporting Models* (Chartered Accountants in England and Wales, 2005). Web published at: http://www.icaew.com/index.cfm/route/115933/icaew_ga/pdf.

lawful management of the corporate entity, protection of shareholder interests, and the efficiency of capital markets.¹⁸⁹

When Congress enacted *The Securities Act 1933* in the aftermath of the 1929 stock market crash and in the midst of the Great Depression it was the first federal intervention in the offer and sale of securities to the public. The Act's objectives were to require companies offering securities to potential investors to furnish sufficient information about both the issuer and the securities to make an informed investment decision and to prohibit deceit, misrepresentations, and other fraud in the sale of securities to the public.

Unlike the British model in which corporate reporting to shareholders, ongoing accounting controls and other governance mechanisms are enshrined in company law and thus part of the company's original constitution, these matters fell outside company law in the United States – a matter of State jurisdiction with generally limited shareholder rights and weak or non-existent reporting requirements – with the State of Delaware being historically the most common state of incorporation with its 'business friendly' statute and judiciary.¹⁹⁰

The *Securities Act 1933* in effect created a 'work around' the constitutional limitations with respect to jurisdiction over incorporated entities, by locating financial reporting and a corporate oversight framework in a federally regulated market system. The framework for accountability and governance is thus set by exogenous rules and standards aimed at market transparency and efficient pricing for the purposes of offering and trading

¹⁸⁹ In this context, 'institutional investor' is understood in a broad sense as any institution that invests professionally on behalf of clients and beneficiaries, for its own account, or both. This class of investors includes those with traditionally long term obligations toward their beneficiaries such as banks, insurance companies, life assurers, retirement or pension funds, state pension reserve funds, endowments, and investment management and mutual funds with long term horizons. It also includes the professional hedge fund investors and private equity funds whose portfolios of assets under management grew significantly in the 1990s and have continued to wield considerable influence in capital markets through the start of the new century.

¹⁹⁰ Over 50% of United States publicly-traded corporations and 63% of the Fortune 500 companies are incorporated in Delaware. The Delaware Court of Chancery is a unique 215 year old business court that has written most of the modern U.S. corporation case law. Source: State of Delaware, Division of Corporations <http://www.corp.delaware.gov/aboutagency.shtml>.

securities of publicly listed companies.¹⁹¹ This approach serves a different function and set of interests – those who trade shares or derivatives, regulators and a range of market actors dependent on the exchange of securities – to those of the British model of shareholder focused capitalism with its emphasis on intrinsic shareholder value and the proper stewardship of shareholders’ capital.

These objectives of informing potential investors and fostering fair dealing in the securities markets are bolstered by the Act’s requirements for issuers to publicly disclose significant information about themselves and the terms of the securities.¹⁹² The notion of disclosure as an important tool in the honest offer and exchange of securities had a place in Franklin Roosevelt’s presidential nomination acceptance speech when he called for the “letting in of the light of day on issues of securities, foreign and domestic, which are offered for sale to the investing public.”¹⁹³

In its original spirit, disclosure was to have the added benefit of discouraging bad behavior. It is premised on corporate management complying with their reporting obligations with full, true and plain disclosure. In practice, however, the disclosure based system has proven to be truly effective in this regard only in relation to the willfully compliant. For others who are intent on profiting from the provision of deceptive or misleading information to the market, or failing to inform, the deterrents have shown to be limited and the moral hazards to be high.

Added to this, the emphasis and reliance on disclosure as an effective deterrent to engagement in undesirable conduct has led to unintended and in some cases perverse consequences. With respect to the latter, a prime example is the case of executive compensation. In the 1990s escalating remuneration levels for executives and the dilutive impact of large scale equity based awards, in particular stock options, prompted policy makers to consider regulatory and market based solutions to prevent boards from

¹⁹¹ Seligman, Joel, *The Transformation of Wall Street* 3d ed. (New York: Aspen Publishers, 2003) 70-71

¹⁹² *Ibid.* 70-71.

¹⁹³ *The Public Papers and Addresses of Franklin D. Roosevelt*, vol. 1. (New York: Random House, 1938) 653. Supreme Court Justice Louis Brandeis expressed a similar sentiment in the phrase “sunlight is the best disinfectant” in *Harper’s Weekly*, December 20, 1913.

engaging in or enabling the payment of excessive levels of compensation to senior executives.

A reluctance to interfere in the workings of the free market through direct regulation of pay levels, led policy makers to opt for a market based regulatory mechanism.¹⁹⁴ This took the form of required disclosures in respect of the compensation for senior executives.

The theory behind the disclosure requirement was that boards, faced with the requirement to disclose excessive pay levels and the prospect of adverse shareholder and public reaction, would exercise their powers to moderate compensation levels. Instead, the annual disclosures became a kind of competitive league table for assessing whether or not one's company was paying its executives sufficiently relative to other companies, as opposed to in relation to company and other measures of performance.

The unintended result was a ratcheting up, rather than moderation of, compensation levels through the 1990s and an increasing disparity with average pay levels, the minimum working wage levels and other benchmarks that has continued into the new millennium.¹⁹⁵

¹⁹⁴ At the same time in the United States many companies added stock options to the compensation mix in response to tax changes aimed at curbing excessive employee pay and favorable corporate accounting treatment for options-based compensation that enabled a company to recognize the compensation cost for tax purposes, but not recognize it as a cost for accounting purposes. The use of stock options at zero cost to the company was first developed in the context of start up companies with little or no revenue, but significant upside share price potential. The issuing of stock options functioned in this context as a way to engage employees early on with the promise of a share in future share price growth. The dilutive impact was not considered material in such companies. As the practice transferred to established and mature stage companies, and as an adjunct to rather than in lieu of cash based pay, the effect of issuing stock options as compensation changed. Instead of 'at risk' incentive compensation directly linked to building and sharing in a success, it became a no risk incentive for management and employees to engage in corporate risk taking in pursuit of short term share price increases that would translate into option gains. Since external market factors largely govern share price movement, option gains were only indirectly and often unrelated to correlative individual effort or upturns in company fundamentals. (Note: The accounting treatment for options issued as compensation has since changed and companies are required to account for the costs.)

¹⁹⁵ See for example, P. Gelin, Michel Magnon and Sylvie St. Onge, "Increased compensation cost as an externality of mandatory executive compensation disclosure: evidence from Canada" (2009) *International Journal of Business Environment* Vol. 2, No. 3: 376-90. According to the 13th Annual CEO Compensation Survey from the Institute for Policy studies and United for a Fair Economy, *Executive Excess 2006*, in the

The mandatory disclosures also led to massive expansion of the recruitment and compensation consulting industries.¹⁹⁶ Compensation consultants working on behalf of executives fuelled the notion that the higher the pay, the better the executive, the better the company. At the same time, they advised boards that failing to pay top dollar risked a company's competitiveness in the increasingly global marketplace for talent, with attendant risks in terms of generating shareholder returns.¹⁹⁷ The result was a much higher rate of escalation in the level of executive pay than prior to the mandatory disclosure.¹⁹⁸ The issue of disproportionate escalation in levels of executive pay is a problem that continues to this day as will be discussed further in section 13.2.2.

In recent times, the deficiencies in the United States system of corporate governance entered the public spotlight in North America in the late 1990's, at the time of the accounting scandals and financial fraud that led to the high profile collapse of Enron and the demise of the then big five accounting firm Arthur Andersen. Enron's appearance of legally acceptable accounting and compliance under the United States federal reporting requirements masked the reality of its toxic corporate culture, manipulative financing and broken business model.

In a statement to a United States Senate Committee, the Chairman of the Consumer Federation of America observed:

The problems that ultimately brought down Enron were a long time in the making. They were simply hidden from investors' eyes... The rules that dictate what information companies have to disclose and how they disclose it failed to produce an accurate picture of Enron finances, even where the company complied with the rules.¹⁹⁹

period 1990 to 2005 CEOs pay increased 298.2% while production workers pay increased only 4.3% and the federal minimum. Over the same period the S& P index increased 141.4%.

¹⁹⁶ The High Pay Commission, *More for Less: What has happened to pay at the top and does it matter?* (The High Pay Commission, May 2011) 9 at 43. <http://www.highpaycommission.co.uk> (High Pay Commission, *More for Less*)

¹⁹⁷ H. Waxman, "Executive Pay: conflicts of interest among compensation consultants" (US House of Representatives, 2007). www.eri.com/PDF/Executive_Consultant_Conflicts.pdf.

¹⁹⁸ The High Pay Commission, *More for Less* supra note 195 at 43, 47 - 49.

¹⁹⁹ The Honourable Howard M. Metzenbaum, Chairman, Consumer Federation of America, Former U.S. Senator, to a committee of the U.S. Senate, 20 March 2002 as quoted in Tim Bush, *'Divided by Common Language' Where Economics Meets the Law: US Versus Non-US Financial Reporting Models* (Chartered

This circumstance, among others serves as a stark example of what nature of company could succeed in a rules-based regulatory environment.²⁰⁰

The corporate governance regulatory regime that emerged in the United States following the accounting scandals of the late 1990's – most notably the *Sarbanes Oxley Act* and other instruments in its vein – was initially and continues to be criticized as disproportionately burdensome and an overly formalistic response to the circumstances of the years immediately preceding.²⁰¹

The United States Government introduced the *Sarbanes Oxley Act* with the explicit purpose of restoring public confidence and trust in corporate governance, in the integrity of the markets and of corporate America, generally.

The Act's approach is extensively prescriptive in the requirements imposed on corporate management and boards to demonstrate accountability and sound governance processes and with respect to the information companies must provide to regulators and the market.

Based on his examination of securities market failures, Coffee has observed that public policies intended to protect market integrity and preserve investor confidence can be easily justified and, equally, policies to offset the negative externalities of public scandal, even if the result of the measures is to impede small and non-fraudulent firms from raising capital.²⁰²

Accountants in England and Wales, 2005). Web published at:
http://www.icaew.com/index.cfm/route/115933/icaew_ga/pdf.

²⁰⁰ John C. Coffee, "Understanding Enron: It's About the Gatekeepers, Stupid" (2002) *The Business Lawyer* 57 (August 2002). "Enron has shown that we have a 'rules-based' system of accounting that arguably only asks the gatekeeper to certify the issuer's compliance with an inventory of highly technical rules". See also: Tim Bush, 'Divided by Common Language' *Where Economics Meets the Law: US Versus Non-US Financial Reporting Models* (Chartered Accountants in England and Wales, 2005). Web published at: http://www.icaew.com/index.cfm/route/115933/icaew_ga/pdf.

²⁰¹ The law included provisions to improve financial reporting by requiring the chief executive and financial officers to certify the financial statements. The company had to document its internal controls and subject them to a separate audit, and auditing firms had to be inspected by a new government agency. The goal was to increase auditors' independence, because the law restricted auditors in the kinds of services they could perform for their audit clients.

²⁰² John. C. Coffee, "Understanding Enron: It's About the Gatekeepers, Stupid"(2002) *The Business Lawyer*, 57 (August 2002).

However, as many commentators have suggested, the broader objects of the *Sarbanes-Oxley Act* were not best served by the heavily prescriptive one-size-fits all approach with its backward focus on preventing the recurrence of specific past transgressions.²⁰³ Its focus on process is also contested, such as in the case of the Section 404 Internal Controls, that requires management to certify only as to the controls over the internal processes by which the company complies with its federal reporting obligations. A very different concept from that in the United Kingdom where the Board of Directors is responsible for the internal controls for the purposes of safeguarding corporate assets and to prevent and detect fraud or other irregularities.²⁰⁴

Furthermore, criticism of the ‘exportation’ of United States corporate governance norms under the *Sarbanes-Oxley Act*, focusing on the application of (1) the audit committee requirement to foreign issuers from European countries with codetermination laws,²⁰⁵ and (2) the prohibition of loans to executives with respect to German issuers challenged the United States assertion of prescriptive (or legislative) extraterritorial jurisdiction, and made clear that cultural attitudes toward the behavior targeted by these laws vary widely across the globe.²⁰⁶ In response to such criticism, the Securities and Exchange Commission (SEC) has granted foreign issuers some limited exemptions from the Act,

²⁰³ But see: Dennis Chambers, Dana Hermanson, and Jeff Payne Kennesaw “Did Sarbanes-Oxley Lead To Better Financial Reporting? A Survey Of Recent Research” *CPA Journal* - Vol. 80, No. 9, Pgs. 24-27 where the authors reviewed five studies of financial reporting pre- and post-Sarbanes Oxley to determine if reporting has improved. The studies reviewed generally use a statistical analysis of companies before and after the enactment of the *Sarbanes-Oxley Act*, assessing whether abnormal or discretionary accruals have increased or decreased. (Academic studies for 20 years have used accruals as a measure of the quality of financial reporting). The authors found that all five conclude that financial reporting did improve after the enactment of the *Sarbanes-Oxley Act*, but note that the studies did not control for other factors such as media exposure and harsher criminal penalties for fraud that may have influenced the improvements in reporting.

²⁰⁴ Principle C.2 of the 2006 *Combined Code* states that ‘The board should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets’. *The Combined Code of Corporate Governance*, 2006.

²⁰⁵ Codetermination refers to the requirement that supervisory boards of companies of a certain size must have an equal number of representatives of shareholders and labor. See Thomas J. Andre, Jr., *Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany*, (1998) 73 TUL. L. REV. 69, 84 n.79 (citing GESETZ ÜBER DIE MITBESTIMMUNG DER ARBEITNEHMER [MITBESTG] [Act Concerning Co-Determination of Employees] (1976) (F.R.G.), reprinted in *Business Transactions in Germany*, app. 9 (Dr. Bernd Rüster ed., release No. 19 May 1998))

²⁰⁶ Mindora, D. Vancea, “Exporting U.S Corporate Governance Standards Through Sarbanes Oxley: Unilateralism or Cooperation?” (2004) 53 *Duke Law Journal* 833 at 835. For discussion of the relevance of Sarbanes Oxley in the Canadian context, see: Ron Davis, “Fox in S-Ox North, A Question of Fit: The Adoption of United States Market Solutions in Canada” (2003-2004) 33 *Stetson Law Review* 955.

including an exemption dealing with the audit committee independence requirement, motivated, among other things, by the desire to regain the listings of foreign companies that were canceled in response to the Act.

With hindsight, the interventions have for many proven to be an unnecessarily costly and burdensome compliance-focused regime. When the SEC estimated the cost of implementing Section 404, its staff economists estimated the total cost at US\$1.24 billion. In reality, the estimated cost of compliance with Section 404 of the Sarbanes Oxley Act is approaching \$35 billion – a cost borne by all companies and their investors and with disproportionate cost implications for smaller companies.²⁰⁷ Another study puts the annual cost of business compliance with governmental regulations at “\$1.1 trillion–more than 10 percent of the GDP.”²⁰⁸

In his comparison of United States equity market share of global initial public offerings over the period 2000 to 2005, Zingales found a dramatic drop that could not be attributed to geographic or sectoral factors, but could be attributed in part to an increase in compliance costs in the United States following the implementation of the Sarbanes-Oxley Act reforms.²⁰⁹ A 2008 research study found that, once the Sarbanes Oxley regime came into force, smaller international companies were more likely to list in the United Kingdom, rather than on United States stock exchanges.²¹⁰

Furthermore, despite its far-reaching scope, the implementation of the Sarbanes-Oxley regime has as yet proven insufficient to close the gap between non-compliance and compliance with the minimum legal standards, and beyond that to create an effective

²⁰⁷ American Electronics Association, “Sarbanes-Oxley Section 404: The ‘Section’ of Unintended Consequences and its Impact on Small Business”, February 2005. Online at: www.aeanet.org/governmentaffairs/AeASOX Paper Final021005.asp.

²⁰⁸ Stephen M R Covey. “The Business Case for Trust” (2007) *Chief Executive* 226: 38–40.

²⁰⁹ Luigi Zingales, “Is the U.S. Capital Market Losing Its Edge?” November, 2006 Working paper Prepared for the Committee on Capital Market Regulation. <http://faculty.chicagobooth.edu/luigi.zingales/papers/competitiveness.pdf>.

²¹⁰ Joseph D. Piotroski and Suraj Srinivasan, “Regulation and Bonding: The Sarbanes–Oxley Act and the Flow of International Listings”, (January 2008). Available at SSRN: <http://ssrn.com/abstract=956987>

bridge to conduct and behaviour necessary for effective, ethical and responsible governance.

Recent studies indicate that many of the specific governance changes and structures dictated by the *Sarbanes Oxley Act* such as the director independence requirement, mandatory board committees, and the separation of the Chief Executive and Chairman roles, have failed to deliver the intended governance improvements such as more effective monitoring.²¹¹

As Tim Bush explains, the paradox of the United States model is that a company incurring expenditure beyond the economic needs of the business may not be defrauding the secondary market on a strict interpretation of the federal laws.²¹² While the market price may reflect this operational efficiency there is nothing technically wrong, despite the fact that shareholders' interests in the efficient use of capital are potentially adversely affected and the practical reality that they cannot generally access the information necessary to initiate steps to address the problem.

In the aftermath of the 2007 – 2009 financial crisis the United States government once again responded with a blue print for extensive legislative intervention in the operation of companies and markets. The *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the Dodd Frank Act) is arguably the most far-reaching package of regulation reforms for the United States financial system since Roosevelt's New Deal.²¹³ The 2,319 pages contain the blue print for 243 rulemakings along with numerous studies and reports

²¹¹ For example, David Erkens, Assistant Professor of Accounting, Mingyi Hung and Pedro Matosteam at the University of Southern California - Marshal School of Business, found that strongly independent directors had a negative impact on the performance of 296 of the world's largest banks, brokerages and insurance companies during the 2007-08 financial crises. David H. Erkens, Mingyi Hung and Pedro P. Matos, "Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide", (September 1, 2010). ECGI - Finance Working Paper No. 249/2009. CELS 2009, 4th Annual Conference on Empirical Legal Studies. Available at SSRN: <http://ssrn.com/abstract=1397685>.

²¹² Tim Bush, *'Divided by Common Language' Where Economics Meets the Law: US Versus Non-US Financial Reporting Models* (Chartered Accountants in England and Wales, 2005). Web published at: http://www.icaew.com/index.cfm/route/115933/icaew_ga/pdf.

²¹³ *The Dodd-Frank Wall Street Reform and Consumer Protection Act* (Pub.L. 111-203, H.R. 4173).

ensuring that it will take years before the reforms aimed at preventing the recurrence of a similar financial crisis in the future are actually in place and operational.

The *Dodd-Frank Act* contains more than 90 provisions that require SEC rule making, and dozens of other provisions that give the SEC discretionary rulemaking authority. The Act specified that the six relevant regulatory agencies have until January 2012 to conduct studies, seek outside commentary and implement the final regulations. However, nearly a year after being signed into law, the top leadership positions in the relevant regulatory agencies were still vacant. Furthermore, as of July 2011, rules for approximately two thirds of the mandatory rulemaking provisions have been proposed or adopted, with the majority of them in the proposal stage and some of the most significant under challenge.²¹⁴

While it is laudable that the legislation allows time for the various agencies to give full consideration to the implications of the various *Dodd Frank Act* provisions that would create new regulatory regimes, including inviting input from stakeholders on the practical effect of these new regimes, the uncertainty as to when and how the implementation will proceed is proving problematic. Furthermore, there are concerns being expressed, including by Democratic Congressman Barney Frank who lent his name to the Act, that delays in implementation are at least in part due to political resistance to the Act's reforms and efforts to limit or postpone its implementation until collective memory of the events that led to its adoption have faded.²¹⁵

A case in point is the *Dodd Frank Act*'s proposed new regulatory regime for over-the-counter trading of derivatives. In June 2011, the SEC announced a delay in the implementation of certain regulations that relate to the over-the-counter derivatives

²¹⁴ United States Securities and Exchange Commission, "Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act" (United States Securities and Exchange Commission). Undated web document. Online at: <http://sec.gov/spotlight/dodd-frank.shtml>.

²¹⁵ Donovan Slack, "Bank Overhaul Battle Pays Off for Republicans", *The Boston Globe*, May 15, 2011. http://www.boston.com/news/nation/articles/2011/05/15/bank_overhaul_battle_pays_off_for_republicans.

market.²¹⁶ Under the *Dodd-Frank Act*, the deadline for laws surrounding security-based swaps was July 16, 2011. Earlier, in May, Commodity Futures Trading Commission (CFTC) Commissioner Jill E. Sommers more specifically identified concerns with the cross-border implications of the Act relating to its failure to address foreign entities and transactions.²¹⁷ Currently, the *Dodd-Frank Act* refers only to US or US-related commerce, and does not provide a mechanism for the SEC to work with foreign regulators in order to supervise entities located outside the United States, thereby creating regulatory uncertainty for entities with global operations. This lacuna gives rise to the potential for regulatory arbitrage, particularly in light of differences between reform proposals and timelines for implementation in other markets such as the European Union.

While the *Dodd Frank Act*'s primary objectives are directed at the financial regulatory framework with greatest impact on the financial services industry, the legislation extends to the federal regulation of matters relating to corporate governance more broadly and for all United States public companies. The Act includes measures relating to shareholder proxy access, 'say on pay' (in particular executive compensation and golden parachute arrangements) and limits on broker discretionary voting that are aimed at fostering more active and more direct shareholder engagement in the oversight of public companies.²¹⁸

Historically, shareholder activism in the United States has tended to independent, rather than collective, efforts and competitive rather than collaborative intervention with ultimate mechanisms of shareholder exit and change of control.²¹⁹ With the advent of

²¹⁶ SEC Provides Guidance and Temporary Relief Regarding Security-Based Swap Provisions of Dodd-Frank Act, 2011-130. <http://sec.gov/news/press/2011/2011-130.htm>

²¹⁷ Statement of Jill E. Sommers, CFTC Commissioner, Before the Subcommittee on General Farm Commodities and Risk Management, House Committee on Agriculture, May 25, 2011, at the hearing on "Harmonizing Global Derivatives Reform: Impact on U.S. Competitiveness and Market Stability." <http://www.cftc.gov/PressRoom/SpeechesTestimony/sommersstatement052511.html>

²¹⁸ Such provisions of the *Dodd Frank Act* include: proxy access at s. 971; limits on broker discretionary voting at s. 957; requirement for periodic shareholder 'say on pay' votes on executive compensation and advisory votes on 'golden parachute' payments at s. 951; and expanded proxy statement disclosure on corporate governance and executive compensation matters at sections 972, 955, 953, s. 165 (risk).

²¹⁹ In contrast to the United Kingdom where the thirty or so largest institutional shareholders' holdings are sufficiently large in many companies to exert influence, in the United States there are thousands of institutional funds that individually own only a fraction of any given company's shares. Rainer Kraakman et al. *The Anatomy of Corporate Law* 2 ed. (Oxford: Oxford University Press, 2009) at 30. For a discussion of the function of institutional investors in mandatory disclosure jurisdictions, see: Merritt B. Fox,

new types of institutional investment in the form of hedge funds and private equity firms, there is increasing potential for divergence of interests among the largest shareholders. In 2009 institutional asset owners, such as life insurers, pension funds, endowments and sovereign wealth funds, held US\$27,000bn globally. At the time of measurement this was less than half the world's professionally managed assets of about US\$65,000bn.²²⁰

Distinct from the historically longer term and stable investment objectives of most life insurance, mutual and pension funds, hedge funds are often associated with taking large highly speculative positions in companies that may seek changes of control for strategic rather than corporate objectives. A recent study by Cheffins and Armour found that private equity firms generally look for short term, majority stake acquisitions specifically to effect changes in corporate management, structure or strategy.²²¹

Further, the restrictions on communication between companies and their investors introduced by *Regulation Fair Disclosure* (Regulation FD) in an attempt to restrict companies from providing important market-moving information to certain investors ahead of general disclosure, has limited the development of ongoing dialogue between companies and shareholders.²²²

Reflecting concerns over the potential for inadvertent violation of Regulation FD with its restrictions on 'selective disclosure' by companies to investors, the Securities and Exchange Commission's Investor Advisory Committee in June 2010 identified that

"safeguarding channels for...dialogue [between shareowners and corporate boards] is especially important in the context of changes to board election

"Required Disclosure and Corporate Governance" (1999) *Law and Contemporary Problems* Vol. 62, No.3: 113.

²²⁰ According to a report by the World Economic Forum and consultancy firm Oliver Wyman "The Future of Long Term Investing", *World Economic Inc. USA*, 2011.

²²¹ Brian R. Cheffins, and John Armour, "The Eclipse of Private Equity" (2008) 33 *Delaware Journal of Corporate Law* 1.

²²² Regulation FD (Fair Disclosure), 17 CFR 243.100-243.103, commonly referred to as Regulation FD is aimed at the practice of selective or private disclosure of material nonpublic information to certain investors, who are then in a position use that information to make decisions to buy or sell stock ahead of other investors and the public. This practice is considered unfair and damaging to the integrity of markets. Online at: <http://www.sec.gov/rules/final/33-7881.htm>.

practices and the spread of advisory votes on executive compensation policies.”²²³

The same month, SEC staff issued interpretive guidance on how boards can pursue dialogue with investors without breaching fair disclosure regulations at the request of the Investor Advisory Committee.

Measures aimed at improving shareholder voice in the governance of companies and widely supported by investor advocates suffered a setback when Rule 14a-11 – the “proxy access” rule – introduced by the SEC to implement the Dodd Frank legislation to allow investors or shareholder groups meeting certain shareholding thresholds to put their own board nominees on proxy statements was rejected by a United States Court of Appeal for the District of Columbia Circuit on July 22, 2011.²²⁴

The legislation and implementing rules are intended to make it easier for shareholders to eject underperforming board members of listed companies. However, the United States Chamber of Commerce and The Business Roundtable, among others, objected to the ‘potential intrusion’ by special interest shareholders into boards’ ability to oversee business activity and what they claimed was a disproportionate cost burden on companies who, under the proposed rules, would have been required to bear much of the cost of proposing alternative nominees to the board of directors. The Court ruled that the SEC acted “arbitrarily and capriciously” in not fully considering the impact on companies, stating,

“The commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.”²²⁵

²²³ SEC Division of Corporate Finance C&DI (101.11) June 2010 makes it clear that Regulation FD does not prohibit directors and shareholders from speaking privately, and suggests actions companies can take to address Regulation FD compliance concerns.

²²⁴ United States Court of Appeal for the District of Columbia Circuit, No. 10-1305 *Business Roundtable and Chamber of commerce of the United States of America v. Securities and Exchange Commission*, July 22, 2011.

²²⁵ *Ibid.* at 7, U.S. Circuit Judge Douglas Ginsburg, United States Court of Appeal for the District of Columbia.

Absent the institutional and social framework for collective institutional shareholder involvement that supports institutional investor engagement in jurisdictions such as the United Kingdom and other European countries, it remains to be seen whether and how shareholder engagement will address collective action problems of the past and the tendency toward more adversarial relations between shareholders and management.²²⁶

5.4 Corporate Governance in Western Europe

The differences between the United Kingdom and United States models of corporate governance derive not only from differences in corporate law, but also from differences in philosophy and approach. By contrast, the greatest distinctions in corporate governance practices among European Union Member States (EU Member States), including the United Kingdom in some respects, appear to stem primarily from differences in the legal and regulatory requirements rather than from differences in the substance of the guidelines and recommendations that emanate from the corporate governance codes.²²⁷

Furthermore, with considerable advancements in the standardization of company law throughout the European Union (including the United Kingdom) in recent years, fewer significant legal differences still remain.²²⁸ That said, fundamental governance principles

²²⁶ Agency theory and agency conflicts have long been dominant influences in United States corporate governance with particular focus on the notion that the primary agency relationships between shareholders and corporate management (and between debt holders and shareholders) are not necessarily aligned and in conflict of interest. Significant and frequently costly measures (agency costs) are often incurred in order to monitor and sustain the effectiveness of the agency relationship in the absence of trust and presumption of self-dealing behaviour by management. See note 476.

²²⁷ European Commission, Internal Markets Directorate General, *Comparative Study Of Corporate Governance Codes Relevant to the European Union And Its Member State on behalf of the European Commission*, 2002. Online at: http://ec.europa.eu/internal_market/company/docs/corpgov/corp-gov-codes-rpt-part1_en.pdf, 8.

²²⁸ There are four distinct legal traditions among the most advanced EU Member States: British, French, German and Scandinavian. For a detailed description of the nature of the different national corporate governance codes and their relationship with the applicable national legislation in the 27 Member State of the European Union see: European Commission, *Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States*, Appendix 1 - Detailed Legal Analysis (European Commission, 23 September 2009. Online at: http://ec.europa.eu/internal_market/company/docs/ecgforum/studies/comply-or-explain-090923-

such as the purpose of financial accounts and the audit to serve shareholders, the ability of shareholders to nominate directors and majority voting are common among corporate statutes of Western European nations, as well as Commonwealth nations that follow the British model.

It has been suggested that the remaining differences are the ones most deeply rooted in national attitudes, culture and legal traditions, and consequently, the most difficult to change.²²⁹

One area where this is evident is in the different approaches among EU Member States to the formal structure of boards of listed companies. For example, the United Kingdom is a unitary board jurisdiction where a single board fulfils the legal requirement to supervise and manage a corporation on behalf of shareholders, either directly or indirectly, by committee pursuant to delegated authority. By contrast, in Germany, Austria and the Netherlands two tier boards comprised of a supervisory and management board are mandatory for domestic companies. While companies in France and Italy may choose between a single tier and two tier board structure by opting into the *Societas Europaea* which permits either board structure.²³⁰

The unitary and two tier boards fulfill similar functions despite structural difference. In the two tier system, the managerial function is formally separate in a board appointed managerial board. In the unitary board the supervisory and managerial function are unified although the latter is effected, from an operational standpoint, by board appointed officers pursuant to delegated authority. In both systems the supervisory role entails the responsibility for ensuring that proper financial reporting and appropriate internal

appendix1_en.pdf http://ec.europa.eu/internal_market/company/docs/ecgforum/studies/comply-or-explain-090923-appendix1_en.pdf

²²⁹ For a discussion of different traditions of share ownership, capital markets within political, legal and cultural contexts see: Mark J. Roe, "Political Determinants of Corporate Governance: Political Context, Corporate Impact", Discussion Paper No. 451, 12/2003 Harvard Law School, Cambridge MA 02138. Available at SSRN: http://papers.ssrn.com/abstract_id=472366. Also see R. La-Porta, F. Lopez-de-Silanes, A. Scchleifer, and R. W. Vishny, "Law and Finance" (1998) 106 *Journal of Political Economy* 1113.

²³⁰ For France see Art. L. 225-57 Code de Commerce. For Italy, see Art. 2409-8 to 2409-15 Civil Code. For the *Societas Europaea*, see Art 38 Council Regulations (EC) No 2157/2001 of 8 October 2001, 2001 O.J. (L294).1. A similar choice exists in Austria, but deviation from the traditional two tier structure is rare.

controls are in place and in compliance with the law. The supervisory responsibilities, in either board structure also include the hiring of executive officers and for monitoring and ratifying the decisions of management.²³¹

It is interesting to note that the EU Member State corporate governance code provisions regarding best practice as to board and committee composition and structure, the critical roles and responsibilities of the supervisory body, director independence and separation of the chair and chief executive roles underlines the functional, if not formal, distinction and importance associated with the two board functions. There is other evidence of this kind of functional convergence among EU Member States governance practices that can be attributed to the evolution of corporate governance codes and the internal market across the European Union.²³²

The role and right of representation of employees in corporate governance among some EU Member States is another area of fundamental legal difference. Employees of companies of a certain size in Austria, Denmark, Germany, Luxembourg and Sweden have the legal right to elect representatives for membership on the supervisory body. In Finland and France, the law provides that companies may provide employees the right of representation on supervisory boards.

This right to employee representation creates a difference in the governance dynamic in these EU Member States as compared to jurisdictions where shareholders have the

²³¹ Rainer Kraakman et al. *The Anatomy of Corporate Law* 2 ed. (Oxford: Oxford University Press, 2009) at 3.

²³² Ronald J. Gilson in “Globalizing Corporate Governance: A Convergence of Form or Function” (2001) 49 *American Journal of Comparative Law* 329 identified functional convergence as an intermediate position whereby similar outcomes are reached via different formal rules. John C. Coffee, in “Privatization and Corporate Governance: Lessons from Securities Market Failures” (1999) 25 *The Journal of Corporate Law*, No. 1 proposed that functional convergence may be more significant than formal convergence following his observation of systems with similar legal origins developing different ways to deal with problems. There are numerous articles addressing the topic of governance convergence, generally. These include the following selection of writings on the topic. Lucian A. Bebchuk and Mark J. Roe, “A Theory of Path Dependence in Corporate Ownership and Governance” (1999) 52 *Stanford Law Review* 127; William M. Bratton and Joseph A. McCahery, “Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference” (1999) 38 *Columbia Journal of Transnational Law* 213; John C. Coffee, “The Future As History: The Prospects for Global Convergence in Corporate Governance and its Significance” (1999) 93 *Northwestern University Law Review* 641.

exclusive right to elect members of the supervisory body, and therefore undiluted influence over the composition of the supervisory body – the unitary board and the supervisory board in the two tier structure.

Historically, there has been considerable variance among EU Member States in the legal and regulatory approach to shareholder rights including the treatment of minority shareholders in the event of takeovers and transactions controlled by dominant shareholders. Shareholders participation, proxy access and rules relating to the conduct of annual general and special meetings of shareholders also vary in law. Many of these differences stem from traditionally different patterns of shareholding.

In EU Member States with dispersed shareholding, such as the United Kingdom and Ireland, the main issue in respect of protecting shareholders' interests is the objective supervision and monitoring of management.²³³ In EU Member States that have a tradition of dominant or controlling shareholders such as Austria, Belgium, Germany and Italy, the issues concerning the protection of shareholders' interests involve ensuring that minority shareholders are treated fairly and their interests are not adversely affected by such dominant or controlling shareholders' disproportionate influence over board supervision and monitoring of management.²³⁴

In France, the state has considerable influence over how many of the country's top corporations are governed as a result of extensive direct and indirect shareholdings in important sectors such as defence, energy, transportation, banking and insurance.²³⁵

²³³ Companies with dispersed ownership are now more common in other European countries, but still the minority.

²³⁴ In general terms, dispersed ownership creates managerial incentives to manipulate income, while concentrated ownership invites the low-visibility extraction of private benefits. For a survey of the influence of different patterns of corporate ownership, see: R. La Porta, F. Lopez-de-Silanes, A. Schleifer, "Corporate Ownership Around the World" (1999) *Journal of Finance* 54: 471-517. See also: Mark J. Roe, "Political Determinants of Corporate Governance: Political Context, Corporate Impact", Discussion Paper No. 451, 12/2003 Harvard Law School, Cambridge MA 02138. Available at SSRN: http://papers.ssrn.com/abstract_id=472366.

²³⁵ The French state shareholdings include: AIR France-KLM, Electricite de France, France Telecom, GDF Suez, Renault and Thales as well as EADS (the European Aeronautic Defence and Space Company) through holding company Sogade and AXA through its main investor BNP in which the state is a majority

While this political influence has allowed for advances such as the New Economic Regulation (*Nouvelles Regulation Economique*) that introduced, among other things, mandatory disclosure of non-financial information, it has also been associated with frequent corruption allegations involving France's companies and politicians attributed to the challenges of monitoring and oversight of companies with dominant State controlling interests.

However, notwithstanding the formal legal differences, in practice, there is commonality among the corporate governance codes of EU Member States in terms of general best practice expectations for equitable treatment of shareholders, regardless of ownership stake, and for transparency where disproportionate shareholder rights exist.

At the supra-national level of the European Union, the corporate governance framework for European listed companies is a combination of legislation and 'soft law'. As in the United Kingdom, the European Commission has taken a primarily principles based approach to corporate governance, combining a limited number of core rules with the greater flexibility of recommendations that companies may choose to follow and shareholders may choose to enforce.

To date, the European Union does not have a uniform corporate governance code for EU Member States. This reflects the European Commission's current position that governance codes are properly within the jurisdiction of EU Member States and, beyond that, the requirements of the securities marketplace. In its 2003 'Action Plan for Corporate Law and Governance', the European Commission stated that far-reaching harmonisation of corporate law or governance codes was neither possible nor desirable within the foreseeable future.²³⁶ Instead, its stated expectation was that all EU Member

shareholder. Source: Stephen Gardner and Boris Peters, "State of Affairs, Country Briefing: France", *Ethical Corporation*, March 2011.

²³⁶ European Commission, *Communication from the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward*, COM (2003) 284, Brussels, 21.5.2003 at p. 4 and 11. Online at: http://www.ecgi.org/commission/documents/com2003_0284en01.pdf

States would introduce national corporate governance codes, if they had not already done so, based on their own legislation and other conditions.

The Commission also decided that harmonization would be limited to certain key issues within corporate governance. Since then, the Commission has issued a significant number of recommendations and directives concerning corporate governance, many of which have been implemented in the EU Member States through legislation.²³⁷

By 2007, all 27 EU Member States had issued corporate governance codes modeled on the principles based ‘comply or explain’ approach pioneered in the United Kingdom.²³⁸ With the exception of the United Kingdom which introduced the first of its corporate governance codes in 1992, the majority of European corporate governance codes were issued after 1997. From 1998 through 1999, corporate governance codes were issued in

²³⁷ EU measures in the area of corporate governance include: the takeover directive (Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, OJ L 142, 30.4.2004, p. 12-23); the transparency directive (Directive 2004/109/EC of the European Parliament and of the Council of 15 December, 2004 on the harmonization of transparency requirements in relation to information about issuers whose securities are issued to trading on a regulated market and amending Directive 2001/34/EC, OJ L 390, 31.12.2004, p. 38-57); the reporting and disclosure directive (Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts on banks and other financial institutions and 91/674/EEC on annual accounts and consolidated accounts of insurance undertakings, OJ L 224, 16.8.2006, p. 1-7); the shareholders’ rights directive (Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14.7.2007, p. 17-24); the market abuse directive (Directive 2003/6/EC); the audit directive (Directive 2006/43/EC); Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC) OJ L 385, 29.12.2004, p. 55-59; Commission Recommendation of 30 April 2009 complementing Recommendation 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (2009/385/EC), OJ L 120,, 15.5.2009, p. 28-31.

²³⁸ For a comprehensive listing of corporate governance codes, including those of EU Member States, see: www.ecgi.org/codes/all_codes.php.

eight of the original fifteen EU Member States.²³⁹ Codes appeared in the remaining six original EU Member States between the years 2000 and 2006.²⁴⁰

It is worth noting that the timing of this proliferation of codes across the European Union coincides with the report by the OECD Business Sector Advisory Group on Corporate Governance, “Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets” (the *Millstein Report*), and the ensuing publication of the OECD *Principles of Corporate Governance* in 1999.²⁴¹

The approaches to corporate governance across the original Member States of the European Union have distinct origins in the diverse national cultures, financing models, ownership structures and legal systems.²⁴² As such, there is potential for significant variation. However, despite obvious differences in the terms of the content, legal status, and origin of the codes, as well as the techniques used for their implementation, the national codes of governance express a relatively common view of the importance of good governance and how to achieve it.²⁴³

The EU Member State codes are remarkably similar in terms of the principles and standards for good and responsible governance. A majority of them contain express

²³⁹ Belgium: Corporate Governance for Belgian Listed Companies (the Cardon Report) 1998. France: Recommendations for Corporate Governance June 1998 (following the 1995 Vienot I Report). Greece: Principles of Corporate Governance in Greece, 1999. Ireland: Corporate Governance, Share Options and Other Incentive Schemes, 1999. Italy: Report and Code of Conduct (The Preda Code) 1999. Netherlands: Peters Report and Recommendations, 1997. Portugal: Recommendations on Corporate Governance, 1999. Spain: Code of Good Governance (*Codigo Buen Gobierno*) 1998. All online at: www.ecgi.org/codes/all_codes.php.

²⁴⁰ Austria: Austrian Code of Corporate Governance, 2002. Denmark: Guidelines on Good Management of a Listed Company (Corporate Governance) 2000. Finland: Corporate Governance Recommendations for Listed Companies, 2003. Germany: Corporate Governance Rules for German quoted Companies, January 2000. Sweden: Corporate Governance Policy, 2001. All online at: www.ecgi.org/codes/all_codes.php.

²⁴¹ OECD Business Sector Advisory Group, *Report to the OECD on Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets* (OECD, April 1998). *OECD Principles of Corporate Governance* (OECD, 1999). Online at: www.oecd.org.

²⁴² The 27 EU Member State corporate governance codes, in common, comprise guidelines for listed companies that address board structure, composition and operation and are drafted by market participants pursuant to the authority of an exchange or regulator.

²⁴³ European Commission, Internal Markets Directorate General, *Comparative Study Of Corporate Governance Codes Relevant to the European Union And Its Member State on behalf of the European Commission* (2002) 8. Online at: http://ec.europa.eu/internal_market/company/docs/corpgov/corp-gov-codes-rpt-part1_en.pdf.

recognition of the interconnectedness and interdependency between corporate success, sustainable profitability and respect for the interests of internal and external stakeholders.²⁴⁴ In general, they reflect a continued push for greater transparency through disclosure on all aspects of corporate governance particularly executive and director compensation, and director independence that signifies a degree of functional, if not formal, convergence.

There is differentiation among the EU Member States in respect of the extent to which they are tailored to different sizes, structure and types of listed companies. For example France has a specific corporate governance code for small and medium sized listed companies, *Code de gouvernement d'entreprise pour les valeurs moyennes et petites*, while the United Kingdom's corporate governance code contains provisions adapted for smaller and medium sized companies. Currently, the European Union's corporate governance framework makes no distinction between types and sizes of companies.²⁴⁵ *European Commission Directive 2006/46/EC* on company reporting promotes the use of corporate governance codes through the requirement for listed companies in the European Union to refer to a governance code in their mandatory corporate governance statement and to report on the code application on a 'comply or explain' basis.

Since 2009, listed companies in the European Union are required to publish annually a statement of corporate governance that refers to the applicable EU Member State code, discloses whether and the extent to which the company is complying with the provisions of that code and provides explanations for departures.²⁴⁶

²⁴⁴ See for example: *UK Corporate Governance Code, 2010* and the Danish Corporate Governance Code – *Recommendations on Corporate Governance*, Committee on Corporate Governance, August 2011.

²⁴⁵ The Commission's consultation on corporate governance pursuant to the May 4, 2011 Green Paper raises the question as to whether the European Union should have a differentiated approach and how best to deal with diversity of companies and avoid the deficiencies of the one-size-fits-all approach witnessed in other jurisdictions. European Commission Green Paper, *The EU corporate governance framework*, COM (2011) 164 (Brussels 5.4.2011) at 5.

²⁴⁶ Article 46a(1) Fourth Company Law Directive - Council Directive 78/660/EEC on the annual accounts of certain types of companies as amended by, amongst other instruments, Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts on banks and other financial institutions and 91/674/EEC on annual accounts and consolidated accounts of insurance undertakings, OJ L 224, 16.8.2006, p. 1-7.

As in the United Kingdom, the ‘comply or explain’ device in other European corporate governance codes enlists the forces of reputation, shareholder voice, coercive and market pressure rather than rigid rules and prescription to encourage companies to adopt or adapt governance ‘best practices’.²⁴⁷

Studies of reported compliance have shown that the effectiveness of the ‘comply or explain’ approach in Europe, as elsewhere, depends on the substantive quality rather than the formality of compliance.²⁴⁸ Companies may self-report compliance when in fact they have adopted strategies to comply with the letter but not the spirit of the provision, resulting in overly mechanical “box-ticking” exercises, or deviate from the letter of the code provisions.²⁴⁹ These findings illustrate the moral hazard that exists where corporate decision makers determine that the risk of public or private enforcement and any consequential costs, economic penalties and reputational damage are outweighed by the perceived advantages of non-compliance. This is not to suggest that the ‘comply or explain’ or variations thereof are ineffective, but rather to illustrate the necessary role of normative and informal standards of best practice in influencing decision makers in their choices.

²⁴⁷ The investment community wields significant economic power, and competition for investment capital can lead companies to follow a ‘comply rather than explain’ approach, perceiving it to be less risky. Thus, although the use of non-binding codes is intended to avoid the rigidity of the one-size-fits-all approach, this latter can result where market participants in practice prefer standardization notwithstanding that more bespoke solutions suited to companies’ individual circumstances better serve shareholder interests. See: Gerard Hertig, “On-Going Board Reform: One Size fits All and Regulatory Capture” (2005) 21 *Oxford Review of Economic Policy* 269: 273-4.

²⁴⁸ Regarding compliance in France, see: AMF, *AMF 2008 Report on Corporate Governance and Internal Control* (2009) at <http://www.amf-france.org>. For Italy and Germany, see: Eddy Wymeersch, “The Corporate Governance ‘Codes of Conduct’ Between States and Private Law” (2007) 26-7. Available at SSRN: <http://www.ssrn.com>.

²⁴⁹ The Italian company, Parmalat is a case in point where the corporate governance statement declared (among other things) its full compliance with the Italian corporate governance code principle requiring ‘an adequate number’ of independent directors. Of the 13 directors, 3 were claimed to be independent but turned out to be related to, respectively, the dominant shareholder and CEO, the CEO and the company. See: Guido Ferrarini and Paolo Giudici, “Financial Scandals and the Role of Private Enforcement: The Parmalat Case”, in Armour, J., and Joseph A. McCahery (eds.) *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Oxford: Hart Publishing, 2006) 159, 174. For another detailed review of the Parmalat scandal, see Andrea Melis, “Corporate Governance Failures. To What Extent is Parmalat a Particularly Italian Case?” (September 30, 2004). Available at SSRN: <http://ssrn.com/abstract=563223>.

For the European Union, the 2007 – 2009 upheaval in global financial markets served as a catalyst not only for immediate response and crisis intervention, but in time for more studied examination of the effectiveness of the European Union corporate governance framework, just as it did in the United Kingdom, the United States and jurisdictions around the globe.

The European Commission announced in March, 2009 a programme for reforming the regulatory and supervisory framework for financial markets with corporate governance at its heart.²⁵⁰ The programme, based on the conclusions of the *Report of the High-Level Group on Financial Supervision in the EU* published on 25 February 2009 (*The de Larosière Report*), had two primary mandates to: examine corporate governance rules and practice within financial institutions, particularly banks, in the light of the financial crisis; and, make recommendations, or propose regulatory measures, as appropriate to correct deficiencies in the financial market corporate governance system.²⁵¹

The Commission's subsequent Green Paper 'Corporate Governance in Financial Institutions and Remuneration Policy' canvasses solutions to identified governance deficiencies in financial institutions and broadens the review of corporate governance to listed companies.²⁵²

“The Commission considers that an effective corporate governance system, achieved through control mechanisms and checks, should lead to the main stakeholders in financial institutions (boards of directors, shareholders, senior management, etc.) assuming a higher degree of responsibility.”²⁵³

In May 2011, the European Commission issued its Green Paper on corporate governance, *The EU corporate governance framework* (the May 2011 consultation). The

²⁵⁰ COM (2009) 114 final.

²⁵¹ The High-Level Group on Financial Supervision in the EU, Report (Brussels, February 2009) (“*The de Larosière Report*”). http://ec.europa.eu/internal_market/finances/.../de_larosiere_report_en.pdf
Jacques de Larosière chaired the High Level Group and as a consequence the report generally came to be referred to as *The de Larosière Report*.

²⁵² COM (2010) 284 (Brussels 2.6.2010.)

²⁵³ European Commission, Green Paper: *Corporate governance in financial institutions and remuneration policies* COM(2010) 284 (Brussels, 2.6.2010) {COM(2010) 285 final} {COM(2010) 286 final} {SEC(2010) 669} 6

consultation's stated purpose is to assess the effectiveness of the current corporate governance framework for European companies.

Part of a longer term review of corporate governance, the assessment is informed by the unfolding lessons of the financial crisis, such as the prevalence and damaging consequences of short-termism, excessive risk-taking, and activities associated with unsustainable growth activities, and the apparent limitations of self-regulation to curb such behaviour.²⁵⁴

At its launch, Internal Market and Services Commissioner Michel Barnier stated that:

“In the current economic situation, we need more than ever to ensure that companies are well governed and consequently reliable and sustainable. Too much short term thinking has had disastrous consequences ... we need company boards to be more effective and shareholders to fully assume their responsibilities.”²⁵⁵

The May 2011 consultation has wider application than the consultation pursuant to the ‘Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies’ published in June 2010.²⁵⁶ While both address governance fundamentals of general application, the June 2010 consultation particularly considered solutions reflective of the specific challenges associated with the issues of systemic risk in the financial system, while the May 2011 consultation looks at the corporate governance of companies at large.

The May 2011 consultation highlights a number of issues for particular attention. One of these areas concerns the effective functioning and appropriate composition of boards of directors. The consultation document indicates that the Commission has a specific interest in, and desire to bring attention to, the need to encourage greater board diversity in respect of gender, professional background and experience, and nationality. It moots

²⁵⁴ European Commission, Green Paper: *The EU corporate governance framework*, COM (2011) 164 (Brussels 5.4.2011).

²⁵⁵ EUROPA Press release: “Corporate governance framework for European companies: what needs to be improved?”, (Strasbourg 5.4.2011) <http://www.europa.eu>

²⁵⁶ European Commission, Green Paper: *Corporate governance in financial institutions and remuneration policies* COM (2010) 284 (Brussels, 2.6.2010)

the possibility of board composition quotas or targets, as well as a more enabling measures such as requiring enhanced disclosure on board diversity issues. Both types of approaches have already been pursued in a number of EU Member States.²⁵⁷

The Commission's position is that for boards to be effective, they must be comprised of members who, individually and collectively, are capable and willing to enter into constructive debate with management and where necessary to challenge management decisions. The consultation paper cites numerous studies that suggest that more diversity on boards yield more diverse views, greater debate and more willingness to ask questions of management.²⁵⁸

A second area addresses the role of shareholders in ensuring effective and responsible governance in the companies in which they invest. For the purposes of the consultation, shareholder engagement is understood as activity, primarily of long-term investors, aimed at improving the governance of companies in the interest of long term value creation.²⁵⁹ Such activities include: the active monitoring of companies' conduct and performance, engagement in dialogue with company boards, and the exercise of shareholder rights such as voting, cooperation with other shareholders and exit.²⁶⁰

²⁵⁷ See: Chapter 10, section 3 – Enabling Change Through Governance Disclosure.

²⁵⁸ Cited reports and studies include: 'Enhancing Stakeholder Diversity in the Board Room', 'The Erfurt meetings' series, No 1, March 2008, European Citizens' Seminars e.V. (Erfurt, Germany) publishers. Women Matter, McKinsey and Company, 2008. Adams and Ferreira, "Women in the boardroom and their impact on governance and financial performance", *Journal of Financial Economics* 94 (2009). Wooley, Chabris, Pentland, Hasmi and Malone, 'Evidence for a Collective Intelligence Factor in the Performance of Human Groups', *Scienceexpress*, 30 September 2010. *Female Leadership and Firm Profitability*, Finnish Business and Policy Forum – EVA 2007. *The Bottom Line: Connecting Corporate Performance and Gender Diversity*, Catalyst, 2004.

²⁵⁹ The consultation paper does recognize that engagement by institutional investors with typically short-term oriented investment objectives, such as activist hedge funds, can be beneficial to corporate governance in that they can serve as catalysts for change and increased awareness among other shareholders. European Commission, Green Paper, *The EU corporate governance framework*, COM (2011) 164, (Brussels 5.4.2011) at 11, note 46.

²⁶⁰ The Commission has acknowledged that there is legal uncertainty associated with European acting in concert rules that include: different definitions of acting in concert in the Transparency Directive (Directive 2004/109/EC, TD), Takeover Bids Directive (Directive 2004/24/EC, TBD) and (Level 3 guidance to the Acquisitions Directive; differences in interpretation of the definitions by national competent authorities; uncertainty about the scope of the rules, for instance on when cooperation between shareholders should be regarded as a 'lasting common policy' (TD), when a (tacit or oral) agreement between shareholders should be regarded to be aimed at acquiring control of the company or frustrating the successful outcome of a bid (TBD) and whether an understanding in good faith between shareholders solely aimed at exerting influence

The consultation requests feedback on matters such as: the need for more active shareholder involvement on matters of corporate governance, including the protection of minority interests; changes to existing EU law on acting in concert to facilitate effective shareholder cooperation; mechanisms for better engagement with companies; concern over the role of proxy advisory firms and increasing shareholder dependence on these as yet unregulated actors; and the need to engender a more long term sustainable approach to corporate and investment performance.²⁶¹

The third area relates to improving the monitoring and enforcement of the provisions of EU Member State corporate governance codes in order to ensure that companies' corporate governance statements required pursuant to Directive 2006/46/EC convey accurate, complete and meaningful information to investors, regulators and the public. This issue arises from evidence suggesting that governance reporting pursuant to the 'comply or explain' model is unsatisfactory, both in terms of the quality of disclosure and effective monitoring by oversight bodies.²⁶²

In respect of all these areas, actions that may be taken at the European Union level include the possibility of legislative proposals that would complement corporate governance frameworks and actions taken at the national level.

If the Commission were to respond with formal legislative proposals, rather than recommendations, it would represent a shift in the Commission's current balance between legislative and soft law approaches to corporate governance. It would also

intended to promote generally accepted principles of good corporate governance constitutes acting in concert (Acquisitions Directive).

²⁶¹ The May 2011 Green Paper notes that the turnover rate on major equity exchanges is 150% per year if aggregate market capitalization indicating a decline in holding periods of shares over the last decades to an average holding period of shares of eight months. COM(2011) 164 at 12. The holding period was derived from data on share turnover sourced from the World Federation of Exchanges: www.world-exchanges.org.

²⁶² See the study on Monitoring and Enforcement Practices in Corporate Governance in the Member States, http://ec.europa.eu/internal_market/company/ecgforum/studies_en.htm. The study's objectives were to describe the relationship, in the 27 Member States, between legislation and "soft" law (codes) in corporate governance; to examine the existing monitoring and enforcement mechanisms in the Member States as far as corporate governance codes are concerned and to evaluate their effectiveness; to obtain an impression of the companies' perception of the codes; and to evaluate the perception of shareholders as to the quality of companies' disclosure on the application of corporate governance principles and of explanations given where the company declares not to comply, and of their reactions to disclosure perceived as insufficient.

signify a further step toward achieving formal harmonization of EU Member State corporate governance at the European Union level and a move away from the previous position to achieve functional harmonization while respecting the different national regimes.²⁶³

5.5 Beyond the ‘Either/Or’ Paradigm of Corporate Governance

The preceding discussion, at first glance, might appear to suggest that neither systems heavily based on prescriptive rules such as the United States, nor ones like the United Kingdom that are founded on explicit statements of principle reinforced by a limited number of rules, are adequate to direct the conduct and governance of corporate and other business enterprises – the actors that animate them, and the markets in which they trade – in a highly competitive, technologically–empowered, global marketplace.²⁶⁴

Closer consideration reveals a reality and a future for the governance of corporations and governance practices more broadly that will entail few, if any, clear cut answers or straightforward choices between one governance system and another. As will be explored in Part 3, this is partly a function of the evolution of business and its influence in contemporary society, partly of changes in political and social structures, both magnified with the advent of modern globalization.

The preceding overviews of UK, US and European governance regimes highlight the simple fact that similar goals can be pursued by different means. With this fact in mind, it is easier to perceive the differences between approaches and the institutional legacies of alternative regulatory paths as having at least as much to offer in terms of alternative perspectives and complementary goals and strengths as for arguing fundamental

²⁶³ Any such Commission measures would necessarily follow a careful examination of responses to the consultation and entail thorough impact analysis before being issued as a legislative Directive for implementation by Member States, or a Commission recommendation.

²⁶⁴ Certainly, consideration of the United States, United Kingdom and European Union responses to the recent financial crisis and the coordination of interventionist measures agreed by the governments of developed economies around the globe under the auspices of the G8/G20 suggest widespread systemic deficiencies.

incompatibilities, or comparative weaknesses. As such, there is a case for engaging constructively rather than choosing between them in the shared pursuit of accountable, ethical, and effective governance.

Furthermore, in the light of recent past events that highlighted the extent to which previously distinct governance regimes or systems are now even more profoundly and irreversibly interdependent, there is more evidence to support the proposition that for such engagement to be effective the governance discourse needs to transcend the limitations of institutional and political boundaries. That is, to take place within a conceptual framework – a meta-framework for governance discourse – that is broad enough to encompass the different governance regimes, systems and sub-systems and the dynamic interactions between them and yet provides a common point of reference by reflecting and reinforcing the fundamental shared values and public policy objectives that establish the foundations of good governance.

Part Three – The Corporate Structure: Challenging Conventional Boundaries

6. Legal Limits and Moral Boundaries: the Corporate Challenge to Formal and Normative Conventions

I believe that principle should be the point of departure for all activities that we should do right because it is right and not because economic interest or the law compels it. If we make this issue solely of law and not of morality we will never win.

Sir Geoffrey Chandler²⁶⁵

6.1 The Root of the Problem

Whatever the inadequacies and failures of laws and norms to curb the circumstances of abuse, excess and misconduct arising in the course, or as a consequence, of business activity, regulation whether formal or informal is not the root cause of the problem.

That distinction rests with the existence of an entity for conducting business that effects a separation between the benefits of business activity – the rights and entitlements of shareholding – and the responsibility for the consequences that such activity may cause.

The limited liability company, as it has evolved into the modern corporate form, remains the primary vehicle through which business is conducted in developed capitalist economies.²⁶⁶ With its characteristic attributes of separate legal personality, transferable shares, centralized management pursuant to delegated board authority, and investor ownership it has translated across geographic, cultural and economic boundaries as the growth of stock markets in developing and former socialist economies attests.²⁶⁷

²⁶⁵ Sir Geoffrey Chandler, “Business and Human Rights – A Personal Account from the Front Line” *Ethical Corporation*, February 11, 2008.

²⁶⁶ Other forms of business organization such as limited partnerships, partnerships, trusts, co-ownerships, and joint ventures are common. In general terms, they do not offer the advantages associated with the corporation’s separate legal existence from its owners although each of these other forms has particular attributes that may make them the vehicle of choice according to individual circumstances such as for example tax treatment.

²⁶⁷ R. Kraakman et al., *The Anatomy of Corporate Law* 2 ed. (Oxford: Oxford University Press, 2009).

Due to the enduring success of the corporate structure throughout modern history, the corporation has evolved beyond a legal construct for conducting business. Its influence has transcended the business sphere to the extent that corporate entities now wield considerable socio political power. The largest corporations rival or dominate many political economies in financial terms.²⁶⁸ These factors pose numerous challenges to the traditional normative and formal mechanisms for establishing and maintaining standards of acceptable conduct and achieving effective restraints on unreasonable behaviour.

There are the inherent limits stemming from the construct of the corporation as a “person” in law. Having been granted the status of person under the law, the corporation is free to enjoy all the rights and freedoms of a natural person. Natural persons, however, enjoy those rights and freedoms subject not only to limits established by law, but also the self-constraints of conscience, ethics, moral responsibility and voluntary adherence to boundaries established through societal and institutional norms over and above any described in law.²⁶⁹ As Selznick explains, “[I]n etymology and social theory *person* suggests particularity, coherence and responsibility. The Latin and Greek terms (*persona* and *prosopon*) refer to the masks used in classical drama” that associate the character with the role and expectations assigned to it in the proper order of things.²⁷⁰

In contrast, the activities of corporations are potentially limited only by the baseline standards and boundaries established in law, and the moderating force of market based

²⁶⁸ Based on 2010 figures: the combined sales of the top 5 oil and gas companies (Royal Dutch Shell, Exxon, BP, Chevron, Conoco Phillips) are approximately USD\$1.725 trillion, larger than Canada’s US\$1.574 trillion GDP; the combined sales of the top 5 automobile companies (Toyota, Ford, Daimler, VW, GM) are approximately US\$783 billion, larger than the GDP of the Netherlands, the world’s 18th largest economy; and the combined sales of the top 5 technology companies (Microsoft, Dell, Sony, HP, IBM) are in the region of US\$463 billion, approximately the same as Saudi Arabia’s GDP, the 23rd largest economy. Calculations based on the Forbes list of companies, and GDP estimates from the IMF.

²⁶⁹ There is an extensive body of work in this area, including for example: John Dewey, *Human Nature and Conduct: An Introduction to Social Psychology* (Cosimo Inc., 2007) first published in 1922; L. Kohlberg, *Essays on Moral Development, Vol. I: The Philosophy of Moral Development* (San Francisco, CA: Harper & Row, 1981); W.M. Kurtines and J.L. Gewirts (eds.) *Morality, Moral Behaviour and Moral Development* (New York: Wiley, 1984); A. MacIntyre, *After Virtue* 2d. (Notre Dame, IN: Notre Dame University Press, 2003); Elliott Sober and David Sloane Wilson, *Unto Others: The Evolution and Psychology of Unselfish Behaviour* (Harvard UP, 1999).

²⁷⁰ Philip Selznick, “Personhood and Moral Obligation” in A. Etzioni (ed.) *New Communitarian Thinking* (University Press of Virginia, 1995) 110.

competition. This is because, despite the legal fiction that bestows personhood on the corporation, it possesses none of the innate human capacity for compassion, empathy, reason or self-restraint²⁷¹ that are preconditions to conscience, moral consciousness, shame and autonomous decision making that are the bases for ethical conduct.

The potential risks of this condition were recognized from the earliest inception of capitalist theory. As stated succinctly nearly four hundred years ago by Sir Edward Coke in the *Case of Sutton's Hospital* (1612), 10 Rep. 32, 77 ER 960 at 973, corporations have no souls. Yet, Adam Smith, in his 1776 treatise on the capital markets, identified morality as one of three essential constraints on corporate entities along with market forces and jurisprudence to limit otherwise unchecked self interest in deference to the welfare of society.²⁷²

That is because Smith recognized that, no matter its legal form, the corporate entity relies on human agency for its substantive existence and physical activity. It is to these human actors, individually and collectively, that Smith looks to as the potential source of good judgment, moral conscience, and probity necessary to curb corporate power.

Smith's approach in the *Theory of Moral Sentiments* establishes a model form of conduct for the betterment of society and examines the role of social institutions to encourage and foster that conduct. This prescription is modest – Smith believed a decent and prospering commerce based society depends on institutions that foster in individuals: prudence; self-restraint; respect for life and property; concern for the good opinion of respected peers; and, among sufficient of its members, an ability to grasp the implications and consequences of action (individual and collective) on others and, in so doing, to respect and understand the necessity of limits to ensure freedoms.

²⁷¹ Joel Bakan, *The Corporation: The Pathological Pursuit of Profit and Power* (New York: Free Press, Simon and Schuster, 2004); Christopher D. Stone, *Where the Law Ends: The Social Control of Corporate Behaviour*, 1975 (Waveland Press Inc. 1991) 35

²⁷² A. Smith *Theory of Moral Sentiments*, Robert L Heilbroner (ed.) *The Essential Adam Smith*, 3d (New York: WW Norton & Company, 1987) 107-08.

He identifies this capacity to appreciate implications and consequences of actions on others as moral sympathy – the idea of seeing oneself in others, appreciating one’s own interests as fundamentally intertwined and reflected in the interests other members of society – a sense of community and shared humanity. In Chapter III – Of the Influence and Authority of Conscience, *Theory Of Moral Sentiments* he asserts that:

There is no commonly honest man who does not ... inwardly feel the truth of that great stoical maxim, that for one man to deprive another unjustly of any great thing, or unjustly promote his own advantage by the loss or disadvantage of another, is more contrary to nature than death, than poverty, than pain, than all the misfortunes which can affect him, either in his body or in his own external circumstances.²⁷³

Most in Smith’s time could not ‘afford’ to gain a reputation for untrustworthiness (a man’s word and his honour were his measure), nor to be blacklisted, shamed or cast out for behaving unethically, opportunistically, willfully disregarding others because of dependence on the community and the social networks emanating from it.

The web of commercial interactions, the resulting economic and social benefits of the marketplace led to the institutionalization of the market’s influence on and within society, alongside the family, religious institutions, communities, and the law. And like those other social institutions, it became a source of learning both of the freedoms and opportunities and the necessary limitations and restraints on the individual that enable fair and effective marketplaces. Thus, far from fostering the unfettered pursuit of self-interest, the market in Smith’s conception operates as an integral part of the network of institutions that promote social order and the public good that flows from it.

The social and commercial bonds of, relatively speaking, closer, more geographically and culturally proximate communities of past centuries meant that any individual’s self-interest was inextricably bound up in the collective interests of the community. For in those times it was the community that every member depended upon, for their identity,

²⁷³ A. Smith, *Theory of Moral Sentiments*, Robert L. Heilbroner (ed.) *The Essential Adam Smith*, 3d (New York: WW Norton & Company, 1987) 107-08.

individual and collective security as well as for their livelihoods – essentially their very existence. As Smith suggests:

[I]f we examine, I say, all these things and consider what a variety of labour is employed about each of them, we shall be sensitive that without the assistance and cooperative of many thousands the very meanest person in a civilized country could not be produced, even according to what we falsely imagine the easy and simple manner in which he is commonly accommodated.²⁷⁴

However, when the social bonds are stretched and broken by distance – cultural, spatial and temporal – as in our contemporary digitalized, globalized, pluralistic and peripatetic world, the influences that would historically restrain individuals from acting contrary to community-based norms weaken. The advent of electronic communication technologies have served to further distance individuals from their immediate physical surroundings and provided a platform for unlimited virtual interactions without the constraints of context, consequence and identity.

Interestingly, the more compelling of the corporate codes in the sample studied explicitly invoke community-based norms, requiring employees to ask themselves questions such as: [H]ow would you explain your decision to your family or in public?²⁷⁵; [W]ould my colleagues or manager consider my behaviour appropriate?²⁷⁶; and [I]f the story appeared in the paper, would I feel comfortable with the decision?²⁷⁷

At the time of writing *Wealth of Nations*, morality or the moral fascia of ‘oughtness’ connected members of a far less diverse community than today – as such there was no need to articulate explicitly what was embedded and assumed to be held in common by members of that community.

In *On Value and Values*, Douglas Smith explains values as the reflection of the way we do things, act, speak and behave many of which are internalized through custom without

²⁷⁴ A. Smith, *The Wealth of Nations*, Robert L. Heilbroner (ed.) *The Essential Adam Smith*, 3d. (New York: WW Norton & Company, 1987) I.i.11.

²⁷⁵ BT plc, ‘*The Way We Work*’ *Statement of Business Practice*. Online at: www.bt.com

²⁷⁶ ANZ, *Code of Conduct and Ethics*. Online at: www.anz.com

²⁷⁷ BHP Billiton, ‘*Working With Integrity*’: *Code of Business Conduct*. Online at: www.bhpbilliton.com

any conscious engagement or explanation as to why things are as they are or indeed how they ought to be. However, when it cannot be assumed that certain values are shared – as is the case today with so many of the traditional values frameworks being eroded or subsumed and with the accommodation of many different cultural backgrounds – the building of shared understanding and widespread observance of principles of right and wrong is nearly impossible without conscious and explicit explanation. Consequently, Smith contends that in terms of engaging with values, exhortations work well in the absence of explanation as long as it calls upon values already shared, but are less effective when such shared values do not exist.²⁷⁸

Douglas Smith also relates the shifts from the bonds of community and common good to an emphasis on “unfettered individualism” and pursuit of self-interest in capitalist society to the transition from a ‘place-based world’ to a ‘purpose based world’ that accelerated in the latter half of the twentieth century with the ascendance of technology.²⁷⁹ In the ‘place-based world’ of past centuries, the limits and the social and physical significance of place reinforced a consciousness of co-inhabitation, interdependence, shared resources and common fates. This, along with what Smith describes as an inherent orthodoxy to the nature and influence of shared ideas and individual response, meant that the probabilities were high that there would be congruence of predictable shared values via multiple overlapping and reinforcing contexts.²⁸⁰

The erosion of social institutions such as the family, the church, the community, and public education in contemporary society has been associated with an increasing alienation and isolation of individuals from traditional community and commercial bonds.²⁸¹ It has also distanced individuals from the primary sources of learned shared values. In many cases the influences of these social institutions have been replaced by powerful social forces promoting, directly or indirectly, corporate interests. Success that

²⁷⁸ Douglas Smith, *On Value and Values*, (New Jersey, USA: Pearson Education Inc. publishing as Financial Times Prentice Hall, 2004), 54. (Smith, *On Value and Values*)

²⁷⁹ Ibid. 21 and 73-76.

²⁸⁰ Ibid. 113-4.

²⁸¹ Robert D. Putnam documented the erosion of traditional social bonds in twentieth century United States in *Bowling Alone: The Collapse and Revival of American Community* (New York: Touchstone, 2000)

is defined in monetary terms, identification with brands, idolization of professional athletes, the culture of celebrity and image, and value defined in material terms as worth, rather than moral terms as ‘worthiness’.²⁸²

From a political economic standpoint, advances in capital and corporate mobility and access to markets around the world have enabled corporate power and influence to transcend that of domestic governments in terms of social and environmental well-being as well as economic stability.²⁸³ History has shown that if one of society’s institutions gains disproportionate power, the influence, if unchecked, becomes corrupting – as with all power, inevitably.

In his exploration of Adam Smith’s centuries old warning of the inherent dangers of the corporation: unlimited life, size, power and licence and their ability to externalize risk in thus unconstrained pursuits, Justice Louis Brandeis argued that “no methods of regulation ever have been or can be devised to remove the menace inherent in private monopoly and overweening commercial power”.²⁸⁴ Monks recasts the four dangers in a contemporary context. The last – ‘unlimited license’ – he describes as unconstrained behaviour with diminished accountability and imperviousness to penalties of other enforcement mechanisms and relative impunity to government coercion.²⁸⁵

The characterization of the multinational enterprise, carrying with it the ability to cause social and environmental as well as economic harm, is manifestly the danger of ‘unlimited license’ of which Monks warns. The economic force of globalization, the rapid expansion of capital markets and the advent of business enterprise as a dominant economic, social, and increasingly, political²⁸⁶ influence has conspired over the last three

²⁸² Douglas K. Smith, *On Value and Values* supra note 277 at 115-18.

²⁸³ See discussions in: W. Cragg, *Ethics Codes, Corporations and the Challenge of Globalization* (Edward Elgar, 2005); D. Korten, *When Corporations Rule the World*, (West Hartford, Conn. and San Francisco: Kumarian Press and Berrett-Koehler Publishers, 2005).

²⁸⁴ Melvin I. Urofsky, *Louis D. Brandeis*, (Pantheon, 2009) at 346.

²⁸⁵ Robert A.G. Monks, *The Emperor’s Nightingale: Restoring the Integrity of the Corporation in the Age of Shareholder Activism* (Reading, Massachusetts: Addison-Wesley, 1998) at 21.

²⁸⁶ In the United States, in particular, the role of business interests and corporate political donations in the political process are longstanding and looks set to increase with the recent landmark decision of the United States Supreme Court in *Citizens United v. Federal Election Commission*, 558 U.S. 08-205 (2010). The

decades to create such imbalance with the concentration of power and influence in corporate entities exceeding that of most nation states.²⁸⁷ Korten, in 1995, wrote that corporations “have emerged as the dominant governance institution on the planet, with the largest among them reaching into virtually every country in the world and exceeding most governments in size and power”.²⁸⁸

According to the principles of democracy, power comes with responsibility and must be subject to a system of checks and balances: the institution of democratic government, for example, is constrained by the rule of law and the separation of powers. There are suggestions that the corporation can be theorized as a democratic institution and therefore subject to the same checks and balances.²⁸⁹ However, the present reality is that to a considerable extent the power of corporations exceeds the capacity or limits of state regulation and as a consequence is unchecked, but for exercises of self-restraint and the observance of self-imposed limits.

It is in such situations that Habermas’ discourse theory of law and democracy offers an alternative means to establish greater balance or alignment between the business and public interest.²⁹⁰ In particular, as Parker has suggested,²⁹¹ the possibility of dialogue

Court held that corporate funding of independent political broadcasts in candidate elections cannot be limited—because of the First Amendment to the United States Constitution enshrining the right to freedom of expression. The effect is to allow corporations and unions to use their general treasuries to pay for political advertisements that expressly call for the election or defeat of a candidate, also known as an “independent expenditure”.

²⁸⁷ Douglas M. Branson, “Teaching Comparative Corporate Governance: The Significance of “Soft Law” and International Institutions” (2000) 34 *GA. Law Review* 669: 682-84.

²⁸⁸ D. Korten, *When Corporations Rule the World*, (West Hartford, Conn. and San Francisco: Kumarian Press and Berrett-Koehler Publishers, 2005) 54.

²⁸⁹ Christine Parker, *The Open Corporation – Effective Self-Regulation and Democracy* (Cambridge University Press, 2002). (Parker, *The Open Corporation*)

²⁹⁰ See, J. Habermas, *Between Facts and Norms: Contributions to a Discourse Theory of Law and Democracy* (Cambridge, Mass.: MIT Press, 1996) 186 – 93, 430 – 46, regarding the ideal of deliberative democracy as the guarantor of legitimate law and regulation, particularly where the administrative and regulatory functions of the state are necessarily connected with large powerful private institutions.

²⁹¹ Parker, *The Open Corporation* supra note 288 at 40. Parker contrast this possibility with Teubner’s contention that business systems are largely impenetrable to external influences such as democratic processes, normative systems of law and stakeholder interests due to the internal system of values, that as Habermas contended dominate the ‘lifeworld’ of management and employees. Teubner, G., “Juridification: Concepts, aspects, limits, solutions”, in G. Teubner (ed) *Juridification of Social Spheres: A Comparative Analysis of the areas of Labour, Corporate, Antitrust and Social Welfare Law*, (Berlin: Walter de Gruyter, 1987). J. Habermas, J. (tr. T. McCarthy) *The Theory of Communicative Action, Volume Two Lifeworld and*

within “a suspicious, mobile and alert public sphere” as a means to “permeate” the business sphere as well as the political sphere with wider societal norms of accountability and a sense of responsibility to serve the common good.²⁹²

There are conceptual and practical challenges associated with this approach that, in effect, seeks to ‘socialize’ business such that internal controls on behaviour are instilled in order to inhibit irresponsible or otherwise antisocial conduct. For example, Coleman acknowledges that, from a sociological perspective, internal controls are an important complement to external forms of social control such as formal and informal mechanisms of reward and punishment. In his view, “[T]he particular virtue ... is that once the internal change has been brought about, others’ interests or rights will be taken into account even when no one else can observe the action” thus avoiding the costs, difficulties and impediments to administering and enforcing external sanctions.²⁹³

However, for corporations and other forms of business enterprise, establishing the site and objects of responsibility is complex involving a “multiplicity and diversity of interests” that potentially compete or conflict.²⁹⁴ This complexity is a business challenge as real as any other. As will be discussed in Chapter 9, for those businesses that perceive the challenge not as an obstacle to pursuing their own interests, but as an opportunity to acknowledge and engage ethically and constructively with a range of other interests to mutual advantage there are very real benefits.

System: A Critique of Functionalist Reason, (Cambridge Polity Press, 1987). Both as cited in Parker, *The Open Corporation* supra note 288 at 41.

²⁹² Habermas, J., (tr. W. Rehg) *Between Facts and Norms: Contributions to a Discourse Theory of Law and Democracy* (Great Britain: Polity Press in association with Blackwell Publishing Ltd., 1996), 441 -2.

²⁹³ J. Coleman, “Responsibility in Corporate Action: A Sociologist’s View”, in *Corporate Governance and Directors’ Liabilities: Legal, Economic and Sociological Analyses on Corporate Social Responsibility*, eds. K. Hopt and G. Teubner (Berlin; New York: de Gruyter, 1984) 70.

²⁹⁴ *Ibid.* at 77.

6.2 Corporate Responsibility – A Misnomer?

Viscount Haldane. L.C delivering the judgment of the House of Lords in *Lennard's Carrying Co. Ltd. V. Asiatic Petroleum Co. Ltd.* [1915] AC 705 said:

My Lords, a corporation is an abstraction. It has no mind of its own any more than it has a body of its own: its acting and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of personality of the corporation.

This insight and the earlier observation of Lord Coke are timeless antidotes to the more recent popular tendency to anthropomorphize the corporation into an entity capable of independent thought, decision and action as necessary precursors to moral or social responsibility.

As Phillips has argued, the fact that the law imputes mental states to corporations for the purposes of establishing legal liability for actions performed by their agents does not satisfy the conditions of *moral* responsibility.²⁹⁵ There is a distinction between the capacity for legal responsibility on the one hand, and ethical and moral culpability on the other.²⁹⁶ Moral culpability or responsibility for an action (or inaction), Phillips contends, requires a state of consciousness sufficient to form purpose and intention in regard to performing the act, and to have reasonable knowledge of the nature and consequences of such action.²⁹⁷

²⁹⁵ Michael Phillips, "Corporate Moral Personhood and Three Conceptions of the Corporation" (1992) *Business Ethics Quarterly*, Volume 2, Issue 4, 435 at 436.

²⁹⁶ The capacity theory of responsibility is based largely on the work of H. L. A. Hart in *Punishment and Responsibility* (London: Oxford University Press, 1968). The capacity theory considers a responsible agent to be one that is capable of reason and capable of exercising control, and thereby choosing whether to comply with the law. This choice provides an opportunity to avoid wrongdoing, and the fact of this choice invites judgment where actors fail to take reasonable steps to do so. This theory supports and explains the notion of corporate negligence liability and the ability to find fault for failure to take reasonable steps to avoid harm to others. Under the capacity theory, the exercise of control and the choice between various courses of action can often only be fairly attributed to the company itself, manifest through established systems and structures for decision making that operate on, rather than through any human agency, from which it follows that organizations are moral agents capable of being regarded as culpable in their own right.

²⁹⁷ For the argument that corporations possess decision making structures and processes sufficient to attribute decisions and thus moral agency to the corporation, see: Peter French, "The Corporation as a

In light of the limitations of the concept of corporate moral personhood in law and its lack of acceptance beyond certain branches of business ethics scholarship,²⁹⁸ it would seem that the individuals acting for or on behalf of the corporation – the natural persons through whose agency the corporation is animated and capable of action – should be engaged directly with the expectation of, and at a level that can assume, moral and ethical capacity.

Recent research on the nature of moral reasoning concludes that moral sensitivity involves three distinct areas of the human brain and their interaction is, at least in the initial stage of moral reasoning an intuitive response. When faced with ethical issues, subjects invoked the parts of the brain associated with: the ability to understand or empathize with other perspectives; the ability to evaluate the appropriateness of solutions to personal moral dilemmas; and the ability to rationalise or justify intuitive responses according to “non-emotional” processing of situations and social conventions. The research indicates that “for the most part, ethical decision making is an innate capacity that the majority [of people] possess”.²⁹⁹

However, the construct of the corporation as a separate entity for the purposes of limiting the legal liability of shareholders over time has also proved to be a convenient means to deflect not only the legal, but also the ethical and moral responsibility and culpability of its agents. One difficulty is that the locus of responsibility with respect to harms caused or produced by the activity of a corporate entity may not necessarily rest in any specific

Moral Person” (1979) 16 *American Philosophy Quarterly* 207 and “Principles of Shame, Responsibility and the Corporation” in Hugh Cutler ed., *Shame, Responsibility and the Corporation* (New York: Haven Publishing Company, 1986) at 191. In contrast, see Manuel Velasquez in “Why Corporations are Not Morally Responsible for Anything They Do” (1983) 2 *Bus. & Prof. Ethics J.* No. 3: 1-18 arguing that the corporate decision making structures on which French bases his argument are fundamentally the product of and dependent on human agency and design. As such, they are an extension of the individual or collective actions, intentions and decisions of those human agents on behalf of the corporation.

²⁹⁸ Patricia Werhane, *Persons, Rights and Corporations* (Englewood Cliffs NJ: Prentice-Hall, Inc., 1985) chs. 1-2; Peter French, “The Corporation as a Moral Person” (1979) *American Philosophy Quarterly*, 207: 208-10.

²⁹⁹ Robertson, Snarey, Ousley, Harenski, Dubois Bowman, Gilkey, and Kilts, “The neural processing of moral sensitivity to issues of justice and care: an fMRI study” (2007) *Neuropsychologia*, Volume 45, Issue 8, 1985.

natural person or persons.³⁰⁰ This may be due to the complex structure and workings of the organization, or a lack of causality between individual actions and the harm in question.³⁰¹ Even from the perspective of aggregate or ‘nexus of contracts’ theories of the corporation³⁰², studies of group behaviour, processes of socialization and the influence of structural dynamics and organizational environment on individual actions in any given context suggest that there are limitations to the extent that all corporate actions can be reduced to independent autonomous acts of its constituents.³⁰³

³⁰⁰ A recent ruling of the Quebec Superior Court in *Girard et al. v. Productions BBR inc. et al.*, SCM 500-17-053835-099, December 15, 2010 (Justice Jean-Pierre Chrétien) (*BBR Productions*) dismissed an application for the extension of a suit against the corporate defendants for breaches of contractual obligation to include personal suits against certain individuals who were directors or officers or had acted on behalf of the corporate defendants. The Court held that only the contracting parties themselves can be held liable for breaches of their contractual obligations. In order for persons who were acting on the behalf of the contracting parties to be held liable the plaintiffs must have basis to assert that the fault being alleged against these persons does not flow solely from the breach of a contractual obligation owed by the corporation. If there is no possibility of the breach of a legal obligation that was incumbent on the individuals and was independent of the contractual relationship the individuals must benefit from "agent's immunity", even if the individuals may have acted in bad faith and with the aim of causing harm to the plaintiffs. Directors or employees who act on a corporation's behalf are not acting in their own right, but for a legal entity that can only act through the intermediary of one or more individuals.

³⁰¹ For example, Metzger in M.B. Metzger, "Corporate Liability for Defective Products: Policies, Problems, and Prospects" (1984) 73 *Geo. L.J.* 1, 57 discusses the possibility that fault attribution is not possible due to cumulative actions none of which are blameworthy, or "the source of wrong [could be] internal bureaucratic failures rather than the deliberate act of any particular corporate employee or employees".

³⁰² Aggregate theory proposes that groups such as corporations are no more than the sum, or aggregate, of smaller independent units which in the case of corporations include the collection of individuals who engage in particular contractual relationships with each other as well as other constitutive elements such as contracts, organizational structures and rules. Robert Hessen, *In Defense of the Corporation* paperback ed. (Hoover Institution Press, 1979) xiii; David Millon, "Theories of the Corporation" (1990) *Duke L.J.* 201, 220-29, 231. The 'nexus of contracts' theory of the firm from law and economics views the firm as the sum of rational individual autonomous actors entering contracts freely through the corporate structure based on their individual utility calculations, from which it follows that there is no separate corporate entity to bear responsibility only the individual agents. William W. Bratton, "The 'Nexus of Contracts' Corporation: A Critical Appraisal" (1989) 74 *Cornell L. Rev.* 407; Henry N. Butler, "The Contractual Theory of the Corporation" (1989) 11 *Geo Mason L. Rev.* 99, 99-100.

³⁰³ See for example, James A. Brickley, Clifford W. Smith Jr., Jerrold L. Zimmerman, "Corporate Governance, Ethics & Organizational Architecture" (2003) *Journal of Applied Corporate Finance* Vol. 15.3:34; Lynne Dallas, "A Preliminary inquiry into the Responsibility of Corporations and their Directors and Officers for Corporate Climate: The Psychology of Enron's Demise" (2003) 35 *Rutgers Law Journal*; Marleen A. O'Connor, "The Enron Board: The Perils of Groupthink" (2002-2003) *Univ. Cinn. L. Rev.* 1233; Christopher, D. Stone, *Where the Law Ends: The Social Control of Corporate Behaviour*, (London: The Economist in Association with Profile Books Ltd., 1991).

In terms of legal responsibility, lawmakers and those tasked with regulation and enforcement encounter: the agency doctrine³⁰⁴, privity of contract, and the immunity of roles-based decision making.

The United States doctrine of corporate *scienter* (intentionally fraudulent conduct) exemplifies the challenges inherent in attributing the fraudulent intent of officers and employees to the corporation. Under federal securities law, to establish a Section 10(b) fraud on the market³⁰⁵ whereby a corporation can be found liable for damages under section 10(b) of the 1934 Act requires proof of corporate *scienter*.

However, as Hansen and Corinis have shown, the standard for proving corporate *scienter* is contested.³⁰⁶ The most traditional approach requires proof that whatever individual made the untrue or misleading statement being attributed to the corporation had an intention to defraud. That is, the court must determine the state of mind of the specific corporate official who made or issued the statement.³⁰⁷

In what is considered the hybrid approach, the fraudulent intent of senior corporate officers has been attributed to the corporation, even if it was not the officers that made the alleged fraudulent statement. In *Nordstrom v. Chubb & Son, Inc.*, it was sufficient that the relevant committee members had reviewed and approved the press releases containing the misstatements.³⁰⁸ However, the case law is as yet unsettled on the question of the degree of seniority required for this attribution of *scienter* to the corporation.

In a third approach, a corporation's collective knowledge and intent is sufficient to prove *scienter*. That is, a corporation is possessed of a state of mind distinct from those of its

³⁰⁴ Regarding agency, see notes 225, 295, 296.

³⁰⁵ *Scienter* is used in the context of *Securities and Exchange Act 1935* Rule 10-b5 where proof of *scienter* - necessary level of 'guilty knowledge' - for civil liability. Although the Sarbanes-Oxley Act shifts the assessment of culpability back to consideration of whether executives were aware of deficiencies in the internal control processes for identifying fraud rather than awareness of the specific circumstances of the fraud at issue.

³⁰⁶ Steven Hansen and Jennifer Corinis *Judicial Views of Collective Scienter in A section 10(b) Case* January 2008 *Review of Securities and Commodities Regulation* - Vol. 40, No. 18, 207-213.

³⁰⁷ *Southland Securities v. INSpire Ins. Solutions* 2004 Fifth Circuit

³⁰⁸ *Nordstrom v. Chubb & Son, Inc.*, 54 F.3d 1424, 1435 (9th Cir.1995)

individual officers and employees and capable of being inferred from the information available to those officers and employees as a collective.³⁰⁹

In their analysis, Hansen and Corinis suggest that the standard for finding a corporation liable is proof of circumstances where it is most able to deter fraudulent statement, specifically when the maker of the statement or the top management collectively has the intent to defraud.

Courts in the United States, the United Kingdom, Canada, Australia and New Zealand have tended to defer to the business expertise of directors and officers in assessing whether due care has been exercised in corporate decision making. The so-called ‘business judgment rule’ recognizes that many decisions made by directors and officers in the course of business may with the benefit of hindsight appear imprudent or unreasonable, but are reasonable and defensible at the time they are made based on the knowledge, information and circumstances then available.

This is not to say that all such decisions are immune from judicial review. In *Peoples Department Stores Inc (Trustees of) v. Wise*, the Supreme of Canada observed that:

courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, *but they are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear* in reaching what is claimed to be a reasonable business decision at the time it was made. (emphasis added).³¹⁰

The Oxford English Dictionary defines ‘prudent’ as: “acting with or showing care or thought for the future.” This choice of language leaves open the possibility for consideration of a broad range of factors with potential implications or consequences on the future, in other words the long-term best interests and sustainability of a corporate

³⁰⁹ Steven Hansen and Jennifer Corinis, “Judicial Views of Collective Scienter in a section 10(b) Case” *Review of Securities and Commodities Regulation* (January 2008) Vol. 40, No. 18, 207-213

³¹⁰ *Peoples Department Stores Inc. (Trustees of) v. Wise*, 2004 SCC 68, [2004] 3 SCR 461, at par. 67.

entity, including ethical and moral considerations that have been shown to be materially significant in both financial and reputational terms.³¹¹

Notwithstanding the doctrine of *scienter* for officers and employees in the United States, or protections such as those provided by the ‘business judgment rule’ for boards of directors in their corporate decision making capacity, such agents or fiduciaries cannot escape their personal ethical and moral responsibility and culpability for the consequences of their decisions. However, this becomes a matter of individual conscience or where this is lacking, the possibility of unofficial censure from peers or the public – the so-called sunlight and newspaper tests – rather than official censure through the formal adjudicative process.³¹²

That said, the notion that the individual agents behind the corporate action are inevitably and always accountable in ethical and moral terms overlooks the sociological effect of institutional frameworks on the agents that work within them. Not only do these frameworks have the effect of diminishing individual responsibility³¹³, but their implicit influence operates to distance the individual from their action and to transform the acts of individuals to something other than the mere aggregate of those individual actions.³¹⁴

³¹¹ Barron’s Most Respected Companies ranking, and the Financial Times, Forbes and Business Week rankings, are based on metrics reflective of the broader recognition that how business is perceived on a quantifiable set of standards has influence in the boardroom and in fund managers’ portfolio allocation decisions. The Reputation Institute, “The Financial Impact of Reputation”, *ReputationIntelligence*, vol. 2, issue 3, Fall 2010, p. 5. The influential Reputation Quotient (RQ) developed by Harris Interactive and the Reputation Institute rates a company’s reputation based on a comprehensive instrument that rates a company’s reputation on 20 attributes (each measured on a seven point scale) that fall into six key spheres that include Social Responsibility, Vision and Leadership.

³¹² One third of the corporate codes in the sample provide decision making matrices that explicitly invoke these personal and public forms of behavioural checks.

³¹³ See: J. Slovak, “The ethics of corporate lawyers: A sociological approach” (1981) *American Bar Foundation Research Journal* 777, on the problem of ‘role morality’ in which the conscience of individuals acting within organizations is subsumed by organizational bureaucracies.

³¹⁴ For a fascinating examination of group disfunction from a social psychology perspective, see: Marleen A. O’Connor, “The Enron Board: The Perils of Groupthink” (2002-2003) 71 *U Cin. L. Review* 1233 and Dallas, Lynne, L. ‘A Preliminary Inquiry into the Responsibility of Corporations and their Officers and Directors for Corporate Climate: The Psychology of Enron’s Demise’ (2003) 35 *Rutgers Law Journal* No.1, 1.

This combined with an increasing remoteness between decision and outcome as a result of time, space and technology at times can make it virtually impossible for courts to find a causally responsible human agent let alone to hold that individual accountable in law.³¹⁵

Studies of organizational behaviour, organizational culture, and organizational conscience associate these sociological effects as contributing to the development of institutionalized norms of behaviour.³¹⁶ Observance of, and compliance with, these organizational norms over time becomes the price of entry, continued membership and success in the organizational sub-culture or group that holds the sets of obligatory behavioural expectation and standards. This builds (and builds on) individuals' socially constituted need to identify with and desire to be part of a community where certain behaviours, and underlying values are manifest. There is both potential benefit and potential danger in this phenomenon depending on the content as well as the nature of the process by which these norms are created and disseminated.

In a pluralistic, complex society membership is rarely limited to one or two sets of 'norms communities' therefore ensuring a continuous balancing and reconciliation. However, when a dominant culture and its values permeates and is reinforced in all aspects of society – work, leisure, entertainment, family and interpersonal relationships –

³¹⁵ For example, in August, 2010, Federal District Judge Emmet Sullivan of the U.S. District Court for the District of Columbia approved a deal between the Department of Justice and Barclays Bank for Barclays to pay a \$298 million fine for processing financial transactions in violation of United States trade sanctions. In what the judge called an "elaborate" scheme over 10 years, Barclays processed more than \$500 million in wire transfers stripped of identifying information yet the DOJ investigations yielded no individual and no person from senior management who could be identified for prosecution.

³¹⁶ This is a vast area of inter and cross-disciplinary study. In relation to ethics, conduct and governance see, for example: Kenneth D. Butterfield et.al "Moral Awareness in Business Organizations: Influence of Issue-Related and Social Context Factors" (2000) 53 *Human Relations* 981; W.M. Kurtines and J.L. Gewirts (eds.) *Morality, Moral Behaviour and Moral Development* (New York: Wiley, 1984); Richard H. McAdams, "The Origin, Development and Regulation of Social Norms" (1997) 96 *Mich L. Rev.* 338; Lawrence Mitchell, "Understanding Norms" (1999) 49 *U of T L.J* (Spring 1999); S.P. Robbins and N. Langton, *Organizational Behaviour: Concepts, Controversies, Applications*, 2d (Toronto: Prentice Hall, 2001); Cass Sunstein, "Social Norms and Social Roles" (1996) 96 *Columbia Law Review* 903-968; Linda Klebe Trevino, "A Cultural Perspective on Changing and Developing Organizational Ethics" in R. Woodman and Passmore (eds.) *Research in Organizational Change and Development* 4: 195-230 (JAI Press, 1990); Linda Klebe Trevino, "Moral Reasoning and Business Ethics: Implications for Research in, Education and Management" (1992) *Journal of Business Ethics* Vol. 11 445; Kenneth E. Goodpaster, *Conscience and Corporate Culture* (Blackwell Publishing, 2007); Josef Wieland, "The Ethics of Governance" (2001) *Business Ethics Quarterly* Vol. 11, Issue 1.

as profit-seeking, wealth acquisition and the pressure to consume has in many segments of so-called western and newly westernized society the norms become internalized independent of source.³¹⁷

Other than for the willfully compliant, the consequences of non-compliance and wrongdoing are often far outweighed by profit or competitive advantage gained by ignoring or breaking the rules. Lawmakers can create legal standards and processes, and regulators can punish breaches of them, once proven. However, while this spectre of legal punishment may serve as an effective deterrent to some, for others it might merely pose a risk viewed as a necessary cost of doing business.

A strictly cost-benefit analysis applied to choices about whether to act in breach of rules can provide economic justification for a decision to do so. This is generally referred to as a ‘moral hazard’ and is an enduring regulatory challenge. Despite what that phrase might suggest it is so far impossible to legislate for corporate, or individual, moral conscience, nor to create a regulatory prescription for ethical behaviour and responsible conduct, let alone provoke a moral crisis.

6.3 Geographically Unbounded

Globalization, as it is generally understood, has provided corporations with unprecedented freedom to choose where and, to a significant extent, how they conduct their businesses.³¹⁸ These freedoms are largely unfettered by governmental regulation

³¹⁷ Elliott Aronson talking about internalization: “Once it is part of our own system [of values] it becomes independent of its source and will eventually become extremely resistant to change.” *The Social Animal* 6th ed. (W.H. Freeman & Co. Publishers, 1992).

³¹⁸ See note 64, as explained by Crane and Matten in Andy Crane and Dirk Matten, *Business Ethics: A European Perspective Managing Corporate Citizenship and Sustainability in the Age of Globalization*, 2d (Oxford: Oxford University Press, 2004) “frequent misuse of this term has contributed to a lack of clarity and definition” such that the distinctions in Schlote’s classification are subsumed within a generalized use of the term.

due to limited intra or supra jurisdictional means to regulate business activity and limited or no extraterritorial enforcement powers.³¹⁹

In a moral universe, with such freedom comes responsibility and there are many examples of business enterprises that recognize the advantages of operating with due regard to the norms of responsible business conduct.³²⁰ However, there are also examples where such freedom is exploited. In other cases, even responsible companies recognize that their personnel are potentially at risk of inadvertently violating domestic norms due to the fact that they conduct their day to day operations in contexts with profoundly different practices and ways of doing business.³²¹

As a consequence, circumstances can and do arise whereby the actions of a corporation or its agents abroad that would violate domestic laws or governance norms escape sanction both at home and away. That is, whilst the ‘host’ country may lack the necessary sanctions, political will, or resources to impose any applicable laws of its state on a non-domiciled multinational corporation, the ‘home’ country may be constrained by jurisdictional limits and issues of appropriate forum to impose any State laws and sanctions that it may have for domestic application on a domiciled corporation for its actions in the host country’s sovereign territory.

In Canada, for example, where criminal law is the basis for offences such as corrupt practices by Canadian corporations in contravention of Canada’s anti-overseas corruption act, the law has limited extraterritorial effect.³²² Leaving aside the difficulty of detecting

³¹⁹ M.B. Steger, *Globalization: A Very Short Introduction* (Oxford, UK: Oxford University Press, 2003) on the declining influence of national governments as a result of economic globalization.

³²⁰ Transparency International, *Transparency in Reporting on Anti-Corruption: A Report on Corporate Practices*, 2009. www.transparency.org.

³²¹ In the sample, 31 company codes contain specific provisions regarding commitments to eliminate international bribery, corruption and fraud. Six company codes contain specific provisions concerning operations in high risk countries.

³²² Canada enacted *The Corruption of Foreign Public Officials Act* pursuant to its international obligations under the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. The Act makes it a criminal offence for any person to bribe or attempt to bribe, directly or indirectly, a foreign public official for the purposes of obtaining or retaining an advantage in the course of international business transactions. “Person” is defined in s. 2 of the Canadian *Criminal Code* RSC 1985 c-

such practices, only in limited circumstances will it extend to a person, including a Canadian citizen, who is alleged to have committed a criminal offence wholly outside of Canada.³²³

In *R. v. Libman*³²⁴ [1985] 2 SCR 178 the Supreme Court of Canada, on considering the application of the conspiracy provisions of the Canadian *Criminal Code*, determined that Canadian courts will have jurisdiction in respect of an offence only if a significant portion of the activities constituting that offence must take place in Canada and have a real impact on Canadians. As a consequence, under the current law, Canadian individuals or businesses engaging in corrupt activity *wholly* in foreign jurisdictions can do so with relative impunity notwithstanding that if such conduct were to take place in Canada, it would be illegal.³²⁵

Canada's record in relation to the implementation and enforcement of the *Convention on Combating Bribery of Foreign Officials in International Business Transactions* has been criticised in the past by, among others, the OECD³²⁶ and Transparency International.³²⁷

C46 (*Criminal Code*) and as such includes provincially or federally incorporated companies and their directors, officers and employees.

³²³ Regarding the numerous indirect ways that corporations employ to influence foreign officials or to secure advantage, see: Marshall B. Clinard and Peter C. Yeager, "Political Contributions, Bribery and Foreign Payoffs", *Corporate Crime* (New York Free Press, 1980) 155-186 at 171.

³²⁴ *R v. Libman* [1985] 2 S.C.R. 178

³²⁵ Bill C-31 (*An Act to amend the Criminal Code, the Corruption of Foreign Public Officials Act and the Identification of Criminals Act and to make a consequential amendment to another Act*) introduced May 15, 2009 and currently at the Committee after passing Second Reading, if passed, would amend the CFPOA to allow Canada to prosecute Canadian companies, or Canadian citizens or permanent residents for bribing a foreign public official without having to provide evidence of a link between Canada and the offence. The Bill provides that any act or omission committed outside of Canada by Canadian citizen, permanent resident or Canadian incorporated organization, if that act or omission would be considered an offence if committed within Canada, will be deemed to have been committed in Canada. By establishing Canadian citizenship, residency or incorporation as the basis for legal jurisdiction, the new provisions would eliminate the need for Canadian law enforcement agencies to establish a link between the offence, Canada and Canadian citizens. Karen Katz, "Here Comes the Bribe: Canada's Efforts to Combat Corruption in International Business, *The Advocate*, Vol. 69 Part 4, 501.

³²⁶ OECD Working Group on Bribery, *Canada: Phase 3 report on the Application of the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the 2009 Revised Recommendation on Combating Bribery in International Business Transactions* (OECD, 18 March 2011). Online at: www.oecd.org/dataoecd/55/25/474384413.pdf

³²⁷ Transparency International, "Progress Report 2011 Enforcement of the OECD Anti-Bribery Convention" (TI, May 2011. Accessible at: www.transparency.org).

However, on June 23, 2011 Niko Resources Ltd. (Niko) a Calgary-based oil and natural gas company was indicted for bribery under the country's *Corruption of Foreign Public Officials Act* S.C.1998 c. 34 (the CFPOA).³²⁸ The charges related to bribes paid in 2005 to Bangladesh's State Minister for Energy and Mineral Resources in order to influence the Minister in dealings with Niko Bangladesh following a blowout of one of the country's natural gas wells. Specifically, the bribes were made at the time when the Minister was assessing how much compensation was owed to Bangladeshi villagers for water contamination and other environmental concerns caused by explosions at the Niko operation that caused significant physical and environmental damage to the surrounding area and forced an evacuation of a nearby village.³²⁹

The Alberta Court of Queen's Bench sentence comprised fines totaling C\$9,499,000 and a probation order placing Niko under the Court's supervision for three years to ensure audits demonstrating Niko's compliance with the CFPOA. The sentence is the most severe penalty handed down since the CFPOA was proclaimed in 1999. No individuals were identified as culpable.

The Niko indictment follows an initiative launched by the Royal Canadian Mounted Police (RCMP) in 2010 to pursue charges and fines for breaches of the Act more aggressively. At the beginning of 2011, the RCMP revealed it was conducting 23 investigations into other Canadian businesses for alleged corruption involving foreign public officials.³³⁰ This suggests a new willingness on the part of federal authorities to intervene directly in business practices abroad that are inconsistent with acceptable norms of behaviour in the domestic context.

³²⁸ Court of Queen's Bench of Alberta, Judicial District of Calgary, Indictment – *Her Majesty the Queen against Niko Resources Ltd.* 20 June 2011. Last accessed June 26, 2011 at www.Osler.com/upload/Files/Indictment.pdf.

³²⁹ Court of Queen's Bench of Alberta, Judicial District of Calgary, Agreed Statement of Facts – *Her Majesty the Queen against Niko Resources Ltd.* 23 June 2011. Last accessed June 26, 2011 at www.Osler.com/uploadedFiles/Agreedstatementoffacts.pdf

³³⁰ Transparency International, "Canada: with 23 RCMP corruption investigations underway, corporations will welcome TI-Canada's Anti-corruption Compliance Checklist", 31 January, 2011, Press Release. www.transparency.org/news_room/latest_news/press_releases_nc/2011/2011_01_31_canada_checklist

Other countries have recognized and taken steps to address the jurisdictional issue, and the adverse impacts that corrupt overseas business practices have on international trade and the principles of the free market.

The new *United Kingdom Bribery Act 2010 c. 23*, which came into effect July 2011, promises to be the toughest piece of anti-bribery legislation in the world. Unlike other states' anti-bribery legislation that focus on bribery involving public officials, the United Kingdom's *Bribery Act 2010* extends to corruption between commercial entities.

Furthermore, the Act reaches extraterritorially such that corrupt conduct committed anywhere in the world by an associated person will be caught if the corporate entity concerned carries on business in the UK (regardless of whether or not the bribe is paid in connection with the business). Even organizations incorporated elsewhere but carrying on business in the United Kingdom may fall within the Act's reach. However, if the experience of the United States is any indication, it may well be that the promise of such legislation proves difficult to deliver in practice.

In the United States, jurisdiction in relation to foreign corrupt practices is already established based on the nationality principle such that laws enacted to curtail and prosecute corrupt and illegal behaviour by United States corporations overseas are enforceable regardless of the location of the activity or harm. However, even with such legal certainty the detection and successful prosecution of such behaviour has proven to be challenging.³³¹

One obvious illustration of this is the operation of the United States *Alien Torts Claims Act* (ATCA), 28 U.S.C §1350 which permits non-US citizens to bring death and injury claims in United States federal courts where such claims are connected to violations of international law, including crimes against humanity and war crimes.

³³¹ For example: *Foreign Corrupt Practices Act of 1977* (FCPA) (15 U.S.C. §§ 78dd-1, et seq.); *Alien Torts Claims Act* (ATCA), (28 U.S.C §1350).

The ACTA dates back to 1789 when it was introduced as part of the *Judiciary Act*. After an extended period of virtual disuse, a 1980 U.S. federal court ruling made it available for suits against foreign government officials for human rights violations.³³² From 1997, the ATCA extended to suits against United States and foreign corporations for aiding and abetting human rights violations by foreign governments.³³³ This, in effect, allows members of the United States judiciary to act as an “International Civil Court” exercising universal civil jurisdiction over the activities of non-U.S. companies in foreign countries.³³⁴

Of the approximately 60 companies that have been the subject of ATCA suits, none have lost a case.³³⁵ That said, the series of high profile actions against multinationals under the Act has served the function of increasing corporations’ awareness of the potential for scrutiny of their actions abroad, reputational harm, and high cost of mounting a defense or settling an ACTA claim. However, on September 17, 2010, the second circuit Court of Appeals in New York ruled in *Kiobel et al v. Royal Dutch Petroleum et al* that the Alien Tort Statute does not permit suits against corporations for breaches of international law abroad. This decision, if upheld by the United States Supreme Court on appeal, could have serious implications for the future of the ATCA, and particularly the future of claims against corporations that have been brought in United States courts.

³³² See, e.g., *Filartiga v. Pena-Irala*, 630 F.2d 876, 887 & n. 21 (2d Cir.1980) identifying only two previous cases that had relied upon the ATCA for jurisdiction. See, e.g., *Abebe-Jira v. Negewo*, 72 F.3d 844 (11th Cir.1996) (alleging torture of Ethiopian prisoners); *Kadic v. Karadzic*, 70 F.3d 232 (2d Cir.1995) (alleging torture, rape, and other abuses orchestrated by Serbian military leader); In *Re Estate of Ferdinand Marcos*, 25 F.3d 1467 (9th Cir.1994) (alleging torture and other abuses by former President of Phillippines); *Tel-Oren v. Libyan Arab Republic*, 726 F.2d 774 (D.C.Cir.1984) (alleging claims against Libya based on armed attack upon civilian bus in Israel); *Filartiga*, 630 F.2d 876 (alleging torture by Paraguayan officials); *Xuncax v. Gramajo*, 886 F.Supp. 162 (D.Mass.1995) (alleging abuses by Guatemalan military forces).

³³³ The *Unocal* litigation was the first in which it was held that ATCA actions could apply to private corporations. *Doe I v. Unocal Corp.*, 963 F. Supp. 880(C.D. Cal. 1997)

³³⁴ J.B. Bellinger, “Shortening the Long Arm of the Law”, *N.Y Times*, Opinion Pages October 8, 2010 <http://www.nytimes.com/2010/10/09/opinion/09iht-edbellinger.html>? Last accessed November 29, 2010.

³³⁵ Companies that have been the subject of ACTA suits include: ExxonMobil, Chevron, Talisman, Rio Tinto, and many other companies engaged in the energy and resource sector in Indonesia, Papua New Guinea, and the Sudan.

Freedom from regulation by the rule of law of either home or host jurisdiction creates a kind of sovereign immunity providing corporate decision makers with a choice whether to operate in jurisdictions requiring high standards or in those with comparatively lower levels (where the standards are not observed or enforced) as a means to reduce their costs of production and increase competitiveness.³³⁶

Furthermore, with the increasing fluidity of markets and capital, corporate entities operating across traditional geo-political boundaries, global money managers and multinational enterprises can enter a grey area between state boundaries. For example, on July 16, 2010 Goldman Sachs agreed to pay \$550 million US dollars to settle civil fraud charges of misleading investors. On 9 September, 2010 the United Kingdom Financial Services Authority fined Goldman Sachs £17.5 million for failing to tell the United Kingdom regulator that it was under SEC investigation for fraud. Speaking at a conference organized by Eurofi a European think tank in Brussels three weeks later, Lloyd Blankfein chief executive issued the warning that in the face of “mismatched regulation” “[O]perations can be moved globally and capital can be accessed globally”. And, that “[I]t’s not arbitrage to thwart [regulation] it’s about a need to compete with rivals.”³³⁷]]

Within this macro-economic framework, the multinational enterprise poses a unique question as to which authority, boundaries or combination exist to constrain their behaviour when their operations take them variously outside the specific geo-political limits of domestic public law and into a market place populated by a plurality of standards, interpretations and expectations.

³³⁶ See A. Appadurai, “Disjuncture and Difference in the Global Cultural Economy” (from Mike Featherstone (ed.) *Global Culture: Nationalism, Globalization, and Modernity* (London: Sage Publications, 1993) on an early discussion on the deterritorialization of money and finance, and the concept of ‘finanscapes’.

³³⁷ Patrick Jenkins and Megan Murphy, “Goldman warns Europe on regulation” *Financial Times*, September 29, 2010.

The difficulty in finding an answer is further exacerbated by the absence of a democratically accountable international authority³³⁸ and neutral forum in which to adjudicate transgressions by multinational enterprises and no objective, absolute measure by which to judge such actions that can stem from variously willful disregard, benign neglect, contradictory legal or cultural interpretations, conflicting socioeconomic and political perspectives, power asymmetries, and ignorance.

While the challenges are not insurmountable, they do suggest that any framework for effective governance discourse must include corporate decision makers, recognizing the inherent difficulties discussed but also the opportunities for constructive engagement on and solutions to issues that transcend the capacity of governments. To embark on this kind of engagement – where the regulator enlists or enables the regulated party in efforts to achieve desirable outcomes – requires a willingness on both sides to reframe traditional relationships. As the next two chapters will show, this process is neither easy nor straightforward, particularly for regulators who must confront the limitations of their traditional expressions of authority, while making realistic appraisals of existing regulatory methods and adaptations to conventional techniques in the light of new information and changing conditions.

³³⁸ Paul B. Stephen, “Accountability and International Law Making: Rules, Rents and Legitimacy” (1998) 17 *NW. Journal of International Law and Business* 681.

Part Four – Re-framing Regulatory Discourse

7. From Debate to Innovation

7.1 Reconstructing the Regulatory Debate

Thousands of pages have been written on the comparison between regulatory models and their relative effectiveness in relation to the governance of corporations and the means by which standards of corporate conduct – both necessary and desired – are expressed, respected and, where necessary, enforced.

Many governance scholars, particularly in the United States, have argued persuasively for the likelihood and the necessity of a future homogeneity of regulatory practices, a one size fits all system of regulation that reflect dominant established approaches both for the sophisticated capital markets that already employ them and those aspiring to join their ‘elite’ ranks.³³⁹

Others as readily take the alternative tack of arguing for the undesirability and remote possibility of such a circumstance arising in a diverse, global marketplace driven by the pursuit of competitive advantage and value enhancing differentiation.³⁴⁰

³³⁹ See for example: Lawrence A. Cunningham, “Commonalities and Prescriptions on the Vertical Dimension of Global Governance” (1999) 84 *Cornell Law Review*, 1133; Brian R. Cheffins, “Current Trends in Corporate Governance: Going from London to Milan to Toronto” (2000) 10 *Duke Journal of Comparative and International Law* 5; John C. Coffee Jr., “The Future as History: The Prospects for Global Convergence of Corporate Governance and Its Implications” (1999) 93 *NW University Law Review* 641; Jeffrey Gordon, “Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany: Deutsche telekom and Daimler Chrysler” (1999) 4 *Columbia Journal of European Law* 219; Henry Hansmann and Reinier Kraakman, “The End of History for Corporate Law”, Social Sciences Research Network (SSRN) Electronic Paper Collection. Available at SSRN: http://papers.ssrn.com/paper.taf?abstract_id=204528 (2000) [UPDATE]; Lucien Bebchuk and Mark Roe, “A Theory of Path Dependency in Corporate Ownership and Governance” (1999) 52 *Stanford Law Review* 127.

³⁴⁰ See: Douglas M. Branson, “The Very Uncertain Prospect of “Global” Convergence in Corporate Governance” (2001) 34 *Cornell Int’l L. J.* 321; William Bratton and Joseph A. McCahery, “Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference” (1999) 38 *Colum. J. Transnational Law* 213; Roberta Romano, “The Need for Competition in International Securities Regulation”, Yale ICF Working Paper No. 00-49 (June 2001) SSRNid+278728.

Even those who favour some middle way have a tendency to bear allegiance to one regulatory approach or another, most commonly either the primarily rules based U.S. style model or the primarily principles based model that currently dominate the contemporary marketplace. As a consequence they construct their particular vision of the future on foundations defined by the institutional and cultural influences and prior regulatory choices embedded within those established structures.³⁴¹

The long-standing debate over the relative merits of the so-called rules based prescriptive or principles based approaches to corporate governance and securities regulation runs this risk – such that the lens through which the alternatives are viewed are coloured by a predisposition to prefer one system over another.

The debate's 'either/or' construction can obscure the reality that in numerous practical instances regulators employ hybrid approaches to considerable effect. In the United States, Federal Securities regulation (distinct from accounting regulation and regulation of financial institutions) in practice uses both approaches, for example, a rules-based approach to public offering disclosure, and a principles-based approach in Rule 10b-5. The Canadian securities regulatory authorities also combine the two, such as in the recently introduced National Instrument 55-104 *Insider Reporting Requirements and Exemptions*.

An essentially hybrid approach has long been the norm in the United Kingdom, where corporate governance falls under the statutory authority of *The Companies Act 2006*, and the regulatory authority of the Financial Reporting Council overseeing the *UK Corporate Governance Code 2010*, formerly the *UK Combined Code on Corporate Governance*.

³⁴¹ Anita Anand and Peter Klein, "Inefficiency and Path Dependency in Canada's Securities Regulatory System" (2005) *Canadian Business Law Journal* 42:1, 41-72; Douglas M. Branson, "Teaching Comparative Corporate Governance": The Significance of Soft Law and International Institutions" (2000) 34 *GA. Law Review* 669, 682-84; Douglas M. Branson, "The Very Uncertain Prospect of 'Global' Convergence in Corporate Governance" (2001) 34 *Cornell Int'l L. J.* 321 (regarding the potential for distortion by insular approaches to comparative analysis).

More fundamentally, the debate creates an artificial dichotomy that suggests that the rules are somehow divorced from the principles that inform them and, vice versa, that the principles from the rules that apply them. That is, on the one hand suggesting that rules are created in a vacuum and, on the other hand, that a principles-based system operates exclusively of rules directing or prohibiting specific behaviour.³⁴²

With respect to the former, for a very practical example of how principle and rule are fundamentally connected, one only need look as far as the system for discretionary, or exemption based relief from strict observance of securities regulations. The exemption based relief process creates an opportunity for issuers to submit and regulators to consider applications for relief from strict compliance, on a case by case basis. In each case where the regulator in its discretion grants relief, the applicant must have satisfied the regulator that the spirit and the principle from which the specific rule is derived can be satisfied without technical (or strict) adherence to the letter of the law, and without prejudicing the public interest.³⁴³

In the latter regard, ‘principle’ is defined as a truth or general law used as the basis for a system, a rule governing behaviour.³⁴⁴ A principles based system of governance and governance regulation is therefore one that articulates the fundamental principles, or rules, that govern conduct in conjunction with the baseline legal standards and requirements established in legislation. It makes use of examples of the practical application of the general rule in specific circumstance to assist compliance rather than a myriad of specific, detailed rules prescribing or prohibiting conduct in particular instances – for these latter would undermine the certainty and integrity of the general

³⁴² Under the UK corporate governance regime, the *UK Corporate Governance Code 2010*, as its predecessors, sets out Main Principles of Corporate Governance. Each Main Principle is accompanied by Supporting Principles and specific Code Provisions framed in the obligatory “should”. Compliance with the Code either by strict observance or explanation of alternative approaches is in turn a requirement of the UK Listing Rules compliance with which is mandatory for all UK Premium Listed companies. *The UK Corporate Governance Code 2010*, Preface at 1 and ‘Comply or Explain’ at 4.

³⁴³ Sections 48 and 76 of *The Securities Act R.S.B.C. 1996*, c. 418 give the Commission and the Executive Director the power to issue discretionary orders to exempt trades, intended trades, securities and persons from the registration and prospectus requirements of the Act when it is not prejudicial to the public interest to do so.

³⁴⁴ *Paperback Oxford English Dictionary*, (Oxford: Oxford University Press, 2002) 663.

rules and offer no guarantee of results. Further, as Selznick has explained, “[W]e discover principles, in the first instance, by looking for the reason behind the rule. When we know the purposes or policies the rule is meant to serve – we have a basis for making rational adjustments and exceptions.”³⁴⁵

A true principles based system is therefore an approach that allows for flexibility in how the principles are observed and effected through a combination of positive disclosure obligations and ‘comply or explain’ requirements, but with a system of checks in place including the oversight role of the board of directors, the review function of auditors, the scrutiny of regulators and monitoring by existing and prospective investors.

Those who suggest that a principles based system is more lenient fail to appreciate the impenetrability of a system that offers up no lacunae to exploit, loopholes to slip through, or opportunities for creative construction and formal or technical compliance. Experience has shown all too clearly that despite best efforts to draft complete, comprehensive, and effective regulations, there will always be situations that do not fit or can be engineered to fall into the grey area of interpretation or outside their scope.

As Peter Wyman, Past President Institute of Chartered Accountants in England and Wales succinctly put it:

It is a brave standards setter indeed who can be certain to have covered every possible situation, both current and potential, and to have provided a detailed rule for it. A set of principles can cover every situation whether foreseen or unforeseen ... rules encourage avoidance, whereas principles encourage compliance.³⁴⁶

The articulation of principles creates a web of meaning that has compelling and powerful normative influence, that provides direction without the inflexibility of prescription and

³⁴⁵ Philip Selznick, “Personhood and Moral Obligation” in A. Etzioni (ed.) *New Communitarian Thinking* (University of Virginia Press, 1995) 110.

³⁴⁶ Peter Wyman, “Accounting Standards and Financial Reporting” speech at the ICAEW/ICAI Joint Conference 2002. Online at: http://webcache.googleusercontent.com/search?q=cache:ufepdcMfs6kJ:www.icaew.com/index.cfm/route/102875/icaew_ga/en/Home/Press_and_policy/Peter_Wyman_s_speech_on_Accounting_Standards_and_Financial_Reporting_at_the_ICAI_ICAEW_Joint_Conference__2_September_2002+Accounting+Standards+and+Financial+Reporting+wyma+ICAEW&cd=1&hl=en&ct=clnk&gl=ca&source=www.google.ca

one-size fits all approaches. However, for this system to work there is a need for a relationship between those who safeguard and those who benefit that is built on reciprocity, respect and a shared understanding of the common objectives and mutual advantage.³⁴⁷

These elements are critical to the development of trust between the regulated and the regulator. As Charles Handy put it, “[T]rust inevitably requires some sense of mutuality, or reciprocal loyalty”.³⁴⁸ Together these elements provide a foundation for trust to develop and with it the inherent transactional value that comes from the lower costs of doing business that exist when, in Fukuyama’s words, “all [are] operating according to a common set of ethical norms”.³⁴⁹ When they are absent, the system takes on the weaknesses of the prescriptive, rules-based approach wherein, cooperation is only achieved, according to Fukuyama, through “formal rules and regulations which have to be negotiated, agreed to, litigated, and enforced sometimes by coercive means”³⁵⁰ and a natural resistance to imposed rules can lead to: formal, mechanical or technical over substantive compliance; opportunism, and exploitation of the system and of those who are willfully compliant.

In recognition of this reality, the United Kingdom’s Financial Services Authority³⁵¹ moved to develop what it termed ‘values-led regulation’ in the early years of the new millennium. At the heart of values-based regulation is recognition that a legislated set of standards and requirements alone is not enough to ensure ethical business conduct and further, that a rules-based approach and mindset is problematic for a number of reasons.

³⁴⁷ See: Wesley Cragg, *Ethics Codes, Corporations and the Challenge of Globalization* (Cheltenham: Edward Elgar Publishing, 2005); J. Dalla Costa, *The Ethical Imperative Why Moral Leadership is Good Business* (Toronto: Harper Collins, 1998); Gary M. Woller, “Business Ethics, Society and Adam Smith: some observations on the liberal business ethics” (1996) *Journal of Socio Economics* vol. 25, issue 3

³⁴⁸ Charles Handy, “Trust and the Virtual Organization,” in Frederick F. Reichheld, *The Quest for Loyalty: Creating Value through Partnership* (Cambridge, MA: Harvard Business Review Books, 1996) 40

³⁴⁹ Fukuyama, Francis, *Trust: The Social Virtues and the Creation of Prosperity* (New York: The Free Press, 1995) 27.

³⁵⁰ *Ibid.* at 27-8.

³⁵¹ Established in 1997, the FSA (formerly the Securities and Investments Board) operated until 2011 as the independent regulatory body responsible for banking supervision and investment services regulation. A 2011 reorganization of regulatory authorities and oversight jurisdiction, replaces the FSA with the Financial Conduct Authority (FCA), see additional discussion in section 5.2.

First among these is the fact the rules themselves are no guarantee of compliance, they inevitably lag developments in the marketplace and, no matter how comprehensively drafted, circumstances will arise that they do not address. Another is that the burden and cost of compliance, both real and perceived, can lead regulated parties to adopt mechanical or strict compliance practices, exploit loopholes and grey areas, and when disproportionate to the advantages of non-compliance, create moral hazards. Where regulated parties' incentives are misaligned with regulatory intent or purpose, changing the rules alone may not work well since those incentives operate to reward those with the ability to work creatively around those rule changes.³⁵²

Whether the problems are of avoidance or abuse, making new rules and imposing new requirements inevitably risk punishing the compliant for the malfeasance of others. Academic research into the unintended consequences of resorting to tighter regulation, additional rules and increased formal oversight to address problems, suggest that it may undermine observance of existing normative standards of honesty and integrity.³⁵³

Bardach and Kagan, in their work on the effect of overly legalistic regulation, found that it can predispose generally compliant enterprises to satisfy only the minimal level of compliance rather than to comply fully with the law's intent.³⁵⁴

While the adoption of new rules and requirements signify action on the part of regulatory authorities, they also send a message of distrust in existing standards and those who observe them equally with those who do not. In so doing, they can alienate the very

³⁵² The rules of the game are changed when there is an attempt to change the nature of the interactions between individuals and firms, as when the regulation attempts to affect what can be said, offered, or done. Michael S. Barr, Sendhil Mullainathan, and Eldar Shafir, "The Case for Behaviourally Informed Regulation", Moss, David, and John Cisternino (eds.) *New Perspectives on Regulation* (Cambridge, MA; The Tobin Project, 2009).

³⁵³ Roderick M. Kramer, "Trust and Distrust in Organizations: Emerging Perspectives, Enduring Questions" (1999) *Annual Review of Psychology* 50, 591.

³⁵⁴ E. Bardach and R. Kagan, *Going By the Book: The Problem of Regulatory Unreasonableness*, (Philadelphia, Temple University Press, 1982) as referred to in Christine Parker, *The Open Corporation Corporation – Effective Self-Regulation and Democracy* (Cambridge University Press, 2002) 9.

stakeholders who are essential to an organization's cultural integrity which in turn is essential to the integrity of that organization's interactions with the wider system.³⁵⁵

The values based approach seeks to address these concerns by connecting the regulatory requirements with the underlying values such as of fairness, honesty, responsibility, transparency, and accountability to and respect for others that will resonate even if the specific rules do not. Interestingly the approach heeds the advice Adam Smith gave legislators in his *Theory of Moral Sentiments*:

If you would implant public virtue in the breast of him who seems heedless ... it will be more likely to persuade, if you describe the great system of public police [policy]... if you explain the connexions and dependencies of the several parts, their mutual subordination to one another, and their general subservience to the happiness of society.³⁵⁶

The approach aims at encouraging business decision makers to pursue strategies that go beyond mere compliance and to engage in the development of shared values and purpose. It requires a willingness to go beyond the minimum baseline and an instrumentalist approach to compliance. It also involves a commitment to dialogue that elevates it from a mere compliance function and takes it outside the self-regulatory mode.

If there are lessons to be learned from the events in the capital markets over the past two decades one must be that, however predisposed towards rules, principles, hybrids or law and soft law combinations, there is little room for purists in today's governance regulatory environment. That is, systems where the abundance of rules obscures the fundamental principles that underlie them risk a weakening of the spirit of compliance: systems that rely on principles without explicit guideposts for their application risk a weakening of the ability to enforce compliance absent the certainty and definition of the specific letter of the law.

³⁵⁵ A series of studies of regulatory method conducted by John Braithwaite and collaborators found that methods relying on strict coercive strategies weakened the goodwill and motivation of the willfully compliant. Ian Ayers and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, (New York: Oxford University Press, 1992); J. Braithwaite and T. Makkai, "Testing an expected utility model of corporate deterrence" (1994) *Law and Society Review* 25: 7-40.

³⁵⁶ A. Smith, *A Theory of Moral Sentiments*, IV.i.11 in Robert L Heilbroner (ed.) *The Essential Adam Smith*, 3d (New York: WW Norton & Company, 1987).

7.2 Power Shifts

The global contagion of the financial crisis that took hold in late 2007 and the prolonged aftermath exposed new limits to the effectiveness of regulatory regimes around the world. Firstly, that there were no effective safeguards against or restraints on the short-termism and excessive risk taking at its heart. Secondly, that there were no mechanisms to limit or contain the market contagion, the consequential damage to market integrity, and the profound loss of trust in the capital markets and the broader financial system.³⁵⁷

Furthermore, these events added further weight to the position that neither the markets based approach to the ‘just distribution of wealth’ envisaged in Smith’s notion of the ‘invisible hand’, nor the allocation of sole responsibility to governments acting alone or collectively through international organizations and institutions to direct economic activity for the ‘public good’, have been or will be successful in the face of the significant shift in power and influence symbolized by the emergence of the corporation as a dominant social institution and the ensuing forces of ‘globalization’.³⁵⁸

This shift has also effectively removed the possibility that there can be true separation of the economic from the social domain. As Cragg puts it,

“What globalization has done is to extend the reach of corporations and enhance the trend toward the concentration of wealth, thereby increasing the significance of private-sector management decisions for the welfare of increasing numbers of widely dispersed people.”³⁵⁹

The rise and influence of sovereign wealth funds from oil rich Gulf States and the new State capitalism of newly expansionist state-run economies such as China are prompting

³⁵⁷ Virtually no markets were left unscathed. While the trigger events – the collapse of Lehman Brothers, followed by the crises at Bear Stearns took place in the United States – the first banks that fell were IKB in Germany and Northern Rock in the United Kingdom.

³⁵⁸ Wesley Cragg, *Ethics Codes, Corporations and the Challenge of Globalization*, (Cheltenham: Edward Elgar Publishing, 2005) 2. For a discussion of traditional governance choices between shareholder and market based controls, formal and informal regulation and the evolution of those choices due to the changing nature of interests, see: J. Kirkbride, S. Letza, X. Sun “Corporate Governance: Towards a Theory of Regulatory Shift” (2005) *European Journal of Law and Economics*, 20.

³⁵⁹ Wesley Cragg, *Ethics Codes, Corporations and the Challenge of Globalization*, (Cheltenham: Edward Elgar Publishing, 2005) 2.

others to suggest a further possibility that traditional concepts of free market capitalism regulated by the rule of law and institutions of democratic governments may well be overshadowed or eclipsed in decades to come. With massive, non-democratic state-run companies now in control of three-quarters of the world's crude oil reserves and having influence ranging from aviation to telecommunications, it may be that an entirely new era of governance is already on the horizon.³⁶⁰

To the extent that there is capacity to influence – if not regulate – corporate behaviour, government policy has been cognizant of the vital role that corporations play in domestic economies and the need to avoid undue constraints on corporate access to, or competitiveness in, domestic and international markets. Governments therefore have competing pressures when it comes to how and to what extent they regulate business conduct. This is not only because of direct and indirect corporate influence in political process, but also because of the many legitimate policy demands including the need for investment, job creation, resource access and development, education, skills and technology innovation that underpin economic and social prosperity.

As a consequence, the enormous economic influence of corporations, which exerts more power and influence in many parts of the world than traditional governing institutions, is juxtaposed with a diminished ability of governments to adequately regulate the way that wealth generated by economic activity is distributed. What were once stable expectations about the respective roles of government and business in minding and mending the broader social fabric are now less predictable.³⁶¹

³⁶⁰ For a comprehensive discussion of this topic, see: Ian Bremmer, *The End of the Free Market: Who Wins the War Between States and Corporations* (New York: Portfolio, 2010); Stefan Halper, *The Beijing Consensus: How China's Authoritarian Model Will Dominate the Twenty-First Century* (New York: Basic Books, 2010).

³⁶¹ Preface to the UN Draft Guiding Principles to the UN "Protect, Respect, Remedy" Framework http://www.srsgconsultation.org/index.php/main/discussion?discussion_id=19. The Special Representative of the UN Secretary-General (SRSG) for business and human rights, Professor John Ruggie presented the Guiding Principles on the operationalization of the UN 'Protect, Respect, and Remedy' Framework to the UN Human Rights Council in June 2011. (The UN 'Protect, Respect and Remedy' Framework was endorsed unanimously by the UN Human Rights Council in 2008 to address business impacts on individual human rights around the world). The Guiding Principles will provide concrete guidance for companies, states, and other stakeholders on how they can operationalize the UN 'Protect, Respect and Remedy' Framework.

This leads to problems of collective action at the international level³⁶² and a disconnection between corporate centric governance regulation operating at the domestic level, and the mechanisms needed to regulate corporate governance from an external perspective³⁶³ that impede the world community from policing undesirable corporate activity.³⁶⁴

In Canada, for example, the issue of foreign acquisition of resources by non-democratic state controlled enterprises presents many challenges for the Canadian government. They range from public policy objectives such as protection of the national interest and national security to regulatory policy and economic and political issues arising from foreign investment, and concerns regarding the “governance and commercial orientation” of some state-owned enterprises. Among these, a principal concern is ensuring the commitment and ongoing adherence to Canadian corporate governance standards and norms. In this regard, the government has explicitly recognized Canadian norms such as positive business contributions to communities in which they operate as a factor in the net benefit test administered under the *Investment Canada Act*.³⁶⁵

In recent years, the Canadian government has dealt with prospective inward investment on a case by case basis, an approach that has been criticized for lack of clarity.³⁶⁶ What the approach does provide is an opportunity for the government to take measures to ensure that those who acquire material interests in Canadian assets abide by their

³⁶² Paul Stephan, “Regulatory Cooperation and Competition – The Search for Virtue” (June 1999). University of Virginia Law School, Legal Studies Working Paper No. 99-12. Available at SSRN: <http://ssrn.com/abstract=169213> or doi:10.2139/ssrn.169213 as quoted in Branson, Douglas M. “Teaching Comparative Corporate Governance: The Significance of “Soft Law” and International Institutions”, 34 *GA. Law Review* (2000) 669, 682-84.

³⁶³ Lawrence, A. Cunningham, “Commonalities and Prescriptions on the Vertical Dimension of Global Governance” (1999) 84 *Cornell Law Review* 1133 at 1134: Cunningham identifies governance regulation at the multinational level as “rules and regulations imposed upon the corporate entity to address concerns beyond the direct interests of the corporation” distinct from the “internal-vertical” and “internal-horizontal” governance that operate from a corporate centric orientation.

³⁶⁴ Douglas M. Branson, “Teaching Comparative Corporate Governance: The Significance of “Soft Law” and International Institutions” (2000) 34 *GA. Law Review* 669 at 682-84.

³⁶⁵ *The Investment Canada Act*, Chapter I-21.8, R.S 1985, Chapter 28.

³⁶⁶ See for example: Canadian Labour Congress, “Submission to the House of Commons Standing Committee on Industry, Science and Technology re: The Study of the Investment Canada Act”, March 2011. <http://www.canadianlabour.ca/news-room/submissions/submission-house-commons-standing-committee-industry-science-and-technology-re>,

promises and observe and comply with Canada's rules. The risk is that once Canadian companies are acquired by opaque foreign interests, such as those based in non-democratic regimes, it is very hard to verify whether commitments are being kept. As a consequence, state-owned enterprises are required to show that they adhere to Canadian corporate governance standards and that investments in Canadian assets are for valid commercial reasons and not to serve political or strategic agendas contrary to Canada's national interest or security.³⁶⁷

Government concerns over issues of direct or indirect foreign control are influencing the structure of foreign investments in Canadian assets. Transactions are being structured as joint ventures, partnerships or the acquisitions of minority stakes.³⁶⁸ However, while these provide at least the appearance of control remaining in Canada, joint ventures and partnerships with foreign entities involve a transfer of decision-making to the foreign party. Beyond that, once stakes are acquired there is the further issue of future transactions between foreign parties, neither of which have a stake in Canadian corporate governance standards and norms.³⁶⁹

These concerns, while most frequently arising in the natural resources sector and in respect of non-democratic states, recently arose in the context of Anglo-Australian BHP Billiton Limited's hostile bid for Potash Corporation of Saskatchewan and in the context of negotiations concerning the LSE and TMX stock exchange transaction. The former

³⁶⁷ Guidelines issued in December 2007 specify that the Minister of Industry will examine the corporate governance and reporting structure of the state-owned entity, and that this examination will include consideration of whether the foreign controlled entity adheres to Canadian standards of corporate governance – including, for example, commitments to transparency and disclosure, independent members of the boards of directors, independent audit committees, equitable treatment of shareholders, and adherence to Canadian laws and practices.

³⁶⁸ 2010 examples include: Korea Gas Corporation's 50% stake in Encana Corporation properties in Northeastern British Columbia; China Investment Corporation (the state-run sovereign wealth fund) acquisition of 45% of Penn West Energy Trust oil sand leases in the Peace River region; and PetroChina's proposed purchase of 50% of Encana Corporation Cutbank Ridge gas play in British Columbia.

³⁶⁹ In 2010, for example: China's Sinopec purchased its 9% stake in Syncrude Canada from ConocoPhillips; Thailand's PPT Exploration and Production acquired a 40% stake in Canada's Oil Sands from Norway's Statoil; Petrochina entered into an "integrated cooperation" agreement with Royal Dutch Shell plc on oil and gas projects in Canada; and Korea National Oil purchased Hunt Oil Company gas assets in Alberta and British Columbia.

resulted in a failure to satisfy the net benefit test.³⁷⁰ In the latter case, there was a conscious effort to bill the proposed transaction as a merger of equals and to include structural features to appease concerns over the loss of Canadian influence in the governance of the country's primary exchange.³⁷¹

The BHP Billiton case also illustrated the growing influence of non-government sources of concern for the protection of Canadian interests. Foreign acquisitions face additional scrutiny from the press, the public and public interest groups whose concerns extend to whether corporate policies and activities in communities will be consistent with Canadian norms and values as well as in compliance with laws and regulations. Evident in this is a growing awareness and concern that governments have no effective remedy, beyond court action, to ensure that promises made are kept.³⁷²

The Kraft Foods Inc. (Kraft) hostile takeover of Cadbury plc (Cadbury), one of Britain's oldest and nationally treasured firms, is a case in point. Traditionally, the United Kingdom's approach to takeovers has been to leave matters largely to market forces. However, there are growing concerns as to the resulting uncertain prospect for the fulfillment of corporate commitments, or respect for established corporate or national values.

³⁷⁰ On November 3, 2010, Canada's Industry Minister Tony Clement announced his decision that the proposed \$38-billion acquisition of Potash Corporation of Saskatchewan Inc. (PotashCorp) by BHP Billiton Limited (BHP) is not likely to be of "net benefit to Canada" under the *Investment Canada Act*. "Canadian Government Rejects BHP's proposed acquisition of Potash Corporation under the Investment Canada Act – Is Canada Still Open for Business?" *Osler Updates*, Nov. 9, 2010. www.osler.com/NewsResources/details.aspx?id=2958. At the heart of the issue was the fundamental mismatch between the position of the Saskatchewan government which considered PotashCorp to be a provincial resource to be developed in a manner consistent with the overall fiscal and economic needs of the province, including a fair and reliable return to taxpayers, and that of BHP Billiton's position that once it owned PotashCorp it would be free to develop the resources solely in accordance with the company's objectives, including a move to that would lead to more volatile and lower prices for potash. BHP subsequently abandoned its takeover bid on November 15, 2010. <http://www.bbc.co.uk/news/business-11754820/>.

³⁷¹ For example, the merged entity will be jointly headquartered in Toronto and London, and management comprise of executives drawn from both companies. <http://www.ltmxgroup.com/home>

³⁷² As Saskatchewan Premier Brad Wall put it, "Promises don't build schools" as quoted in Janice Mackinnon, "The Potash Takeover Bid: The Deal that Wasn't", *Policy Options*, December 2010 – January 2011.

The Cadbury Board of Directors rejected Kraft's initial unsolicited offer to acquire the company in late 2009, but Kraft persisted. The ensuing months of resistance to the American conglomerate's aggressive overtures and public expression of intent, known in the mergers and acquisitions world as a 'bear hug', fueled short-termist speculation in Cadbury's shares.³⁷³ In January, 2010 the Cadbury Board of Directors was finally pushed to recommend Kraft's increased offer to shareholders on no other basis than that the offer represented "good value for Cadbury shareholders".³⁷⁴

Despite statements by Kraft Chairman and CEO Irene Rosenfeld of Kraft's "great respect for Cadbury's brands, heritage and people"³⁷⁵ the future of Cadbury, its workers and the broader public interest were not well served by the takeover. Within seven days of Kraft's offer being declared unconditional, Kraft announced that it would not honour the commitment it had made consistently through successive offers "that the UK would be a net beneficiary in terms of jobs". The statement referred specifically to continued operation of one Cadbury facility and investment in another "thereby preserving UK manufacturing jobs".

Kraft's U-turn was roundly condemned in Britain. Sir Adrian and Sir Dominic Cadbury, as representatives of the founding family and former Chairmen of Cadbury, issued an appeal to Kraft stating that the company "had accepted a duty to those working for [Cadbury]" and urged it to "live up to that responsibility". The company was vilified in the press, publicly rebuked in Parliament and publicly censured by the Takeover Panel for making promises about jobs and factories that it was not in a position to keep.³⁷⁶

³⁷³ By the time of Kraft's final offer short term investors such as hedge funds owned as much as 31 per cent of Cadbury. Sam Jones, "How the Hedge Fund Industry Influences Boardroom Battles", June 22, 2010, *Financial Times - Special Report*. <http://www.ft.com/cms/s/2/e863f356-7dd8-11df-b357-00144feabdc0.html#axzz1UYH2vBUb>

³⁷⁴ Kraft Press Release, January 19, 2010. <http://www.prnewswire.com/news-releases/recommended-final-offer-by-kraft-foods-inc>

³⁷⁵ Ibid.

³⁷⁶ The Takeover Panel, *Kraft Foods Inc. (Kraft) Offer for Cadbury plc*, 2010/14. www.thetakeoverpanel.org.uk

However, while these responses may have caused damage to Kraft's reputation in the United Kingdom, their impact on a United States multinational the size of Kraft is limited, absent financial or other material penalties being imposed. This was evident in Irene Rosenfeld's refusal to appear before a House of Commons Business, Innovation and Skills Committee set up to investigate the U-turn, sending Kraft's Vice President for corporate and legal affairs in her place.

Furthermore, the terms of the offer required Kraft to assume an estimated \$10.5 billion of debt to fund the takeover, generating fears that Kraft would sacrifice more than the initial 400 jobs that were lost as a result of the U-turn. Presciently, Sir Adrian and Sir Dominic Cadbury, in a letter to the *Daily Telegraph* newspaper January 20, 2010 warned that a high percentage of takeovers fail to realise the advantages claimed by bidders, noting Kraft's past record of underperformance and failure in "their stewardship" of Terry another British company that Kraft had previously acquired.³⁷⁷ A mere 18 months after the takeover, on August 4, 2011 Kraft announced plans to split the Kraft conglomerate into two publicly traded companies. According to Chief Executive Irene Rosenfeld, "[A]s we acquired Cadbury and began to put the businesses together, we continued to look at our strategic plans for the combined company and it was clear that we had very different businesses".³⁷⁸

The losses go beyond jobs, to the communities affected by the increased unemployment and the beneficiaries of Cadbury's 180 year tradition of ethical, principled capitalism based on the Quaker values of its founders. In the words of Sir Adrian and Sir Dominic Cadbury:

³⁷⁷ Louise Armistead, "Kraft must 'live up to its responsibilities', says Cadbury Family", January 20, 2010, *Daily Telegraph*; Sir Adrian and Sir Dominic Cadbury, Letter to the *Daily Telegraph*, 20 January 2010. <http://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/7029959/As-Cadburys-we-will-look-to-Kraft-to-live-up-to-our-high-standards.html>. After Kraft's takeover of Terry's in 1993 Kraft promised not to abandon the firm's York headquarters, which had been in operation since 1767. Yet by 2005 the building had been sold to developers, with production shifted to low-cost Eastern Europe.

³⁷⁸ Helen Thomas, Allen Rappeport, Jim Pickard, Louise Lewis, "Kraft reveals plans to divide into in two", *Financial Times*. Online at: <http://www.ft.com/intl/cms/s/0/5ca5cd3e-be88-11e0-ab21-00144feabdc0.html#axzz1UUSs1eM>

A bidder can buy a business. What they cannot acquire is legitimacy over the character, values, experience and traditions on which that business was founded and flourished.³⁷⁹

This stark reality has prompted renewed attention to the United Kingdom's stance on takeovers, in particular the rules and *Takeover Code* that gives equal voting rights to all shareholders regardless of whether they are long-term investors or short term speculators whose only commitment is to profit, and the role of the investment bankers and advisors who stand to gain regardless of the outcome.

Mark Goyder, the founder and director of Tomorrow's Company, challenged the notion that the board was bound to recommend the offer on the basis of price alone, stating that “[n]either the takeover code nor the general law imposes a duty on directors to recommend a bid on price grounds alone where they feel it is not in the best interests of the company”.³⁸⁰ The then UK Secretary of State for Business, Peter Mandelson convened a roundtable to address the need for long term investment to counteract the risks and “perverse incentives” of excessive short termism.³⁸¹ A review of the *Takeover Code* commenced in February 2010, following Lord Mandelson's criticism of the Kraft takeover and the lack of government power to block it.

In March 2010, Lord Mandelson made the keynote Mansion House speech to the City of London in which he called for board directors to consider the interests of all stakeholders including employees, suppliers, a company's brands and capabilities and should act more like “stewards” than “auctioneers” looking for the highest bidder.³⁸² He even indicated a willingness to restate the 2006 *Companies Act* to make this clear.

³⁷⁹ Sir Adrian and Sir Dominic Cadbury, 20 January 2010, Letter to the *Daily Telegraph*. Online at: <http://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/7029959/As-Cadburys-we-will-look-to-Kraft-to-live-up-to-our-high-standards.html>.

³⁸⁰ Quoted in Jane Simms, “Selling Off Britain”, *Director*, March 2010

³⁸¹ Peter Mandelson, “Britain needs investors for the long term”, January 13, 2010, *The Financial Times*. www.ft.com

³⁸² Tim Webb, “Lord Mandelson call for overhaul of UK Takeover Rules”, March 2, 2010, *The Guardian*. <http://www.guardian.co.uk/business/2010/mar/01/lord-mandelson-mansion-house-keynote>

7.3 Achieving Regulatory Purpose in a Changing World

With the real prospect that state-based regulation, powers of enforcement and coercion will further diminish in the purview of stateless global corporate actors, and non-democratic state controlled enterprises and sovereign wealth funds, the role of regulator must contemplate a broadening of purpose to one that encompasses enabler and facilitator³⁸³ of responsible conduct.

That is, formal regulatory regimes must recognize the inherent and practical limits of command and control approaches and supplement them by finding ways to harness the interests of business, shareholders and other market forces in order to achieve regulatory purpose.

Academics and policy analysts have found fault with the command and control approach to regulation, proposing adaptations of regulatory method such as the more open reflexive approach³⁸⁴ and Ayers and Braithewaite's 'responsive regulation'.³⁸⁵ Bardach and Kagan have criticized the 'regulatory ratchet effect' of making ever more rules, resulting in greater complexity, and over technicality leading to evasion, creative compliance and exploitation of loopholes.³⁸⁶ The OECD has voiced concerns over the negative impact of complex, strict and uniform approaches on efficiency and

³⁸³ Lauren B. Edelman and Robin Stryker, "A Sociological Approach to Law and the Economy" in Neil J. Smelser, Richard Swedburg (ed.) *The Handbook of Economic Sociology*, (Princeton, NJ: Princeton University Press) 527-550. In terms of possible effects of law on the economy, Edelman and Stryker identify law as facilitative, regulatory or consuetive. As a facilitator, law does not intervene directly, but creates a legal environment that enables and provides tools for organizations to conduct their operations according to explicit but voluntary desired standards. For example, in the United Kingdom the mandatory comply or explain legislation where the content of the disclosure is not prescribed, only the requirement to disclose.

³⁸⁴ G. Teubner, "Juridification: Concepts, aspects, limits, solutions" in G. Teubner (ed.) *Juridification of Social Spheres: A Comparative Analysis of the Areas of Labor, Corporate, Antitrust and Welfare Law* (Berlin: Walter De Gruyter, 1987) 3-48.

³⁸⁵ Ian Ayers and John Braithewaite, *Responsive Regulation: Transcending the Deregulation Debate*, (New York: Oxford University Press, 1992) 20.

³⁸⁶ E. Bardach and R.A. Kagan *Going By The Book: the problem of unreasonableness*. (Philadelphia, PA: Temple University Press, 1982).

competitiveness.³⁸⁷ Others have levied criticism and cited weaknesses in the ‘lighter touch’ and hybrid regulatory approaches in the United Kingdom.³⁸⁸

Whatever the regulatory ideal might be, the fact remains that the formal regulatory function is only a part of the overall governance equation. The best contribution from a regulatory standpoint is therefore one that recognizes the limits of command and control, uniform rules, and the imperviousness of some to principles, at the same time as it is harnessing the attributes of the regulated entities and other market forces to achieve regulatory goals.

In North America, industry, academics and regulators debate whether a tendency toward rigid adherence to prescription and a one size fits all approach is the most effective means to address the governance challenges and needs of an increasingly diverse and peripatetic business community, and also to achieve complex public policy and regulatory objectives.³⁸⁹

At the same time, there are similar examinations in other jurisdictions such as the United Kingdom and Europe of whether there is a need to augment the current principles based system and reliance on the greater flexibility of the ‘comply or explain’ approach to corporate governance with new rules and more explicit requirements.

Perpetuating a debate over the secondary consideration of form rather than focusing on the primary issues of substance and purpose unnecessarily limits the range of possible outcomes and impedes the ability to look beyond any perceived dichotomy between

³⁸⁷ OECD, *The OECD Report on Regulatory Reform*, 1997, Paris. 21 ff, 199-201.

³⁸⁸ U.S Treasury Secretary Timothy Geithner remarks in an interview with the BBC 22 February, 2011 attempted to shift blame for the events leading up to the 2007-09 financial crisis onto the UK and other jurisdictions with a ‘light touch’ financial regulatory approach notwithstanding that the institutions at the heart of the crisis were all subject to United States financial regulation.

³⁸⁹ Two examples where the United States has deviated from its tendency toward prescriptive rules are: the insider trading prohibitions of Rule 10b-5 Securities Exchange Act which operate and have been judicially interpreted from a principles basis; and the revised disclosure rules adopted by the SEC on December 16, 2009, that require companies to describe their chosen model for board leadership in a clear departure from the prescriptive approach of SOX. 17 CFR Parts 229, 239, 240, et al. Proxy Disclosure Enhancements; Final Rule – Amending Item 407 of Regulation S-K and a corresponding amendment to Item 7 of Schedule 14A.

principles-based or rules-based regulatory systems, similarly between stakeholder and shareholder models, to their combined strengths in achieving regulatory purpose.³⁹⁰

The narrow purpose of regulation is to effect control within a system by means of rules. In practice, regulators must serve this purpose while seeking to maintain a complex balance between the competing interests of multiple regulated and stakeholder constituents operating within that system and with finite resources far outweighed by those available to those it regulates.

Those charged with regulating the governance and conduct of capital market participants pursue this purpose within a dynamic system. It is a regulatory undertaking that is made more challenging by the ever-increasing complexity and speed of technologically enabled financial and marketplace innovation, and the consequences of globalization. These factors contribute to a scale and a magnitude of issues that ensure each new crisis or scandal will be a larger and more damaging iteration of the ones that regulators have encountered throughout the evolution of capital markets.³⁹¹

Simply acknowledging the complexity and dynamic state of regulatory practice serves as a powerful reminder of the distance between regulatory theory and its subject. The purpose of the former is to study and describe the method and process of regulation – from the development of policy through to enforcement. Like all theoretical disciplines, it develops and then relies on a system of classification based on the identification of distinct characteristics. Unarguably useful for the purposes of study, in practice this taxonomy can suggest much clearer distinctions than actually exist, overlook interdependencies, or lead to generalizations that inaccurately or incompletely reflect reality.³⁹²

³⁹⁰ J. Kirkbride, S. Letza, X. Sun, “Corporate Governance: Towards a Theory of Regulatory Shift”, (2005) *European Journal of Law and Economics* 20.

³⁹¹ See section 3.1.

³⁹² The United States is generalized as a rules-based, prescriptive regulatory system. However, this characterization risks overlooking innovations in regulatory approach such as in connection with the Federal Sentencing Guidelines (see *infra* note 548) and even within established practices. For example, on December 16, 2009, the SEC adopted revised disclosure rules requiring companies to describe its chosen model for board leadership in a clear departure from the prescriptive approach of the *Sarbanes Oxley Act*.

Furthermore, the desire to locate regulatory practice within a fixed taxonomy and analytic framework can result in failure to acknowledge the ongoing efforts of regulators to adapt and respond to changing circumstances. The case of the United Kingdom's FSA provides a striking example. While academics waged the debate over rules versus principles approach to corporate governance regulation, the United Kingdom system most closely associated with the latter was undergoing a significant evolution in their regulatory approach towards values-based regulation with a greater focus on outcomes and proactive intervention.³⁹³

7.4 The Limits of Regulatory Responsibility

Whatever their position in the rules principles debate, the fact is that both the United Kingdom and the United States with all of their G8 peers embarked in 2009, by necessity, on a further set of rapid reforms to their market regulatory architecture – illustrating the oft overlooked gap between theory and practice. With much of the theoretical debate focused on the comparative effectiveness of a set of prescriptive rules or a system founded on principles, the whole basis of discussion was overtaken by world economic events and the need for a practical frontline regulatory response – itself a delayed reaction to the years of unregulated market activity that precipitated the crisis.

In the immediate aftermath, regulatory authorities turned their focus inward to discern the weaknesses and failings of the regulatory structure that 'allowed to happen' the activities leading up to the financial crisis and the wide spread repercussions. This apparent search for defects or shortcomings in the regulatory structure is a distortion of the conventional regulatory response to crisis, in that it seeks to lay blame, but it does do so not at the feet of the perpetrators but of the various public institutions charged with oversight and regulatory authority.

³⁹³ The outcomes-based approach focuses on proactive intervention, and judgments as to the future decisions of firms based on business model and other analysis. It signifies a radical shift that commenced in 2008.

Admittedly these institutions have public interest mandates and duties to ensure the fair and efficient operation of financial markets. However, their inability or failure to do so in circumstances of dedicated, sophisticated, and willful market manipulation and engagement in activities that, while unethical, were not illegal should not overshadow or downplay the valuable function that regulators perform nor the fact of the original sin. As has been discussed, regulation may deter and punish wrongful behaviour and in some instances may provide incentives for good conduct, but even when poor regulations lead to unintended consequences, or a susceptibility over time to regulatory capture, the moral and legal culpability for wrongdoing lies elsewhere and with it responsibility for the consequences that flow from it.

Yet, there is a recurring pattern, whereby in the face of criminal activity it is the police and other enforcement agencies who are blamed. As in the recent case of the Stanley Cup hockey riots in Vancouver, Canada when almost immediately fingers were pointed at the municipal authorities and the police force for not having more officers on the ground to respond, rather than on the individuals who caused the rioting and vandalism in the first place and were thus legally and morally responsible.³⁹⁴

That being said, effective regulation builds on the lessons of the past and analysis of the circumstances, mistakes made, oversights and systemic deficiencies is an important undertaking. However, at the very least, any reform initiatives should place as much emphasis on mandate, purpose and substantive content of the regulation as on the architecture of the regulatory system. This is a fact often overlooked by both those charged with the regulatory reform and those commenting on them.

For centuries, it has been known that it is much easier to conduct reorganization than it is to progress or to make deep substantive changes. As Petronius is said to have observed:

“... it seemed that every time we were beginning to form up into teams, we would be reorganized. I was to learn later in life that we tend to meet any new situation by reorganizing; and a wonderful method it can be for creating the

³⁹⁴ Jeff Lee, Jonathan Fowlie, “Debate over Stanley Cup riot turns political”, June 29, 2011, *The Vancouver Sun*; Vancouver Riot Review www.pssg.gov.bc.ca/vancouverriotreview.

illusion of progress while producing confusion, inefficiency, and demoralization."³⁹⁵

Over the past two years, significant plans have been made for changes to the regulatory landscape in major developed financial and capital markets in response to the global financial crisis. The United States, the United Kingdom and the European Commission have all embarked on proposals for regulatory reform that will entail a shifting around of regulatory authority between existing institutions and the creation of new regulatory structures. The scope of the proposed changes goes much wider than the specific activities at the heart of the crisis. The risk of such proposals is that governments have chosen a politically motivated show of action over thoughtful consideration and in so doing have failed to get to the real pith and substance of the issues before playing musical chairs.

Even in Canada, relatively unscathed by the events of 2007 – 2009, the government has pushed forward on decades long and deeply contentious reform proposals for financial market regulation. The so-called national regulator debate concerns the establishment of a single national (i.e. federal) securities regulator in place of the existing system of harmonized regulation by the provinces pursuant to their exclusive constitutional jurisdiction over property and civil rights. Three of the four provinces with significant capital market activity object to the national regulator and higher courts in two of those provinces, Alberta and Québec, have found that a single federal regulator would violate provincial jurisdiction. Nonetheless, the federal government has taken the issue to the Supreme Court of Canada for final say in the question of who has authority over securities regulation: the federal government, the provincial governments, or a combination of both. Notably, the question before the SCC does not contain anything about the content of securities regulation, only about who has the power to make the rules.

There is no clear consensus among market participants, politicians and academics in Canada as to whether the proposal is of net benefit, or in some cases how benefit is to be

³⁹⁵ Attributed to Roman satirist Gaius Petronius Arbiter, 210 BC.

measured. Proponents of the federal regulator cite streamlined regulation, improved investigation and regulatory powers, and a unified securities representative abroad.³⁹⁶

Those who oppose cite the effectiveness of the already substantially harmonized system of provincial regulation under the auspices of the Canadian Securities Administrators (CSA), and its ability to react to and address local regulatory concerns which is a significant factor in a country as large and diverse as Canada.

Unlike other jurisdictions embarking on structural reform of market regulation as a response to the financial crisis and the tangible concerns over market abuses, irregularities and excessive risk that it exposed, the proposed draft federal *Securities Act (Canada)* proposed no substantive change to the existing body of substantially harmonized securities regulations. Its purpose is to replace the functioning co-operative network of 13 provincial and territorial securities regulators with a single national securities regulator that in practice would devolve significant aspects of its ongoing regulatory function to provincially or regionally situated bodies. In other words, the plan is primarily to effect organizational and structural change and not to change the substance of the regulation.³⁹⁷

Ultimately, neither change to formal structure nor to substantive content will prove a regulatory panacea. Understood in this light, it is impractical to suggest any regulatory authority today should follow any one approach to the exclusion of any other, and unrealistic to expect that such an approach would be infallible. Instead, regulators need to access and consider a range of approaches and all available resources so they can develop policy and select fit for purpose tools to reconstruct regulatory authority, achieve

³⁹⁶ The federal government's argument that the lack of a federal regulator diminishes Canada's international credibility is not supported by evidence that shows that Canada's financial system is consistently rated above average with increasing scores in the CFA Institute's annual global survey of chartered financial analysts. Source: CFA Institute, "Financial Market Integrity Index: Canada 2010", <http://www.cfapubs.org/toc/ccb/2010/2010/8>

³⁹⁷ The Supreme Court made its decision in December 2011 after the completion of this thesis. While the Court found for the status quo in terms of the constitutional division of powers that gives provinces the exclusive right to regulate securities markets, it identified a role for federal powers in respect of issues concerning systemic risk. If pursued, this would follow other jurisdictions that have identified a need for a separate oversight function to anticipate and address systemic risk to markets and the economy.

effective oversight of corporate actions, and ultimately restore the trust on which market order and efficiency rely.³⁹⁸

Returning specifically to the regulation of business conduct and governance, more open, reflexive and responsive regulatory approaches continue to have merit. This is not only because, arguably, a fixed set of optimal standards and best practices will continue to remain elusive, and thus far from satisfying the test of sufficiently precise definition and description that they could be reasonably legislated in a prescriptive manner.³⁹⁹

It is also because the examples of effective codification such as in the United Kingdom's Corporate Governance Code operating in conjunction with a comprehensive body of company law highlight the strength of a combination of guidance and prescription in recognizing and providing needed flexibility to accommodate the diversity of corporate structures and circumstances.⁴⁰⁰ This contrasts with the attempts in the United States at 'one size fits all' prescription with respect to corporate governance pursuant to the *Sarbanes-Oxley Act* to fill the limitations in corporate law (the purview of the individual States) and the restricted constitutional mandate of the federal Securities and Exchange Committee.

They also mitigate the risk that if regulators' only recourse is prescriptive, compulsory standards it will entrench the lowest common denominator, precipitate regulatory arbitrage, or both, rather than enable and encourage corporations to continue to develop and follow best practices as a part of their strategy for success.⁴⁰¹ As Francis Fukuyama

³⁹⁸ The idea that regulatory authorities can and, indeed should, have a range of regulatory tools and approaches available from which to choose is not new. Ayers and Braithwaite, among others, described this approach as the core of what they term 'responsive regulation': "An attitude of responsiveness does generate different policy ideas that do transcend the divide between regulatory and deregulatory solutions. But for the responsive regulator, there are no optimal or best regulatory solutions, just solutions that respond better than others to the plural configurations of support and opposition that exist in any particular moment in history".

³⁹⁹ Ian Ayers and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (New York: Oxford University Press, 1992).

⁴⁰⁰ In *Business Roundtable v. SEC*, 905 F. 2d. 406 (D.C. Cir., 1990) a federal appellate court held that attempting to lay down corporate governance rules exceeded the SEC's mandate to promote full disclosure and to help create a national market system for trading securities.

⁴⁰¹ See discussion *infra* at 10.2 and Figure 11.

has identified “there is usually an inverse relationship between rules and trust” and “past a certain point, the proliferation of rules to regulate wider and wider sets of social relationships becomes not the hallmark of efficiency but a sign of social dysfunction.”⁴⁰²

⁴⁰² Francis Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (New York: The Free Press, 1995) 244.

8. A Matter of Form *and* Substance

If the standard of morals is low it is because the education given by the interaction of the individual with his social environment is defective.

John Dewey⁴⁰³

8.1 Formal Boundaries

As the preceding chapters and the discussion of repeated cycles of crisis and regulatory response have sought to illustrate, merely instituting more laws and creating new authorities to oversee them will likely not be sufficient to prevent future transgressions.⁴⁰⁴ The incidences of acute and chronic fraudulent, malfeasant, and unethical conduct in capital markets continue to occur seemingly unabated, and notwithstanding the ever-increasing arsenal of laws, regulations and sanctions available to established government regulatory authorities around the world.

Furthermore, as recriminations over the failure of existing regulatory agencies to identify and intervene in respect of activity posing risk to the financial and capital market system prompt governments to adopt new regulatory authorities, structures and mechanisms to identify and regulate systemic risk, it becomes clear that efforts to anticipate and react to the complexity of modern markets beget further complexity, the potential for unintended consequences, duplication and measures that may impose burdens and costs disproportionate to their intended goals.

While it is arguably the case that the perpetrators of the worst breaches of the law are in the minority, as noted earlier in section 3.3 their actions and reducing the risk of future similar actions has a tendency to dominate traditional regulatory discourse. That is, where

⁴⁰³ John Dewey, *Human Nature and Conduct: An Introduction to Social Psychology* (Cosimo Inc., 2007). (*Human Nature and Conduct: An Introduction to Social Psychology* was first published in 1922.)

⁴⁰⁴ For an examination of the cycle of crisis and response, see Thomas Clark, "Cycles of Crisis and Regulation: The Enduring Agency and Stewardship Problems of Corporate Governance" (2004) *Corporate Governance* Vol. 12, No.4 (Blackwell: London) 153.

the finite pool of legal and regulatory resources is channeled to compliance, control and enforcement measures and activities ahead or instead of measures designed to enable, express and facilitate the actions of the willfully compliant.

Governments and regulatory authorities are seemingly fully occupied with filling the holes in the legal fabric, developing policy to keep pace with marketplace innovations, and responding to each new crisis as they emerge. With the globalization of capital and financial markets they are also tasked with the challenge of going beyond their traditional regulatory realms and engaging with counterparts at an international level to work towards some degree of multilateral consensus or at least coordination and mutual recognition among nations on key market fundamentals.⁴⁰⁵

Even in the unlikely circumstance of uncapped government resources to commit to these tasks, there are limits to what can be accomplished through law and regulation when it comes to standards of governance and conduct.

Within democratic societies, boundaries are set with a conscious respect for the need to balance individual freedoms such as freedom of choice and the good of society. Standards that become formally enshrined in law serve to define a baseline for conduct – the minimum of necessary and justifiable restraints on individual freedom that can be imposed and enforced for the protection of such freedoms in society. They are intended and should be regarded as a reflection of the minimum acceptable to society, indeed essential to its preservation, and not as a guide to what are sufficient in terms of prevailing moral sentiment.⁴⁰⁶

In practice, the law establishes the minimum threshold necessary to maintain that balance. In the business context, the legal and regulatory framework establishes the baseline for acceptable business conduct. However, the prevalence of business influence

⁴⁰⁵ Examples include: the G8 and G20; the IMF; IOSCO; the OECD; the UN; and the WTO.

⁴⁰⁶ Stone observes that the view of law as an “expression of popular sentiment” fails to address the gap between public expectations and the law-making process and what occurs while the gap exists. Christopher Stone, *Where the Law Ends: The Social Control of Corporate Behaviour*, 1975 (Prospect Heights, Ill.: Waveland Press Inc., 1991) 93.

in all aspects of society and the impact of its operations and demands on human and natural environments has shifted the balance, calling into question the sufficiency of minimum legal standards to enforce appropriate limits and protect against misconduct.⁴⁰⁷

From a sociological perspective, law and regulatory standards as institutionalized norms are primarily reactive⁴⁰⁸: explicitly formulated as a means of formally regulating specific behaviours and achieving conformity to explicit societal expectations.⁴⁰⁹

Unlike normative rules that are fluid, laws (in many instances a codification of normative rules) have a concrete, factual dimension that invites analysis of stated objectives, formulation, and function. The enactment of new laws thus necessitates a formal process designed to ensure that democratic principles are respected and that the checks and balances essential to protect the integrity of the rule of law are observed both in substance and in process.

The procedure for adopting and implementing new law and regulation in mature democracies is governed by statute.⁴¹⁰ It is preceded by a formal process whereby underlying policy issues must first be identified, examined and evaluated to determine whether they support a case for some kind of regulatory response, whether it be rules-based, prescriptive regulation at one end of the regulatory spectrum, or another form of intervention such as issuing guidance at the other end of the spectrum.

Any action or intervention by regulators must be justified when balancing the competing interests of multiple regulated and stakeholder constituents, taking account of finite

⁴⁰⁷ Ten of 36 corporate codes contained explicit statements to the effect that in any instance where there is an inconsistency between an applicable law and the company's code, compliance must be with whichever is the higher standard. For example, Alstom's Code of Ethics includes the statement: "Many of Alstom's activities are not the subject of laws, regulations or other mandatory requirements, in which case principles of fairness and honesty must govern our conduct."

⁴⁰⁸ Christopher Stone, *Where the Law Ends: The Social Control of Corporate Behaviour*, 1975 (Prospect Heights, Ill.: Waveland Press Inc., 1991) 94.

⁴⁰⁹ Mathieu Deflem, *Sociology of Law: Visions of a Scholarly Tradition* (Cambridge, United Kingdom: Cambridge University Press, 2008) 6-7.

⁴¹⁰ For example, see: British Columbia Securities Commission *Rule Making Procedure Regulation* B.C. Reg. 195/97.

resources, and considering the outcome from the market testing of the proposed direction or intervention.⁴¹¹ Furthermore, any resulting regulatory action or measures must satisfy the test of sufficient precision to be capable of being reasonably understood and complied with, yet sufficiently general to be broadly applicable and to stand the test of time. Only then are new measures proposed, considered and formally adopted by the appropriate rule-making authority.⁴¹²

Yet, notwithstanding the rigour of this formal process, an enduring conundrum for lawmakers and regulators remains that the existence of ‘law on the books’ is no guarantee of lawfulness, that there are no rules to be made that can eliminate or ensure immunity from misconduct.

Emile Durkheim in his early work toward a sociological perspective of law identified this differentiation between the law as the formal rules and their stated objective, and the practical application and consequences of those rules within society in his theory of normative integration.⁴¹³

⁴¹¹ For discussion on types of regulatory techniques or interventions to achieve policy objectives in contemporary economic, social and political arenas see Andrew Dunsire’s discussion paper, “Manipulating Social Tensions: Collibration as an Alternative Mode of Government Intervention”, Max-Planck-Institut für Gesellschaftsforschung Discussion Paper 93/7, August 1993. Also see: A. Dunsire, “Modes of Governance” in J. Kooiman (ed.), *Modern Governance: new government-society interactions*. (London: Sage, 1993) 21-34; and J. Kirkbride and S. Letza, “Regulation, Governance and Regulatory Collibration: achieving an ‘holistic’ approach” (2004) *An International Review* Volume 12, No. 1. Regarding the use of reputational sanctioning as an instrument of public policy, see: E.A. Posner, *Law and Social Norms* (Harvard University Press, 2000); C.R. Alexander, “On the nature of the reputational penalty for corporate crime: evidence” (1999) *Journal of Law and Economics* vol. XLII, 489-526; J.M. Karpoff, D. Scott Lee and G.S. Martin, “The Cost to Firms of Cooking the Books”, Working Paper, 4 January 2007. Available at SSRN: <http://ssrn.com/abstract=652121>.

⁴¹² Canadian Securities Administrators, “Policy development and rule-making guidelines” – undated internal reference guide.

⁴¹³ Emile Durkheim, *The Division of Labour in Society*. (New York: The Free Press, 1984 (1893)). Merry has observed that “law is embedded in social structure and culture and cannot be understood in isolation”. S.E. Merry, “Anthropology and the study of Alternative Dispute Resolution”, 34 *Journal of Legal Education* (1984) 278. Further, according to Ewick and Silbey, “the ways in which the law is experienced and understood by ordinary citizens as they choose to invoke the law, to avoid it, or to resist it, is an essential part of the life of the law”. P. Ewick and S. Silbey, “Conformity, Contestation, and Resistance: An Account of Legal Consciousness” (1992) 26 *New England Law Review* 731 at 737. In McCann and March’s summation “law is a . . . force that at once structures the spaces of social life and is reconstructed by citizens’ activity within those spaces”. M.W. McCann and T. March, “Legal Tactics and Everyday Forms of Resistance: A Socio-Political Assessment” Conference Critical Epistemologies in Law, International Institute for the Sociology of Law, Onati, Spain, October 2-4, 1994 as quoted in Peter Fitzpatrick, “Missing Possibility: Socialization, Culture and Consciousness”, in A. Sarat et al. (eds.) *Crossing Boundaries*:

This theory and the dual construction of law that comprises on the one hand the rules of law and their proclaimed objectives and, on the other hand, the actual workings and practice of law – encompassing the whole of the roles, functions, interactions, and organizational forms that interact with those rules – enables an understanding of the analytical distinction between the formal rules and regulatory function, and the actual capacity to regulate activity and behaviour in accordance with legal norms. Where the latter is determined in large part by the operation and consequences of the law and has a distinct existence from the formal body of rules and their stated purposes.

According to Hart, the operation and consequences of law in the hands of officials and citizens – its practice – provides insight into the acceptance of legal norms as giving reasons for action.⁴¹⁴ This idea of the potential of popular acceptance moves the concept of law beyond Austin and Bentham’s legal positivist ‘command theory’ to a more normative understanding of law’s social function.⁴¹⁵

The distance between the formal rules and their recognition⁴¹⁶, interpretation and operation, increases with increasing complexity and uncertainty and declining or contested authority⁴¹⁷. All of these diminish the capacity of regulators to make unambiguous prescription for the actions and interactions of regulated parties.

traditions and transformations in law and society research, Vol. 4 *Fundamental Issues in Law and Society research* (Northwestern University Press, 1998) 185 at 189.

⁴¹⁴ H.L.A Hart, *The Concept of Law* 2d ed. (Oxford: Clarendon Press, 1994) 13, 55-8, 82-4, 88-91,99

⁴¹⁵ For example, Austin’s version of the ‘command theory’ provided for a simple system of law whereby all laws are sovereign commands with the observance or failure to observe motivated and enforced by official sanctions. J. Austin, J. *The Providence of Jurisprudence Determined*, ed. W.E Rumble. (Cambridge, UK: Cambridge University Press, 1994 [1832]) 21-6.

⁴¹⁶ Hart’s ‘Rule of Recognition’ established the criteria of validity within a legal system such that it provides for the acceptance of rules as valid by the system’s officials *and* the general obedience to such rules of the rules as are valid according to the Rule. H.L.A Hart, *The Concept of Law* 2d ed. (Oxford: Clarendon Press, 1994) 116

⁴¹⁷ M.B. Steger, *Globalization: A Very Short Introduction* (Oxford, UK: Oxford University Press, 2003) on the declining influence of national governments as a result of economic globalization.

8.2 Regulating with Hindsight

Lawmakers and regulators are too often caught in a ‘catch up’ conundrum – regulating in response to past abuses, rather than proactively to prevent future transgressions.

The inherent limits of successive regulative responses and compliance mechanisms are, as Larry D. Thompson observed, that — “[r]egulations expand with each ensuing scandal to encompass every possible abuse ... except for the next one”.⁴¹⁸ The 2007 – 2009 global financial crisis provides recent illustration of how a system that relies on the conventionally reactive posture of traditional state-centred, rules-based regulatory approaches is constantly at risk of exposure to the next threat.

The role played by as yet unregulated market actors in the recent financial crisis provides a perfect example of this kind of conundrum. The extensive and ongoing analysis of the circumstances and factors contributing to the perfect storm of events in the period from 2007 – 2009 makes the point that certain market actors – such as the credit rating agencies – with a direct role in the market distortions of value and investment risk that enabled extremes of speculative finance were only peripherally regulated and failed to fulfill a perceived gatekeeper role.⁴¹⁹

This weakness in the system was raised in an earlier 2002 report prepared by the United States Senate Committee on Governmental Affairs “Financial Oversight of Enron: The SEC and Private Sector Watchdogs” found the credit rating “analysts [did] not view themselves as accountable for their actions,” since the rating agencies were subject to

⁴¹⁸ Larry D. Thompson, Senior Fellow, The Brookings Institute, 2003 Federalist Society Address 2 (November 14, 2003)

⁴¹⁹ The first comprehensive analysis on the role of credit rating agencies was published 7 April 2008 in the report of the Financial Stability Forum (FSF) on enhancing market and institutional resilience (Financial Stability Forum 2008). The report identified a need for further steps to improve internal governance, the transparency of rating procedures, and compliance with international codes of conduct. Also see: Lawrence J. White, “Credit Rating Agencies and the Financial Crisis: Less Regulation of CRAs Is a Better Response”, Forthcoming: *Journal of International Banking Law and Regulation*, http://web-docs.stern.nyu.edu/old_web/economics/docs/workingpapers/2010/White_Credit%20Rating%20Agencies%20for%20JIBLR.pdf In White’s view, the response to the failures and shortcomings of the credit rating system should take the form of less regulation, and greater market competition among purveyors of credit and investment quality information.

little regulation or oversight, and their liability for poor quality ratings was limited by regulatory exemptions and First Amendment protections.⁴²⁰

This notion that accountability is contingent on there being an explicit legal requirement, rather than something that is inherent in the proper conduct of affairs for which there are far-reaching consequences, poses significant risk to a system that relies on far more than the letter of the law for its stability and continued existence.

The circumstances that led to the financial and ensuing market crisis, in common with the accounting scandals and internet debacles that preceded it, had at its heart activity that was unethical, but not technically illegal at the time it was engaged in and in some cases remains so today. Granted, there have been some prosecutions in the United States and a handful of high profile settlements by the SEC⁴²¹, but given the scope and scale of the damage caused and losses suffered certainly an inadequate number to satisfy the public's need to see those involved properly held to account. As Judge Jed Rakoff of the Southern District of New York in rejecting the SEC's so-called 'no-admit, no-deny' policy for reaching legal settlements with banks accused of misconduct recently stated, any such deal would "serve no lawful or moral purpose" and simply be "an engine of oppression"

⁴²⁰ 10/8/2002 "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs," prepared by the U.S. Senate Committee on Governmental Affairs, at 122.

⁴²¹ In July 2010, Goldman Sachs agreed to a US\$550 million civil settlement relating to accusations that the bank had misled investors in the bank's Abacus security – no executives were named and the settlement amount is estimated to be equivalent to a mere 15 days profit based on the bank's 2009 stated earnings (A. Jones "But who won? Sizing up Goldman's deal with the SEC", *The Wall Street Journal*, July 15, 2010). Citigroup paid US\$285 million to settle charges that it defrauded investors who bought toxic housing related debt that the bank bet would fail – Citigroup made no admission of wrongdoing. Bear Stearns executives Ralph Ciotti and Matthew Tannin were charged with conspiracy to commit securities fraud and wire fraud, securities fraud, wire fraud, and face a criminal forfeiture count, but found not guilty on all counts. In June 2011 JP Morgan agreed to pay US\$153.6 to settle an SEC suit relating to claims that the bank misled investors but without admission of guilt. In the aftermath of the corporate scandals at the end of the last century a number of individuals were prosecuted. Enron chief executive Jeffrey Skilling was sentenced to 24 years and four months in prison for his role in the demise of Enron and required to surrender US\$43 million in assets to a restitution fund for Enron retirees and shareholders. Former Worldcom CEO Bernie Ebbers received a 25 year prison sentence for fraud however Scott Sullivan was only sentenced to five years on account of his cooperation with the prosecuting authorities notwithstanding that he was more directly responsible for the fraud than Ebbers. For an account of the Worldcom fraud see: Cynthia Cooper, *Extraordinary Circumstances: Journey of a Corporate Whistleblower* (New York: Wiley, 2008).

that fails to shed the light needed to expose to the public the nature and extent of industry's misconduct.⁴²²

Prior to and regardless of the existence of specific rules and detailed regulations, ethical values such as fairness, honesty, and responsibility and principles of integrity, trustworthiness, and good faith must be affirmed as the irrefutable authority and basis for the judgment of conduct, reputation, respectability and ultimately licence to operate.

The latest financial crisis has provided a window, albeit limited if the past is any indication of the future, to do this. Regardless of the technical diagnoses of the myriad causes and specific activities that precipitated the 2007 – 2009 global financial crisis, as discussed previously there is a legitimate and accepted view that this one like those before it stemmed from an endemic culture of reckless disregard for implications and consequences and virtually unfettered pursuit of profit. This is a view that looks to the very roots of a recurrent pattern of behaviour, not a technical and therefore limited diagnosis of particular symptoms in a given set of circumstances.

The recognition in the United States that much of the activity at the heart of the crisis though ethically wrong was not technically illegal prompted new regulatory measures such as two conflict of interest prohibitions introduced under the *Dodd-Frank Act* aimed at restoring the ethical bar against investment banks and other financial institutions profiting at their clients' expense.

The first is a broad prohibition that applies in any circumstances in which a firm trades for its own account.⁴²³ The second, in Section 621, imposes a specific, explicit prohibition on any firm that underwrites, sponsors, or acts as a placement agent for an asset backed security, including a synthetic asset backed security, from engaging in a transaction “that would involve or result in any material conflict of interest” with an investor in that security.

⁴²² *U.S. Securities and Exchange Commission v. Citigroup Global Markets Inc.*, 11 Civ. 7387, U.S. District Court, Southern District of New York (Manhattan).

⁴²³ Section 621 of the *Dodd-Frank Act* (creating a new § 27B(a)) in the *Securities Act of 1933*.

The policy objective is that together, these two prohibitions will operate to protect market participants from the unethical, self-dealing activity that contributed to the financial crisis. However, as with all regulatory approaches, whether or not this objective is served depends on proper implementation, commitment to the behavioural change necessary to ensure observance of the prohibitions in practice by regulated parties, and effective detection of and disciplinary response to conflict cases. Essentially, these new regulations are seeking to use formal means to change behaviour and practices that have become normalized business practices operating throughout an already regulated community and despite existing standards.

In a recent study, the SEC explained that while certain obligations arise under federal securities laws such as the suitability obligation set out in the anti-fraud provisions, the Self Regulatory Organization (SRO) rules are grounded in concepts of ethics, professionalism, fair dealing, and just and equitable principles of trade.⁴²⁴ For example, FINRA Rule 2010, providing Standards of Commercial Honor and Principles of Trade, states: “A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.”⁴²⁵

In the most recent financial crisis, the globalization of finance ensured that the market contagion spread virtually unchecked by state-based safeguards. The subsequent commitment among the G20 to the addition of systemic risk regulation to the market oversight architectures recognizes this shortcoming and signals an intention to get ahead of, or at least keep pace, with activity, products or patterns of business conduct and behaviours that pose potential risks.

In terms of systemic reform, choosing to address behavior at its roots is a huge undertaking but one that promises sustainable change, choosing to address only the latest

⁴²⁴ 1/2011 “Study on Investment Advisers and Broker-Dealers,” study conducted by the U.S. Securities and Exchange Commission, at 61, <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>, (hereinafter referred to as “SEC Study on Investment Advisers and Broker-Dealers”).

⁴²⁵ FINRA Rule 2010. See also Study on Investment Advisers and Broker-Dealers *ibid.* at 55 (broker-dealers also have an obligation under the federal securities laws and FINRA rules to deal fairly with their customers).

set of symptoms risks future recurrence in another form: recognizing the fundamental interconnection between the two and being willing to take on both are steps toward building the foundation for a new paradigm in corporate governance.

8.3 The Importance of Informal or Normative Constraints

Traditional governance choice theory proposes two ideals of formal governance: ‘hierarchical’ governance based on legitimate, recognized authority and ‘market’ governance based on a price mechanism.⁴²⁶ However, as has been discussed, in an open economic system such as the global marketplace, there is no singular authoritative source, no basis for a hierarchical system of governance and consequently no universal set of formal rules to govern conduct. Equally, the complexity, scale and speed of global financial markets increase information asymmetries and diminish the capacity of market participants to govern transactions through accurate pricing and efficient contracts.⁴²⁷

As such, the global economy presents a unique challenge to those seeking to formally regulate governance whether by direct state intervention or through market-based regulatory mechanisms. As De Sousa Santos expressed it, ‘the dramatic growth of world markets coupled with the emergence of worldwide systems of production and transnational agents undermine the capacity of the state to regulate the market at the national level’.⁴²⁸

Understood in this light, an effective legislative prescription or formal, market based regulatory mechanism for good governance suited to the range of activity, scale and complexity of capital markets has been, and remains, elusive.

⁴²⁶ O.E. Williamson, *Markets and Hierarchies. Analysis and Antitrust Implications: A Study in the Economics of Internal Organization* (New York: The Free Press, 1975). Within his transaction cost theory, Williamson frames governance as a choice between the formal mechanisms of ‘markets’ or ‘hierarchies’.

⁴²⁷ S.H. Park, “Managing An Inter-Organizational Network: A Framework of the Institutional Mechanism for Network Control” (1996) *Organization Studies* 17.5: 795-824. Increasing uncertainty and complexity exponentially increases the range of possible circumstances that could arise making it increasingly costly and difficult to establish exhaustively and with sufficient precision all contractual obligations of contracting parties with the result that parties enter into incomplete contracts.

⁴²⁸ Santos Bonaventura De Sousa, *Towards a New Legal Common Sense* (2 ed.) (Butterworths/LexisNexis, 2002) 52.

Yet, the establishment of rules and communicated norms of behaviour are essential to the proper functioning of any system. Recent studies of communication identify that even within outlier systems such as those based on criminal enterprise there is equal if not more reliance on essential elements of clear rules (largely unwritten, but no less powerful), shared meaning, obedience, responsibility, and consequences.⁴²⁹

Even to the extent that formal rules do exist, in a dynamic system it is impossible for them to be exhaustive or even sufficiently comprehensive to deal with all possible contingencies or the roots of intractable domain problems.⁴³⁰

In the resulting lacunae, therefore, informal market, organizational and social norms operate to supplement and in some cases replace formal mechanisms governing standards of conduct and accepted behaviour.⁴³¹ These norms are often opaque and embedded in internal organizational culture, practices, relationships and informal terms of engagement.⁴³²

Much has been written in recent years regarding the extent to which market norms and business culture generally has been determined by dominant market influences such as greed, short term profit, cost externalization, and resource exploitation that unchecked have largely served the subjective interests of powerful actors at the expense of weaker actors and the long-term integrity and stability of the global economic system.⁴³³

⁴²⁹ Diego Gambetta, *Codes of the Underworld: How Criminal Communicate* (Princeton University Press, 2009).

⁴³⁰ L. Falkenberg and I. Herremans, "Ethical Behaviour in Organizations: Directed by the Formal or Informal Systems?" (1995) *Journal of Business Ethics* 14.2: 133-43.

⁴³¹ *Ibid.*

⁴³² The operation and interrelationship of social and organizational norms with more formal corporate law mechanisms serve an important regulatory function, see: Melvin Eisenberg, "Corporate Law, Social Norms and Belief Systems", Working Paper no 151, Centre for Law and Economic Studies, Columbia University School of Law, May 21, 1999.

⁴³³ For discussion of the harmful effects of short termism and excessive risk-taking, see, e.g. OECD, *Corporate Governance and the Financial Crisis – Conclusions and emerging good practices to enhance implementation of the Principles* (OECD, February 2010). Online at: www.oecd.org. Resource exploitation in this context includes human, as well as natural, resources. See the consultation draft UN Guiding Principles released in late 2010 stating the need for an explicit framework to counter human rights challenges associated with business globalization. Online at: <http://www.business-humanrights.org/SpecialRepPortal/Home/Protect-Respect-Remedy-Framework/GuidingPrinciples>.

In this regard, the international reach and the speed of the market contagion during the 2007 – 2009 global financial crisis⁴³⁴ and the repercussions of the accounting scandals a decade earlier exposed new limits to the effectiveness of regulatory regimes around the world in safeguarding against the greed, short-termism, and excessive risk taking at its heart, and the consequential damage to individuals, institutions, overall market integrity and profound loss of trust in the financial system.⁴³⁵

The effectiveness of Williamson's two modes of governance based on authority and price, respectively depends on a third foundation – trust. In the absence of trust, hierarchies must rely increasingly on powers of coercion to enforce authority, whilst the market mechanism of price must build in the additional costs of protections against default, bad faith, information asymmetries due to a lack of full, fair and truthful disclosure, and other failures of parties to honour contractual obligations.⁴³⁶

The disclosure based system of monitoring securities issuers and market transactions is premised and reliant on parties willfully complying with their reporting obligations and is

⁴³⁴ The contagion from the crisis in finance took hold in the autumn of 2007. Global stock prices peaked at the end of October and then progressively declined for nearly a year into the financial crisis catalysed by Lehman Brothers' default and bankruptcy. Prior to that default, global losses in publicly traded corporate equities up to that point were \$16,000bn. In the ensuing ten weeks, those losses more than doubled to almost \$35,000bn in cumulative global losses and global stock market value declined by more than 50 per cent. Combined with an effective doubling of the degree of corporate leverage, thousands of billions of dollars of losses of equity in homes and losses of non-listed corporate and unincorporated businesses the aggregate equity loss during this period was well over \$40,000bn equivalent to two-thirds of 2008's global gross domestic product. Source: Alan Greenspan, "Equities show us the way to recovery", *Financial Times*, March 29 2009. Online at: <http://www.ft.com/cms/s/0/d8c1576c-1c87-11de-977c-00144feabdc0.html#ixzz1RALiPISZ>

⁴³⁵ A 2005 World Economic Forum survey reported a decrease in public trust in "both large national companies and global firms, with the latter at an all-time low". 2005 World Economic Forum Global Opinion Poll conducted by GlobeScan. In 2007, The Better Business Bureau/Gallup Trust in Business Index showed 18 per cent of respondents had lost trust in the companies with whom they regularly conducted business, only 8% reported an increase and 74% stayed the same. BBT/Gallup Trust in Business Index, October 25, 2007. The Edelman Trust Barometer 2009 (Global) found that nearly two thirds – 62% - of the sample trusted corporations less in 2009 than a year ago. Trust in US business fell from 58% last year to 38%. This is the lowest score in the Barometer's tracking history amongst 'informed publics' – below that seen in the post-Enron period. Trust in business in the UK, France and Germany stayed at the previous year's low level of 36%.

⁴³⁶ On the significance of trust in the success of capital markets, see discussions in: Francis Fukuyama, Francis, *The Social Virtues and the Creation of Prosperity* (New York: The Free Press, 1995); Margaret M. Blair and Lynn Stout, "Trust, Trustworthiness and the Behavioural Foundations of Corporate Law" (2001) 149 *University of Pennsylvania Law Review* 1735; Lawrence E. Mitchell, "Fairness and Trust in Corporate Law" (1993) 43 *Duke Law Journal* 425.

undermined when parties cannot be trusted to do so. As Black explains, in the absence of trust and trust mechanisms investors are unable to rely on the assurances of full, fair and truthful disclosure and as a consequence discount the price of shares by way of recognizing that they may not receive true value for their investment.⁴³⁷ This form of discounting in markets that are generally considered untrustworthy can have the effect of driving high quality issuers to other markets – public or indeed, private – due to an unwillingness to offer their shares for less than full value.⁴³⁸

To protect against this authorities have resorted to developing systems of complex assurance, control, enforcement and oversight mechanisms from laws and regulations to tiers of reputational intermediaries each successively vouching for the other.⁴³⁹ These layers introduce cost and administrative burdens and expand the pool of vested interests with the attendant possibility of capture and distorted incentives.⁴⁴⁰ However, they fail to provide an effective antidote to the underlying problem – the absence of trust, and trustworthiness.⁴⁴¹

Trust, along with affiliation, fairness, moral obligation and values systems, has been an essential element of cooperation in society from earliest times. It has gained formal recognition as a third governance mechanism alongside price and authority in recent governance scholarship.⁴⁴² Others identify these three modes of governance as: markets,

⁴³⁷ Bernard S. Black, “The Legal and Institutional Preconditions for Strong Securities Markets” (2001) 48 *UCLA Law Review* 781 at 787.

⁴³⁸ This phenomenon is explained in Akerlof’s classic law and economics theory of ‘the market for lemons effect’. George A. Akerlof, “The Market for “Lemons”: Quality Uncertainty and the Market Mechanism” *The Quarterly Journal of Economics* (August, 1970) Vol. 84, No. 3, 488-500.

⁴³⁹ In advanced markets, these can include: rules governing the preparation, accounting, auditing and disclosure of company financials; systems of laws and regulations specifying the contracting framework, creating duties and responsibilities and the risk of civil and criminal liability and other sanctions with respect to the conduct of companies, insiders, intermediaries and other market actors; explicit and enforceable market standards and protections concerning offerings, listings and trades; and an array of other institutions to guard against deception, fraud manipulation, misinformation and self-dealing. Bernard S. Black, “The Legal and Institutional Preconditions for Strong Securities Markets” (2001) 48 *UCLA L. Rev.* 781 at 791-99.

⁴⁴⁰ *Ibid.* at 784, 840.

⁴⁴¹ For a discussion on the nature of ‘real trust’ as opposed to ‘regulated trust’, see: Ed Smith and Richard Reeve “Papering over the cracks? Rules, regulations and real trust”, Provocation Series Vol. 2, No.1, (January 2006). Online at: www.theworkfoundation.org.

⁴⁴² J.L. Bradach and R.G. Eccles, “Price, Authority and Trust: From Ideal Types to Plural Forms” (1989) *Annual Review of Sociology* 15: 97-118.

bureaucracies and clans⁴⁴³; market-based, command-and-control and voluntarist⁴⁴⁴; market, hierarchy and network⁴⁴⁵; market, unilateral and bilateral⁴⁴⁶; market, hierarchical and collaborative⁴⁴⁷; and mandatory, optimality and voluntary⁴⁴⁸.

In situations where interactions between organizations or individuals are not governed by a shared understanding⁴⁴⁹ of fairness, responsibility and accountability, it is unlikely for the parties to develop the trust necessary to move beyond the pursuance of their own agenda, to put aside costly protection mechanisms, and to co-operate in good faith to seek mutually beneficial outcomes.⁴⁵⁰

As the Nobel Laureate economist Kenneth Arrow puts it:

Trust is an important lubricant of a social system. It is extremely efficient; it saves a lot of trouble to have a fair degree of reliance upon other people's word ... Trust and similar values, loyalty or truth-telling, are examples of what economists would call "externalities." They are goods; they are commodities; they have real practical economic value; they increase the efficiency in the system, enable you to produce more goods or more of whatever values you hold in high esteem.⁴⁵¹

⁴⁴³ W.G. Ouchi, "A Conceptual Framework for the Design of Organizational Control Mechanism" (1979) *Management Science* 25.9: 833-48.

⁴⁴⁴ D.R. Kamp and C.L. Gaulding, "Motivational Underpinnings of Command-and-Control, Market-Based and Voluntarist Environmental Policies" (1995) *Human Relations* 48.5: 439-65

⁴⁴⁵ V. Lowndes and C. Skelcher, "The Dynamics of Multi-organizational Partnerships: An Analysis of Changing Modes of Governance" (1998) *Public Administration* 76: 313-33

⁴⁴⁶ J.B. Heide "Inter-organizational Governance in Marketing Channels" (1994) *Journal of Marketing* 58: 71-85

⁴⁴⁷ N. Phillips, T. B. Laurence and C. Hardy, "Inter-organizational Collaboration and the Dynamics of Institutional Fields" (2000) *Journal of Management Studies* 37.1: 23-43.

⁴⁴⁸ A. Anand, "Voluntary v. Mandatory Corporate Governance: Towards an Optimal Regulatory Framework" (2006) *The Delaware Journal of Corporate Law* 31:1.

⁴⁴⁹ E. Durkheim, *The Elementary Forms of Religious Life*, trans. Karen E. Fields (New York: Free Press, 1995) excerpted in *Emile Durkheim: Sociologist of Modernity*, ed Mustafa Emirbayer (Blackwell Publishing, 2003). Amitai Etzioni, *The Spirit of Community* (New York: Crown, 1993); Roberta Unger, *Knowledge and Politics* (New York: The Free Press, 1975).

⁴⁵⁰ On trust and reciprocity, see Charles Handy, "Trust and the Virtual Organization," in Frederick F. Reichheld, *The Quest for Loyalty: Creating Value through Partnership* (Cambridge, MA: Harvard Business Review Books, 1996) 40. On trust and transaction costs see: Francis Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (New York: The Free Press, 1995) and Amitai Etzioni, *The Moral Dimension: Toward A New Economics* (New York: Free Press, 1988). La Porta, Lopez-de-Silanes, Shliefer and Vishny conducted empirical studies with macro-level data to find that trust promotes cooperation in large organizations in their 1997 "Trust in Large Organizations" (1997) *American Economic Review* 87, 333-38. See also: J. Dalla Costa, *The Ethical Imperative: Why Moral Leadership is Good Business* (New York: Harper Collins, 1998) 232.

⁴⁵¹ Kenneth J. Arrow, *The Limits of Organization* (New York: Norton, 1974) 23; as quoted in Special Report: The Dynamics of Public Trust in Business, Arthur W. Page Society and Business Roundtable

Nothing more aptly describes the importance of these fundamental values and the trust placed in them than the global credit crisis extending into the credit crunch and loss of liquidity precipitated by the financial shocks in the United States that spread with domino effect around the globe.⁴⁵² As Thomas Friedman put it, “[E]veryone stopped lending to everyone because no one knew what the other bank’s assets were worth.”⁴⁵³

The Caux Roundtable highlighted this interdependency in observing about the recent financial crisis that “[T]he current crisis of global capitalism – first in financial markets and now in a recessionary downturn in consumption and production – reveals the dependency of business on an underlying social culture of trust and responsibility.”⁴⁵⁴

In practical terms, the gap between high expectations and reality can be narrowed, but never really closed and efforts to codify or proscribe the way to perfect trust and accountability inevitably lead to compromise or a lowering of standards. Furthermore, as O’Neill has observed, attempts at codification and prescription appear to undermine rather than support the intended objective:

The pursuit of ever more perfect accountability provides ... ever more information, more comparisons, more compliant systems; but it also builds a culture of suspicion, low morale and may ultimately lead to professional cynicism, and then we have the grounds for public mistrust ... Currently fashionable methods of accountability damage rather than repair trust.⁴⁵⁵

This is the case whether the expectations are communicated formally by the state through the instruments of law, by non-state actors via codes, best practice standards, and

Institute for Corporate Ethics (2009) 13. Online at: http://www.darden.virginia.edu/corporate-ethics/pdf/public_trust_in_business.pdf

⁴⁵² See Ben S. Bernanke, “Reflections on a Year of Crisis,” speech delivered at “Financial Stability and Macroeconomic Policy,” a symposium sponsored by the Federal Reserve Bank of Kansas City, held in Jackson Hole, Wyo., August 20-22, 2009. Online at: www.federalreserve.gov/newsevents/speech/bernanke20090821a.htm

⁴⁵³ Thomas L. Friedman, “The Post-Binge World” *The New York Times* (October 12, 2008)

⁴⁵⁴ The Caux Roundtable, *Principles for Responsible Business*, Introduction. Online at: <http://www.cauxroundtable.org/>

⁴⁵⁵ Onora O’Neill, “Trust and Information”, BBC Reith Lecture No 3 (BBC, 2002). Online at: www.bbc.co.uk/radio4/reith2002.

guidelines, between peers through industry practices and standards, or via interaction with professional advisors and the movement of professionals between organizations.⁴⁵⁶

These and many other factors have prompted lawmakers, regulators, investors, stakeholders, scholars and corporations to engage for decades in extensive, sustained debate over optimal approaches to regulating business conduct, to re-evaluate conventional sources of governance in their own jurisdictions, and to consider approaches that are being used beyond their own traditional domains.⁴⁵⁷

The following Chapters Nine and Ten enter into this wider governance landscape and encounter some of the normative influences that are shaping it. Chapter Nine considers the changing nature of the relationship of business to society and in this regard explores the relatively recent formal recognition of stakeholders in general and civil society in particular, as a legitimate source of expectations of and normative influence on standards of corporate conduct and governance. Chapter Ten examines some of the agents and catalysts for change in the nature of, and forum for, governance discourse and recent innovations in disclosure relating to the ethical dimensions of governance.

⁴⁵⁶ Insights from organizational behaviour and the sociology of law reveal the multiple influences on organizational behaviour that lead to similarities – isomorphism – in organizational responses to their formal and informal regulatory environments. Isomorphism has different sources: mimetic when organizations copy successful practices from each another; normative when it results from informal influences; and coercive when organizations react to formal legal and regulatory structures.

⁴⁵⁷ The following are a sample of the range of novel adaptations to the governance regulatory model that emerged in the 1980s and 1990s. Autopoiesis: G. Teubner, *Law As An Autopoietic System*, (Oxford: Blackwell, 1992). Responsive Regulation: Ian Ayers and John Braithewaite, *Responsive Regulation: Transcending the Deregulation Debate* (New York: Oxford U.P, 1992). Self Regulation: J. Braithewaite, “Enforced Self-Regulation” (1982) *Michigan L.R.* 80; Neil Gunningham, “Beyond Command and Control: Toward Flexible and Cost Efficient Business Regulation” in C.A.J Coady, and C.J.C. Sampford, (eds.) *Business Ethics and Law* (Sydney: The Federation Press, 1993); Neil Gunningham and J. Rees, “Industrial Self Regulation: An Institutional Perspective” (1997) *Law and Policy* 19: 363. Smart regulation: Neil Gunningham and P. Grabosky with D. Sinclair, *Smart Regulation: Designing Environmental Policy* (Oxford University Press, 1998). For an exploration of creative adaptation in regulatory practice see: Malcom K. Sparrow, *The Regulatory Craft* (Washington D.C.: Brookings Institution Press, 2000).

Part Five – The Changing Governance Landscape

9. Re-Framing Corporate Governance

“Each man takes care that his neighbour does not cheat him. But a day comes when he begins to care that he does not cheat his neighbour. Then all goes well, he has changed his market-cart into a chariot of the sun.”

Ralph Waldo Emerson⁴⁵⁸

9.1 Reconstructing the Relationship Between Business and Society

The most recent escalation of debate about business conduct and the questions raised about the nature and consequences of individual and collective activities engaged in by agents on behalf of business organizations and other market actors is not a new phenomenon. It is instead, the latest discussion in an ongoing and evolving discourse on the role of business in society.

While internet technology and the rise of social media have opened the discussion to a wider audience, the roots of contemporary public engagement on the role and expectations of business in society are deep. They can be traced back as far as the eighteenth century and the precursor of the modern capitalist system, and even earlier. Interestingly, even as the language and the participants in the discussions have evolved over time, many of the issues endure.

The twentieth century witnessed pioneering work by individuals and civil society organizations⁴⁵⁹ in constructing dialogic frameworks, methodologies and language suited to challenging, engaging and holding accountable the business community –

⁴⁵⁸ American essayist and poet (1803 – 1882)

⁴⁵⁹ The term ‘civil society organizations’ is used to encompass the range of organizations that includes: labour-market players; organizations representing social and economic players that are not social partners in the strict sense of the term; civil society and non-governmental organizations (NGOs) dedicated to environmental, human rights, charitable and educational causes; community-based associations and religious communities, see Commission of the European Community (CEC) “Toward a Reinforced Culture and Dialogue”, COM(2002) 704 final at 6.

management, boards and in some respects shareholders – on issues of responsibility toward present and future stakeholders and society more broadly.⁴⁶⁰

In the closing decades of the last century, these efforts enabled and supported the development of a model for the role of business in society that challenged the traditional capitalist model wherein business and society exist as distinct and separate constructs. This in turn supported the emergence of a theory of modern corporations that recognized accountabilities and responsibilities to society beyond the strictly profit-making purpose of the neo-classical conception of the corporation particularly dominant in capitalist economies such as the United States. That is, a theory proposing that business in general and the corporation in particular are essentially co-existent with and accountable to society, and not something separate and apart from society and largely unfettered by government in its operation.

Berle and Mean anticipated this in their 1932 book *The Modern Corporation and Private Property* observing,

Corporations have ceased to be merely legal devices through which the private business transactions of individuals may be carried on. Though still much used for this purpose, the corporate form has acquired a much larger significance..... Grown to tremendous proportions, there may be said to have evolved a 'corporate system'—as there once was a feudal system—which has attracted to itself a combination of attributes and powers, and has attained a degree of prominence entitling it to be dealt with as a major social institution. [...] We are examining this institution probably before it has attained its zenith. Spectacular as its rise has been, every indication seems to be that the system will move forward to

⁴⁶⁰ Influential writing on the topic of stakeholders and stakeholder theory of the firm include: Thomas Donaldson and Lee E. Preston “The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications” (1995) *Academy of Management Review* Vol. 20, No. 1, 65-91; John Elkington, *Cannibals With Forks: The Triple Bottom Line of 21st Century Business* (New Society Publishers, 2008); R. Edward Freeman, *Strategic Management: A Stakeholder approach*, (Boston: Pitman, 1984); G.K. Meek and S.J. Gray, “The Value Added Statements: An Innovation for US Corporations (1998) *Accounting Horizons* 12(2): 73-81; R. Phillips, *Stakeholder Theory and Organizational Ethics* (San Francisco: Berrett Koehler, 2003). The 1987 report of the Brundtland Commission defined sustainability as being responsible for ‘meeting the needs of the present without compromising the ability of future generations to meet their own needs’. World Commission on Economic Development, *Our Common Future* (‘The Brundtland Report’); Oxford, UK: Oxford University Press). John Elkington originated the concept of the triple bottom line; Simon Zadek was among the early writers on the idea of the civil corporation – Simon Zadek, *The Civil Corporation: The new economy of corporate citizenship* (Earthscan Publications, 2001); Thomas Donaldson and Thomas W. Dunfee, *Ties That Bind: A Social Contracts Approach to Business Ethics* (Boston: Harvard Business School Press, 1999).

proportions which stagger imagination today [...] They [management] have placed the community in a position to demand that the modern corporation serve not only the owners [...] but all society.”⁴⁶¹

To position business in society is to focus on reality rather than artifice. Essentially, the different forms of capitalist business enterprise are creations of and enabled by the most fundamental of social institutions – the law. Their profitability depends on myriad factors that include secure and reliable means of exchange for goods and services, a system of currency, stable operating environments all of which depend to a greater or lesser extent on publicly funded infrastructure and institutions. In all of this they are animated by, and reliant for their continued existence on, a complex of relationships. These relationships extend beyond those with shareholders, creditors, employees, even suppliers and peers to a broader base of stakeholders that includes the local and distant communities that provide not only locations, natural resources, materials and workers but also the consumers that drive profitability.⁴⁶²

In general terms, this positioning of business in society provides a basis and provocation for the business community to consider and take responsibility for the short to long term consequences of their activities beyond the corporate boundaries, to be voluntarily accountable for those impacts, and ultimately to change or modify their activities, practices, and products to reduce, mitigate or avoid altogether adverse impacts. In essence, a broader conception of corporate governance and accountability that includes the culture, processes, structures and systems through which organizations determine and pursue goals, and evaluate the means used as well as the ends achieved.⁴⁶³

⁴⁶¹ A. A. Berle and G. C. Means, *The Modern Corporation and Private Property*. (New Jersey: Transaction Publishers, 1932) 1.

⁴⁶² For a discussion of the corporation as a ‘socially constructed reality’ dependent on power coalitions situated in and a function of social, historical and political relationships, see: Lynne L. Dallas, “Two Models of Corporate Governance: Beyond Berle and Means” (1988) 22 *University of Michigan Law Review* 19.

⁴⁶³ Further readings on this topic include: Linda Klebe Trevino, “Ethical Decision Making in Organizations” (1986) *Academy of Management Review* 601; Linda Klebe Trevino, “A cultural perspective on changing and developing organizational ethics”, in R. Woodman and W. Passmore (eds.) *Research in Organizational Change and Development*, 4: 195-230, (JAI Press, 1990); Lynne L. Dallas, “A Preliminary inquiry into the Responsibility of Corporations and their Directors and Officers for Corporate Climate: The Psychology of Enron’s Demise” (2003) 35 *Rutgers Law Journal* No.1,1; Marleen O’Connor, “The Enron Board: The Perils of Groupthink” (2003) 71 *Univ. Cinn. L. Rev.* 1233; Thomas Donaldson and Thomas W.

This wider notion of corporate governance necessarily extends beyond the internal relationships between management, the board and shareholders, as reflected in the 2000 statement by Sir Adrian Cadbury that:

Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.⁴⁶⁴

This construction of the corporate ideal encompasses ethical, social and environmental responsibility along with the narrow economic responsibility of traditional neo-classical models of the corporation. It expands the constituencies to whom corporations have been accountable – primarily their shareholders, also regulators and in some cases, employees and suppliers – to include a broader base of stakeholders encompassing communities, customers, creditors and others on whom business has an impact within a wider societal context, including the natural environment.⁴⁶⁵

This expanded conception of corporate governance is articulated in the Danish Committee on Corporate Governance's definition of corporate governance as:

The goals, according to which a company is managed, and the major principles and frameworks which regulate the interaction between the company's managerial bodies, the owners as well as other parties, who are directly influenced by the company's dispositions and business (in this context jointly referred to as the company's stakeholders). Stakeholders include employees, creditors, suppliers, customers and the local community.⁴⁶⁶

Dunfee, *Ties That Bind: A Social Contracts Approach to Business Ethics* (Boston: Harvard Business School Press, 1999).

⁴⁶⁴ Sir Adrian Cadbury in *Global Corporate Governance Forum*, (World Bank, 2000).

⁴⁶⁵ Among other who have explored the evolution of this broader construction of corporate accountability and responsibility see: *Academy of Management Review* (Daily et al, "Corporate Governance: Decades of Dialogue and Data", Vol. 28, No. 3 (July 2003), 371-82) and *The Journal of Corporate Citizenship* (Malcolm MacIntosh and Simon Zadek (guest editors) "Corporate Governance, Accountability and Transparency" (2002) *Journal of Corporate Citizenship* 8 at 15-21) early in the new millennium supported expansion of corporate governance and accountability theory as a response to growing societal pressures on business to operate responsibly. In particular, to enable governance thinking to accommodate the complex decisions that take into account the interests of a diverse group of stakeholders.

⁴⁶⁶ The Danish Committee on Corporate Governance, *Danish recommendations on Corporate Governance*, April 2010

From its origins in the concept of community and later communitarianism⁴⁶⁷, stakeholder theory⁴⁶⁸ and examples from centuries old family businesses built and operated with the moral convictions of their founders⁴⁶⁹, this more comprehensive view of the corporation and its responsibilities has entered the lexicon of legislators and regulators⁴⁷⁰, the courts, investors and the language of governance within the business community itself.⁴⁷¹ As the OECD observed in 2004, “corporate scandals have focused the minds of governments, regulators, companies, investors and the general public on weaknesses in corporate governance systems and the need to address this issue.”⁴⁷²

⁴⁶⁷ Communitarianism proposes a theory of rights that gives appropriate attention to community and social structure. Its proponents argue that there are important collective rights which apply to social groups: that communities as well as individuals possess rights. Source: *The Penguin Dictionary of Sociology* 5th ed. (London: Penguin Group, 2006). As a response to liberal capitalism, communitarianism seeks to preserve the system of values and moral codes that are the fundamental underpinnings of a fair and just society wherein there must be a balance between rights and responsibilities. See for example: Richard M. Coughlin, “Whose Morality? Which Community? What Interests? Socioeconomics and the Communitarian Perspectives” (1996) 25 *Journal of Socioeconomics* 135; A. Etzioni, *In the Spirit of Community: Rights Responsibilities and the Communitarian Agenda* (New York: Crown, 1993) regarding the clash between the culture of individualism in the United States and the responsibilities of individuals to one another and to a shared society; and A. Etzioni (ed), *New Communitarian Thinking* (University Press of Virginia, 1995).

⁴⁶⁸ Stakeholder theory originated in the work of R. Edward Freeman in *Strategic Management: A Stakeholder approach*, (Boston: Pitman, 1984). It proposes that the very purpose of a corporate entity is to coordinate, balance and satisfy the needs of its stakeholders.

⁴⁶⁹ In early nineteenth century Britain, in the region of 4,000 Quaker families ran 74 Quaker British Banks (including Barclays) and more than 200 Quaker companies according to the principles of ‘Quaker capitalism’. See supra note 16. For example: Cadbury and Barclays Bank with their roots in Quaker values of integrity, community, equality and peace. Other family enterprises adhere to similar high principles, such as: Boots plc ‘Fellowship in recreation, fellowship in ideals, common hopes, common sympathies, and common humanity bind us together; and whatever fosters this happy union is valuable.’ (Jesse Boot, 1919); Marks and Spencer with its founding values of quality, value, service, innovation and trust; John Lewis Partnership founded with the democratic values of openness, fairness and transparency.

⁴⁷⁰ Examples in national legislation include: in the United Kingdom, the *Pensions Act 1995* as amended and the *Companies Act, 2006* French corporate legislation; in recent jurisprudence the Supreme Court of Canada decision in *Peoples Department Stores Inc. (Trustee of) v. Wise* 2004 SCC 68, [2004] 3 SCR 461; the Bell Canada Enterprises (BCE) decision of the Supreme Court of Canada - *BCE Inc. v 1976 Debentureholders*, 2008 SCC 69.

⁴⁷¹ As of July 31, 2001 there are 6, 263 business participants in the Global Compact. In 2010, nearly 5,000 ‘corporate responsibility’ reports were published on Corporateregister.com. With non-Latin reports included the number increases to nearly 6000. Reports address any or any combination of: Social/Community, Philanthropy, Integrated (Annual Financial & Non-Financial), Sustainability (Environment/Social/Economic), Corporate, Responsibility (EHS/Community/Social), Environment, Health & Safety & Community, Environment & Social, Environment, Health & Safety, Environment. A distinction is made between ‘CSR/Corporate Responsibility’ and ‘Sustainability’ reports. While both can cover multiple issues such as environment, society, community, ethics, supply chain, human rights etc, only ‘Sustainability’ reports include economic and socio-economic information. Source: Corporateregister.com. CorporateRegister.com is the authoritative global directory of corporate responsibility (CR) reports. In January, 2011 the register reached a landmark 30,000 profiled reports file since inception.

⁴⁷² OECD Policy Brief “The OECD Principles of Corporate Governance” (OECD, August 2004).

Lozano enumerates a number of key drivers for the call for a broader corporate responsibility to society. These include: demand for greater transparency linked to increased monitoring and surveillance by non-governmental organizations and civil society and external social pressure; increase in institutional frameworks to promote greater corporate responsibility proposals (such as United Nations Global Compact and Global Reporting Initiative and the recent Draft Principles for the Implementation of the ‘Protect, Respect and Remedy’ Framework) and a wider attention by some governments; increase in responsible consumerism and more informed choices aided by advances in communications technology and an increasingly active social media; and growth in social responsibility investment (SRI) funds and emergence of SRI indexes.⁴⁷³

Branson, writing in 2000, attributed increased interest in good corporate governance practices to a “realization by institutional investors, stock exchanges, regulators, and corporate directors, of the speed that corporate affairs can deteriorate in a world of instant telecommunication, 24 hour stock exchange trading, and hot money that casino style capitalism may move around the globe in a matter of hours”.⁴⁷⁴

However, the most recent global financial crisis of 2007 – 2009, the years of reckless unethical activity that led to it, and the succession of business frauds and scandals in the decades preceding it clearly evidence that the rhetoric has still to translate into corresponding, universally observed ethical standards and responsible conduct.

The dominant influences behind much of contemporary business and financial activity continue to be the single-minded pursuit of financial growth, narrow focus on profit-based measures of success, distorting lens of economic efficiency, short-term pressures from speculative finance and insulation from the consequences of adverse corporate impacts.

⁴⁷³ J. Lozano, “What is a Successful Company? A Path to Understanding Accountability” in George G. Brenkert, (ed.) *Corporate Integrity and Accountability*, (Sage Publications, 2004) 100 at 103.

⁴⁷⁴ Douglas M. Branson, “Teaching Comparative Corporate Governance: The Significance of “Soft Law” and International Institutions” (2000) 34 *GA. Law Review* 669, 682-84.

That said, the arguments for the corporation based on the neoclassical model of the corporation of 19th century political thought⁴⁷⁵, existing separate and apart from society largely unfettered by government with purely profit driven *homo economicus* at its helm, must be weakened by the undeniable reality of the crucial role that coordinated government intervention played in heading off financial and market collapse.⁴⁷⁶

This rational profit-seeking idea of the corporation, strongly influenced by traditional neoclassical economic theory as well as agency theory⁴⁷⁷ and transaction cost economics⁴⁷⁸ sees the sole “ethical” responsibility of business to be that of facilitating the maximization of shareholder wealth through the efficient allocation of economic resources. The wider interests of society – moral and social issues – are, by this construction, properly the domain of the state, not corporate responsibilities. This is reflected in the oft-quoted Milton Friedman assertion that,

there is only one social responsibility of business – to use its resources and engage in activities designed to increase its profits *so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.*⁴⁷⁹ (emphasis added)

It is always worth noting that Friedman’s caveat, often omitted from references to this frequently cited passage, demarcates a clear boundary between acceptable and

⁴⁷⁵ Generally speaking, a rational, profit and utility maximizing entity carried forward by Milton Friedman and others that held that the sole responsibility of corporations was to make profit for shareholders without deception or fraud. See notes 97 and 478.

⁴⁷⁶ Paragraph 9 of the Preamble to the September 25, 2009 G20 *Leaders’ Statement*: “Our national commitments to restore growth resulted in the largest and most coordinated fiscal and monetary stimulus ever undertaken. We acted together to increase dramatically the resources necessary to stop the crisis from spreading around the world. We took steps to fix the broken regulatory system and started to implement sweeping reforms to reduce the risk that financial excesses will again destabilize the global economy”. For example in Canada the government’s intervention to freeze the ABCP market. In the US, the Emergency Economic Stabilization Act of 2008 (EESA) was an initiative by the FDIC and the Federal Reserve to bolster financial stability. The United Kingdom example is the nationalization of The Northern Rock Bank. In Ireland, first the nationalization of Anglo Irish bank, and in late 2010 the massive bailout provided by the IMF, EU, United Kingdom and Sweden. The failure of banks in Iceland resulted in a devaluation of the Icelandic Krona and threatened the country with bankruptcy.

⁴⁷⁷ M.C. Jensen and W.H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure” (1976) *Journal of Financial Economics* 11: 5-50. K.M. Eisenhardt, “Agency Theory: An Assessment and Review” (1989) *Academy of Management Review* 14.1: 57-74.

⁴⁷⁸ O.E. Williamson, *Markets and Hierarchies. Analysis and Antitrust Implications: A Study in the Economics of Internal Organization* (New York: The Free Press, 1975). O.E. Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (New York: The Free Press, 1985).

⁴⁷⁹ Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962) 133.

unacceptable market competition – a boundary that was clearly crossed by corporate actors in the past and in the most recent financial crisis.

Beyond that, its proponents will likely find it more difficult to convince an increasingly informed, distrustful and outraged public that the enormous public cost of absorbing the consequential widespread and likely enduring direct and collateral damage to the wider economic and social fabric of society are merely unfortunate ‘negative externalities’ and a necessary ‘cost of doing business’.⁴⁸⁰

Even from a purely economic standpoint, the loss of financial and reputational capital, the continuing restrictions on business credit, and the increased transaction and efficiency costs associated with conducting business in the absence of trust are compelling arguments for reinvigorating the argument for the type of model free market economy envisaged by the author of modern day capitalism, Adam Smith.⁴⁸¹

It is generally agreed that in Smith’s model the forces of free market competition operate to direct the individual participant to pursue his own economic self-interest in such a way that also advances the public good.⁴⁸² Free market competition would prompt market

⁴⁸⁰ Socialization of loss, privatization of profit, foreclosures, unemployment, cuts in public services. In Britain alone, the bank crisis resulting from speculative finance is estimated to have caused GBP 129bn in lost economic activity.

⁴⁸¹ Trust is commonly defined as: (1) a firm belief in the reliability, truth, ability, strength of someone, or something (2) acceptance of the truth of a statement of proof (OED). The notions of reliance and acceptance import a sense of mutuality and reciprocity as well as the implication that trust only has meaning or relevance in a context of asymmetric information. R. Chami and C. Fullenkamp, “Trust as a Means of Improving Corporate Governance and Efficiency”, IMF WP/02/33, 2003. On the relationship between transaction costs and trust see: Francis Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (New York: The Free Press, 1995) and Amitai Etzioni, *The Moral Dimension: Toward A New Economics* (New York: Free Press, 1988). La Porta, Lopez-de-Silanes, Shliefer and Vishny conducted empirical studies with macro-level data to find that trust promotes cooperation in large organizations in their 1997 “Trust in Large Organizations” (1997) *American Economic Review* 87, 333-38.

⁴⁸² “The prudent man is ever tender to his reputation, and he therefore seeks to advance his own interests through achieving social esteem. It is in this way that selfish behaviour can produce social benefits.” Adam Smith, *The Wealth of Nations* in Robert L. Heilbroner (ed.) *The Essential Adam Smith*, 3d (New York: WW Norton & Company, 1987). This relationship between the individual’s pursuit of wealth and the good of society echoes observation of such early Enlightenment intellectuals as David Hume and Voltaire who espoused a culture that valued society and sociability over militarism and religious asceticism. Voltaire in his *Philosophical Dictionary* stated, “[w]e live in society; therefore nothing is truly good for us that isn’t good for society”. Voltaire, in *Philosophical Dictionary* article “Virtue”. And Hume found no benefit to social cooperation in the Christian virtue of self-denial in his *An Enquiry Concerning the Principles of*

actors to “an unremitting exertion of vigilance and attention”.⁴⁸³ Leaving to the legislator dedicated to serve and protect the public interest the responsibility for enabling the “progressive state” of market competition, and blocking attempts to circumvent or raise barriers that undermine it.

While the 18th century political economist may not have assigned to the influence of capitalism any direct function in public ethics, cooperation based on truth, trustworthiness, individual integrity and responsibility are essential to the social order that allows for the proper functioning of the market system as Smith is widely understood to have conceived of it.⁴⁸⁴

In the aftermath of the financial crisis The Caux Roundtable expressed it thus:

Trust and confidence sustain free markets and ethical business practices provide the basis for such trust and confidence. But lapses in business integrity, whether among the few or the many, compromise such trust and hence the ability of business to serve humanity’s needs.⁴⁸⁵

A market is not ‘free’ in the absence of fairness. This is because with unfairness comes the inequitable distribution of power, the disproportionate costs borne by those without it, and the ability of those with it to act with impunity.

9.2 The Significance of Stakeholders

Direct stakeholders such as investors, creditors and employees are linked to business organizations through explicit contracts. Others like customers rely on largely implicit contractual relations that come into consideration and interpretation only in problematic

Morals (1751), ed. J.B. Schneewind (Indianapolis, 1983) 73-74 cited in Muller, Jerry Z. *Adam Smith In his Time: Designing the Decent Society* (Free Press, New York, 1993) 57.

⁴⁸³ Smith, Adam *The Wealth of Nations* V.i.e. in Robert L. Heilbroner (ed.) *The Essential Adam Smith*, 3d (New York: WW Norton & Company, 1987)

⁴⁸⁴ For a discussion of the social norms that underpin Adam Smith’s market, see: Woller, Gary M. “Business Ethics, Society and Adam Smith: some observations on the liberal business ethics” (1996) *Journal of Socio Economics* Vol. 25, Issue 3.

⁴⁸⁵ The Caux Roundtable, *Principles for Responsible Business*, Introduction. Online at: <http://www.cauxroundtable.org>.

circumstances. Many constituencies that are affected by business operations, whether favourably or adversely – that is, stand to gain or lose as a result of business activity – are outside the network of explicit and implicit contracts. These types of stakeholder relationships are frequently involuntary, and in many cases may exist without the specific knowledge of affected parties until the impact or consequences becomes of material concern by virtue of a specific event or incident.

The consequences and impact of business activity on this latter group are often referred to in economic terms as "externalities," because they occur outside the range of internal and market based economic relationships. Examples of such third party impacts are economic benefits or environmental harms that may be experienced by communities as a result of corporate operations.

This exercise of segmenting certain types of impacts and treating them as external may be effective in achieving economic separation of corporate actions from consequences. However, it cannot negate the ethical, moral as well as legal responsibility that rests with management at the operational level and extends to boards as a matter of strategic direction and oversight.

The notion that important aspects of corporate activity can be disregarded by corporate boards and management because they are treated as economically external (often through deliberate externalization) has weakened significantly in the face of a broader conception of corporate responsibility both in law and custom. The recent troubles and significant loss of capitalization and reputation experienced by Toyota over the largest safety recall in its history of car manufacturing, and BP over the Deepwater Horizon disaster, in 2010 are cases in point although only two of many throughout corporate history.⁴⁸⁶

⁴⁸⁶ For case studies on major corporate crises experienced by such high profile companies as Coca-Cola, Firestone, Shell, BP, Airbus, Societe Generale, AIG, Enron, and Arthur Andersen see: Christopher Parsons, *Roads to ruin. A study of major risk events: their origins, impact and implications*, 19.07.2011. A report by Cass Business School on behalf of Airmic. Online at: www.cassknowledge.com.

In the past two decades, shareholders, regulators and boards as well as stakeholders have fuelled an increasing demand for transparent accounting for so-called non-financial risks. In part due to non-governmental initiatives such as the Carbon Disclosure Project, as well as regulatory requirements such the United States Securities and Exchange Commission mandatory climate risk disclosure in 10K Reports, businesses are now expected to disclose and where possible account for actual and potential financial costs associated with past, present and future impacts and consequences of corporate activity beyond the purview of contractual relationships.⁴⁸⁷

In the past, companies used mainly one-way processes of mandatory financial reporting and disclosure to a limited audience of investors, regulators and a narrowly defined set of stakeholders. The communication occurred at pre-determined intervals primarily to demonstrate accountability in strict financial terms.

This linear, economic approach is increasingly considered insufficient to: properly reflect the changing nature of corporate responsibility; understand and address the diverse and changing nature of the wider stakeholder domain and the evolving relationships with its myriad constituents; and contend with the complexity of common interest environmental, social and governance as well as economic issues.⁴⁸⁸ As a consequence, developing capacity within organizations to build relationships with, and responsibility to a wider constituency of stakeholders has become a central concern of most corporations. In some jurisdictions, like South Africa, building this capacity has become an imperative. South Africa is the first region to advance from the established convention of a mandatory requirement for companies to produce financial reports and a voluntary

⁴⁸⁷ The Carbon Disclosure Project is an independent not-for-profit organization that holds the largest database of primary corporate climate change information in the world. Online at: <https://www.cdproject.net/en-US/Pages/HomePage.aspx>

⁴⁸⁸ See: Catherine M. Daily, Dan R. Dalton and Albert A. Canella Jr., “Corporate Governance: Decades of Dialogue and Data” (July 2003) *Academy of Management Review* Vol. 28, No. 3, 371-82; Malcolm MacIntosh and Simon Zadek (guest editors) “Corporate Governance, Accountability and Transparency”, (2002) *Journal of Corporate Citizenship* 8, 5-21

approach with respect to company reporting on corporate environmental, ethical, social and governance performance.⁴⁸⁹

While voluntary reporting on “non-financial” performance has advanced corporate discourse on these aspects of corporate activities, some including Mervyn King of the eponymous King I, II and III Reports have advocated for a step further toward reporting that will present a more holistic account of the corporation. The King Report on Governance for South Africa 2009 recommended that companies produce an integrated report.⁴⁹⁰ In the King Code of Governance for South Africa (King III) published with the 2009 King Report, the integrated report “should have sufficient information to record how the company has both positively and negatively impacted on the economic life of the community in which it operated during the year under review, often categorized as environmental, social and governance issues (ESG). Further, it should report how the board believes that in the coming year it can improve the positive aspects and eradicate or ameliorate the negative aspects, in the coming year”.⁴⁹¹

Since June 1, 2010, all companies listed on the Johannesburg Stock Exchange must publish an “integrated report” or explain why they have not done so. While South Africa is in the vanguard of corporate reporting in this regard, the GRI has publicly stated goals that envisage environmental, social and governance reporting becoming the norm. The first goal for 2015 is that “all large and medium-sized companies in OECD countries and fast-growing emerging economies should be required to report publicly on their ESG performance, or if they don’t, explain why”. The second goal is that “a standard for integrated reporting should be defined, tested and adopted by 2020”.⁴⁹²

⁴⁸⁹These are commonly referred to as either Corporate Social Responsibility (CSR) Reports or Sustainability Reports, depending on the type of content.

⁴⁹⁰Institute of Directors in Southern Africa, *King Report on Governance for South Africa*, 2009 (King III)

⁴⁹¹Ibid. at 12.

⁴⁹²Justmeans. “GRI announces its 2015 and 2020 goals and launches G3.1 public comment at first day of Amsterdam Global Conference”, Press Release. Online at: <http://www.justmeans.com/press-releases/GRI-announces-its-2015-and-2020-goals-and-launches-G3-1-public-comment-at-first-day-of-Amsterdam-Global-Conference/5516.html>.

9.3 Legitimacy and the Stakeholder Relationship

The relationships between business and those who make up its broader stakeholder constituency are complex and dynamic.

Stakeholder engagement has consequently developed as a key factor in how businesses operate and progress on the basis that unless corporate entities, their stakeholders and peers interact with a shared understanding of the nature of their responsibilities and the importance of transparency and accountability, they are unlikely to develop the necessary trust to move beyond the pursuit of their own agenda and co-operate fully in seeking mutually beneficial outcomes.

Inevitably and in any context, whether public or private, the identification of stakeholders – with all the implications that there is something to be gained from identifying and being identified as a stakeholder – is a contested process. Since interests and the basis for identification are varied, dynamic, and potentially unlimited on the past present and future continuum, the notion of ‘legitimate stakeholder’ is a practical and necessary limitation involving subjective assessment from any one or a combination of moral, political, social, and economic perspectives.

Critics of stakeholder theory suggest that it risks violation of established legal and moral duties enshrined in corporate, fiduciary and agency principles. Goodpaster explains the conflict of duties posited in this critique – the “stakeholder paradox” – as an essential yet in some ways illegitimate call for corporate decision making to accord with ethical values and in so doing to exceed strategic consideration of stakeholders (solely in order to maximize shareholder wealth).⁴⁹³

The identification of stakeholders that have ‘legitimate’ interests thus presents a significant challenge for many companies. Where companies identify stakeholders unilaterally, for example based on objective criteria such as existing economic, property

⁴⁹³ K.E. Goodpaster, “Business Ethics and Stakeholder Analysis” (1991) *Business Ethics Quarterly* (1), 63.

or cultural rights or interests, geographic proximity, and materiality, they risk challenges not only from those they may have excluded, but also in many cases from official and civil society oversight bodies involved in monitoring the engagement process. However, processes involving self-identification are at best unwieldy and in the worst case tainted by the opportunity to exploit or pervert the operation of due process for selfish gain, competitive advantage or malicious motivations.

In Gray's three successive phases of inter-organizational domain development, phase one – problem setting – concentrates on the challenge of identifying the problem and determining the identity of legitimate stakeholders.⁴⁹⁴ For Gray, consensus on what the issue is and who has a legitimate stake is a necessary precursor to constructive collaboration.⁴⁹⁵

Freeman's Stakeholder Theory is premised on the notion that the shareholder is only one of numerous constituencies of a corporation⁴⁹⁶. Taking a wider conception of the firm than the narrow economic view of the shareholder maximization model, employees, suppliers, customers, local communities and government are all recognized as having significant 'stakes' in the corporation and the corporation for its part is dependent on the committed participation of these constituencies in its enterprise in order to function and prosper.⁴⁹⁷ Recognizing these stakeholders' investment in the corporation is seen as critical to achieving a relationship that is based on ethical responsibility⁴⁹⁸ and fairness

⁴⁹⁴ Barbara Gray, *Collaborating: Finding Common Ground for Multiparty Problems* (San Francisco: Jossey Bass, 1989) 917.

⁴⁹⁵ Barbara Gray, "Conditions Facilitating Inter-organizational Collaboration" (1985) *Human Relations* 38:10: 911-36. Gray and earlier E. McCann, "Design Guidelines for Social Problem-Solving Interventions" (1983) *Journal of Applied Behavioural Science* 19: 177-89 and E. Trist, "Referent Organizations and the Development of Inter-Organizational Domains" (1983) *Human Relations* 36.3: 269-84, identified the existence and processes of domain-based collaboration, the need for stakeholders to develop a shared appreciation of the domain problem and in effect define the domain, the shape of which will evolve by virtue of the organizations included (and excluded) and through their engagement in the problem solving process.

⁴⁹⁶ R. Freeman, *Strategic Management: A Stakeholder Approach*, (New York: Harper Collins, 1984) as referred to by James Wallace in "Value Maximization and Stakeholder Theory: Compatible or Not?" (Spring 2003) *Journal of Applied Corporate Finance* Volume 15, Issue 3, 120-27.

⁴⁹⁷ *Ibid.* 120-27 at 122.

⁴⁹⁸ Gary M. Woller, "Business Ethics, Society and Adam Smith: some observations on the liberal business ethics" (1996) *Journal of Socio Economics* Vol. 25, issue 3, 311-332 at 321.

and more closely reflects the principle of distributive justice – where the interests of society are balanced with the interests of shareholders.

As Wallace explains, Jensen in proposing his concept of “enlightened value maximization” (EVM) sought to address what he identified as the lack of strategy in the long-term value model by linking it to the route to that value embodied in stakeholder theory. The additional component in the EVM model addresses the practical reality that not all stakeholders’ interest will be congruent or aligned at any given time necessitating choices between those interests. His basis for that choice is one of economic utility, whereby the investment will be made in respect of those stakeholders’ interests for which the return on that investment will be positive. In this Jensen follows the shareholder value model by ultimately favouring the preservation of shareholder value over the protection of a particular stakeholder interest.

Numerous other approaches and modifications have been theorized, including Mitchell’s ‘instrumental approach’ by which a corporation assesses the relative salience of the stakeholder by reference to factors such as power, influence, and urgency⁴⁹⁹ and, in contrast, the notion of normative legitimacy which considers whether, in ethical and moral terms, a corporation owes a particular an obligation of stakeholder fairness.⁵⁰⁰ Fineman and Clarke⁵⁰¹ posit that the decision is influenced by management’s subjective interpretations and value judgments as to what constitutes a legitimate claim, whereas Zadek considers that corporations “do not really have a choice in deciding who and who is not a stakeholder”⁵⁰² amidst permeable and evolving boundaries.

⁴⁹⁹ Ronald K. Mitchell, Bradley R. Agle, Donna R. Wood, “Toward a Theory of Stakeholder Identification and Saliency: Defining the Principle of Who and What Really Counts” (1997) *Academy of Management Review* Vol. 22, No.4, 853-886.

⁵⁰⁰ For a discussion of normative legitimacy see: Robert Phillips, *Stakeholder Theory and Organizational Ethics* (San Francisco CA: Berrett-Koehler Publishers Inc., 2003) at 124.

⁵⁰¹ S. Fineman and K. Clarke, “Green stakeholders: industry interpretations and response” (1996) *Journal of Management Studies*, 33/6, 715 - 30 as cited in Crane and Matten, *Business Ethics: A European Perspective Managing Corporate Citizenship and Sustainability in the Age of Globalization*, 2d (Oxford: Oxford University Press, 2004) 2-3.

⁵⁰² Simon Zadek, *The Civil Corporation* (London, UK: Earthscan Publications Limited, 2001) 163.

9.4 Ethics and Stakeholder Engagement

Every economic decision has a moral consequence.

Caritas in Veritate, 37

Understanding the needs of diverse stakeholder constituencies requires some form of meaningful dialogue between the corporation and its stakeholders. Given the asymmetries of power and knowledge in this relationship it is widely acknowledged that ethical processes and standards are core to the establishment of the trust necessary for this to occur. One approach that provides a framework for greater interaction and ongoing engagement with the diverse constituents is the ‘stakeholder engagement’ model.

The AccountAbility AA1000 Series which establishes standards focused on the social dimensions of organizational accountability envisages in stakeholder engagement:

“the reflection at all stages of the process over time of the views and needs of all stakeholder groups... the consideration of ‘voiceless stakeholders including future generations and the environment.”⁵⁰³

Enlightened companies are seeing that this model is a basis for an ongoing dialogue that offers the opportunity for increasing awareness and understanding of relevant issues and the context within which they operate. The broader awareness and increased knowledge derived from engagement with stakeholders can inform and strengthen decision-making processes by enabling a wider consideration of the implications and consequences for those affected by them. There are also strategic and operational benefits that flow from having a sound framework for fair and honest engagement with stakeholders that increases the capacity to identify opportunities and innovative means to achieve objectives in ways that are ethical, sustainable, and satisfy the ‘bottom line’.

The ethical and moral responsibility of those who direct and manage business enterprise exceeds the normal market values based standard of rational indifference (in the United

⁵⁰³ AA1000 Stakeholder Engagement Standard 2011 (Accountability 2008) at 20-21.

States, lack of *scienter*, elsewhere not knowingly or intentionally doing harm) and extends to all of the organization's stakeholders, not merely the shareholders. Directors, officers and managers have an obligation to deal openly and honestly with the firm's various stakeholders and to avoid purely self-serving actions which their privileged access to information and discretionary authority may make possible. Recent events have only served to renew recognition of the fundamental interdependence among all stakeholders (shareholders included) and the need for common standards of accountability, honesty, fairness and integrity to govern the economic as well as the social and political domains.

The following chapter examines how these different voices are becoming part of the discourse regarding business conduct and governance.

10. Different Voices: Evolving Governance Discourse

The question whether we belong to a larger community is answered in terms of whether our own action calls out a response in this wider community, and whether its response is reflected back in our own conduct.

G.H. Mead⁵⁰⁴

10.1 Multiple Regulatory Paths

An unprecedented proliferation of non-state emanated codes, guidelines and standards of governance has occurred over the last two decades. Their impact, while debated, is associated with indicators that suggest that corporate compliance with the law is one of multiple criteria against which customers, investors, stakeholders and the wider community judge corporate behaviour.⁵⁰⁵

Consideration and adjudication of corporate responsibility and accountability over and above the legal baseline is occurring in multiple fora, engaging multiple voices, and pronouncing multiple condemnations and penalties for shortcomings beyond those directly charged with a regulatory function. Stock exchanges⁵⁰⁶, institutional investors⁵⁰⁷,

⁵⁰⁴ G.H. Mead, *Mind Self and Society* (Chicago: University of Chicago Press, 1934).

⁵⁰⁵ Recent research on corporate reputation at the Copenhagen University Reputation Institute found that consumers prefer to deal with companies they trust and employees prefer to work at a company with which they are proud to be associated. Pruzan, Peter, "Corporate Reputation: Image and Identity", *Corporate Reputation Review* (Reputation Institute, Copenhagen University, 2001). Online at: <http://reputationinstitute.com/crr/V04/Pruzan.pdf>. Edelman's 2011 Trust Barometer survey of consumers reports that nearly 75% will actively avoid dealing with businesses they don't trust and 85% will go out of their way to do business with a company they trust. Edelman 2011 Trust Barometer, "Trust has Tangible Benefits" (video), <http://www.youtube.com/watch?v=viXTQBBY258>, January 2011.

⁵⁰⁶ The London Stock Exchange, with the FTSE Group, launched the FTSE4Good Index Series in 2001 (www.ftse.com/indices/FTSE4Good_Index_Series/Downloads). The Johannesburg Stock Exchange followed in 2004 with a socially responsible index. OMX, Northern Europe's stock exchange has the Nordic Sustainability Index and the exchange retains the right to review and de-list companies that are found to act in violation of human rights or other international ethical norms. Brazil's Novo Mercado was introduced by Bovespa because Brazilian companies were finding it difficult to access capital markets. The Novo Mercado demands higher governance standards than the main market. To list on the exchange, companies voluntarily agreed to higher governance standards on the basis that this would attract more capital.

and activist investors have a voice on matters of governance through procurement policies⁵⁰⁸, listing standards, investment guidelines, advisory votes⁵⁰⁹ and proxy proposals.⁵¹⁰

The advent of this broader governance discourse opens up the possibility of exploring multiple regulatory and quasi-regulatory paths toward constructive engagement on the role and conduct of business in society. Alongside the baselines drawn in the traditional regulatory sphere – defining the minimum threshold needed to balance freedom of choice and the good of society – there are a myriad of other paths to follow which reflect fundamental beliefs, formal and informal standards and principles that guide patterns of behaviour and judgments across normative boundaries, augmenting and going beyond those which are formally expressed in law.

⁵⁰⁷ For example: Association of British Insurers, National Association of Pensions Funds in the United Kingdom, CalPERS and TIAA-CREF in the United States, Canadian Coalition for Good Governance in Canada. In Norway, the Norwegian Government Pension Fund – Global (formerly the Petroleum Fund of Norway) Statens pensjonsfond utland, SPU, is a fund comprised of the surplus profits generated from Norwegian petroleum assets. The Fund is mandated to avoid "investments which constitute an unacceptable risk that the Fund may contribute to unethical acts or omissions, such as violations of fundamental humanitarian principles, serious violations of human rights, gross corruption or severe environmental damages". As of the valuation in June 2007, it was the largest pension fund in Europe and the fourth largest in the world, although it is distinct from other pension funds in that it is based on national oil profits and not pension contributions. As of 31 December 2010 its total value is NOK 3,077 billion (\$525 bn). Online at: <http://www.nbim.no/en/press-and-publications/News-List/736/femte-beste-resultat-i-fondets-historie/>. It holds approximately one per cent of global equity markets and is considered to be the largest stock owner in Europe. Online at: <http://www.nbim.no/en/press-and-publications/News-List/736/femte-beste-resultat-i-fondets-historie/>.

⁵⁰⁸ For example, in the Netherlands, the government has incorporated the OECD Guidelines for Multinational Enterprise in their processes for granting export notices to companies. Along similar lines, the French organization in charge of managing export credits and investment guarantees, COFACE (Compagnie Francaise pour l'Assurance due Commerce Exterieur), asks companies to sign a letter acknowledging that they are aware of the Guidelines.

⁵⁰⁹ The shareholder advisory vote on executive compensation, the so-called 'say on pay' vote, which became law in the United Kingdom in 2003 pursuant to section 439 of the Companies Act 2006, has long been the subject of independent institutional investment guidelines such as those issued by the Association of British Insurers (ABI), National Association of Pensions Funds, and specific investment fund positions such as those expressed in the Hermes Investment Management Statement on UK Corporate Governance and Voting Policy 2001 and the later Hermes Guidelines.

⁵¹⁰ See section 13.3 for further discussion on the use of shareholder proposals to bring forward environmental, social and governance issues.

However, the extent to which the standards of business conduct can be set through non-governmental scrutiny and quasi-legal regulation of practices, and to a level *significantly beyond the prescribed legal minima* is still to be determined.

One of the many challenges is the source of authority, to set the standards, monitor and hold to account for non-observance in the absence of the rule of law. As will be outlined later in the chapter, this challenge has long been the frustration of non-law standard setters and observers alike. If the ideals expressed in voluntary codes, guidelines or standards reflect a dramatic difference from common practice, and the potential benefits of reform efforts are not well communicated and understood, they may meet with resistance.⁵¹¹

If the standards are discretionary and voluntary, there is a question as to what the risks and rewards would be for observing or failing to observe them. Certainly, financial and opportunity costs are at stake in the case of government procurement criteria and investor guidelines and arguably some of the more established consumer based initiatives. However, inevitably these costs are factored into a larger calculation where they may well be outweighed by alternative profit streams equally legal, but perceived to be less onerous.

This raises the further question of whether it is necessary – or inevitable – that in order for such standards to be observed and maintained they must eventually be subsumed within the formal regulatory framework as a matter of public policy and articulated through legislative intervention. In other words, is it the case that normative self-regulation of corporate governance is inevitably only a prelude to the necessity of prescriptive, formal regulation?

⁵¹¹ European Commission, Internal Markets Directorate General, *Comparative Study Of Corporate Governance Codes Relevant to the European Union And Its Member State on behalf of the European Commission*, (European Commission, 2002) 8. Online at: http://ec.europa.eu/internal_market/company/docs/corpgov/corp-gov-codes-rpt-part1_en.pdf.

New issues arise if it becomes necessary to resort to formal governmental intervention in order to give binding effect to higher standards of business conduct. Issues as to what, if any, are the limits of legislative intervention – beyond setting the minimum legal threshold – to prescribe for example, what constitutes action taken in good ‘corporate conscience’, or to mandate a structure and process for board and corporate decision making, or to adjudicate the ‘right choice’ between equally legal but different alternatives?

Historically, regulators have stopped short of direct involvement and judgment in relation to the ethics, culture and behaviour within regulated organizations. In capitalist systems, this is partly reflective of Freeman’s “separation thesis” wherein he describes an underlying assumption that there is a line between the business domain and the ethical domain.⁵¹² To the extent that these matters have been within the regulatory purview it has been at a high level with the detail and implementation left to the organizations themselves as a matter of governance, internal control, and self-regulation subject to a positive disclosure obligation.

This approach recognizes that wherever the legal baselines are set, the greatest potential for good governance lies in the choices that are made voluntarily to go beyond the path described in law to set new boundaries of responsible conduct.

This is not to say that such choices need be made without assistance or support. The next section 10.2 provides examples that illustrate the role that the market can play in validating ethical and responsible business choices. The following section 10.3 provides an account of instances where regulators have taken intermediate steps that fall between the reliance on purely voluntary choices on the one hand and mandatory requirements on the other. These approaches employ the regulatory technique that Dunsire has termed ‘collibration’ – a limited strategic intervention by government to use existing tensions

⁵¹² R. Edward Freeman, “The Politics of Stakeholder Theory: Some Future Directions” (1994) *Business Ethics Quarterly* 4(4), 409-422.

between market actors to achieve a policy objective by altering the conditions of engagement.⁵¹³

10.2 Market Forces for Change

The challenge for businesses that choose voluntarily to address environmental, social and governance issues responsibly is that, from a market competitiveness perspective, there remains a perception that investors do not value such responsibility.⁵¹⁴ Instead of recognizing the benefits of higher and more stable equity price and reduced volatility that flow from good environmental, social and governance performance over the longer term, investor focus in general remains biased toward short term (half-yearly or quarterly) performance even if that performance comes with the higher risks associated with poor governance.⁵¹⁵

In the United States, the prevailing focus on financial results largely overlooks longer term value drivers such as corporate culture, forward planning, environmental and social responsibility. Since these factors are not readily quantified, they fall into the non-financial assessment of investment potential that has tended to have less weight, or in some economic calculus weigh heavily against, when investors assess comparative investment potential. Sullivan has argued that there is also complacency on the part of

⁵¹³ In his discussion paper, “Manipulating Social Tensions: Collibration as an Alternative Mode of Government Intervention”, Max-Planck-Institut für Gesellschaftsforschung Discussion Paper 93/7, August 1993 Andrew Dunsire first defines his concept of “collibration” as an intervention by government to use the social energy created by the tension between two or more social groupings habitually locked in opposition to one another to achieve a policy objective by altering the conditions of engagement without destroying the tension, unless deliberately. See also, A. Dunsire, “Modes of Governance” in J. Kooiman (ed.), *Modern Governance: new government-society interactions* (London: Sage, 1993) 21-34 at 29. J. Kirkbride and S. Letza, “Regulation, Governance and Regulatory Collibration: achieving an “holistic” approach” (2004) *An International Review* Volume 12, No. 1.

⁵¹⁴ Both Unilever and Rio Tinto stated in 2010 their frustration at mainstream investors’ narrow interest in short performance. Source: Mike Scott, “Poor Governance Now Seen Linked to Inferior Returns”, *Financial Times*, December 19, 2010.

⁵¹⁵ The annual turnover (“churn rate”) for shares of New York Stock Exchange-listed companies increased from a range of 10 percent to 30 percent during the 1940–80 period to more than 100 percent in 2005. Source: CFA Centre for Financial Market Integrity and Business Roundtable Institute for Corporate Ethics, *Breaking the Short-Term Cycle*, 2006 CFA Institute. The advent of day-trading has further

investors who tend to assume companies are dealing fairly well with environment, social and governance issues until something goes wrong.⁵¹⁶

That said, there is empirical evidence to suggest that there are incentives for companies with good governance and responsible business practices to pursue profit with regard to their impact on the economic, environmental and social infrastructure that far exceeds any ‘carrots for compliance’ that a government regulator could offer.

A growing body of research supports a positive correlation between corporate social responsibility and financial performance. Worth noting because of its scope is the Orlitzky Schmidt “meta-study” (study of studies) examining dozens of studies on corporate responsibility released in late 2004. In “Corporate Social and Financial Performance: A Meta-Analysis”, the researchers analyzed 52 studies over 30 years and found a statistically significant correlation varying from “highly positive to modestly positive” between corporate responsibility and financial performance.⁵¹⁷

A study comparing the risk-adjusted performance of socially-responsible funds to conventional funds from 1997 to 2005 suggested that socially responsible funds outperformed on a raw returns basis, and found no substantial difference on a risk-adjusted basis.⁵¹⁸

The increase in information on non-financial issues that companies communicate through such initiatives as the Global Reporting Initiative (GRI) and the Carbon Disclosure Project, and the advent of mandatory environmental, social and governance disclosure

⁵¹⁶ Rory Sullivan, *Valuing corporate responsibility: how do investors really use corporate responsibility information?* (Greenleaf Publishing, March 2011)

⁵¹⁷ Orlitzky, Schmidt, Rynes, “Corporate Social and Financial Performance: A Meta analysis”, *Organization Studies* (2003) 24(3): 403-441. This paper was awarded the Moskowitz Prize for CSR research for the Social Investment forum.

⁵¹⁸ Javier Rodriguez, “The Performance of Socially Responsible Mutual Funds: A Volatility-Match Approach” (2010) *Review of Accounting & Finance* Vol. 9, No. 2, 180-188.

initiatives by stock exchanges has increased the degree to which these factors are taken into account by management, investors and the market generally.⁵¹⁹

The United Kingdom's Business in the Community (BITC), a business-led not for profit organization for the promotion of responsible business, in conjunction with Ipsos Mori conducted research examining the relationship between total shareholder return, dividend yield and share volatility and the management of non-financial issues in the 33 FTSE 350 companies that have measured and managed their corporate responsibility through Business in the Community's Corporate Responsibility Index (CR Index) in each of its six years.

The research reveals a statistically significant link between effective management and governance of environmental and social issues and financial performance. Specifically, the results revealed that those companies which actively managed and measured social and environmental issues outperformed their FTSE 350 peers on total shareholder return by between 3.3% and 7.7% throughout the period 2002-2007.⁵²⁰

Significantly, in the months following the global financial crisis, analysis revealed that companies with greater corporate responsibility (as measured by the CR Index) fared no worse in the economic downturn and recovered more quickly.

Ipsos Mori on behalf of BITC conducted a further analysis in the aftermath of the global financial crisis. The study assessed whether, in the midst of such financial instability which in 2008 saw the FTSE All-Share decrease an average in Total Shareholder Return

⁵¹⁹ Examples of broad-based stock market indices that incorporate environmental, social and governance (ESG) criteria and that select (and de-select) companies for inclusion based on scoring systems include: the FTSE4Good series, the BM&FBOVESPA Corporate Sustainability Index (ISE), the Johannesburg Stock Exchange Socially Responsible Investment Index, the NASDAQ OMX GES Sustainability Nordic Index, and the Wiener Börse VÖNIX Sustainability Index. Recent research shows that firms that have higher scores and report on environmental, social and governance measures have more positive analyst recommendations and that mandatory sustainability reporting effectively promotes socially responsible managerial practices and more effective supervision of management by corporate boards, see: Ioannis Ioannu and Georges Serafeim, "The Consequences of Mandatory Corporate Sustainability Reporting" Harvard Business School Working Paper 11-100, May 17, 2011.

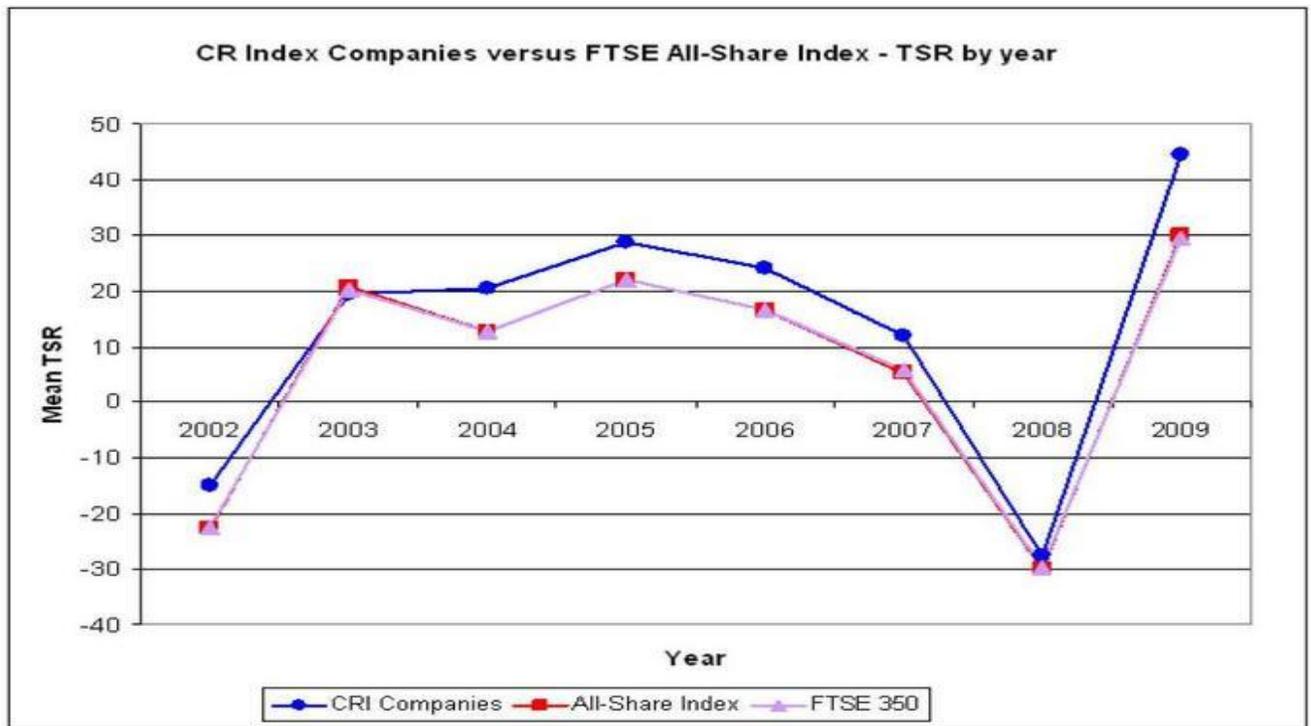
⁵²⁰ BITC Ipsos MORI, *The Value of Corporate Governance: The positive return of responsible business*, (BITC, October 2008). Online at: http://www.bitc.org.uk/resources/publications/value_of_corp_gov.html.

(TSR) of -30%, with a +30.1% recovery observed in 2009 , corporate responsibility made any difference to financial performance in difficult times. Using the financial data of companies which participated in Business in the Community's CR Index each year between 2002 and 2009 and are listed on the London Stock Exchange, Ipsos MORI analyzed the data to assess any link between managing and measuring corporate responsibility and their financial performance by total shareholder return comparing it to the FTSE 350 and FTSE All-Share.

The research found that in 2008, shareholder returns plummeted as much for those companies managing and measuring their corporate responsibility as the rest of the FTSE. However, the research showed that as companies began to provide higher returns for shareholders, companies in the CR Index recovered quicker than their FTSE 350 peers, with an average of 10 percentage points higher shareholder returns as is illustrated in Figure 8 below.⁵²¹

⁵²¹ BITC, Ipsos MORI, *The value of responsible business* (BITC, June 2010). Online at: <http://www.bitc.org.uk/document.rm?id=11314>.

Figure 8 - CR Index Companies versus FTSE All-Share Index - TSR by Year



The value of responsible business (Business in the Community, June 2010) by permission.

The FTSE KLD 400 Social Index, launched in May 1999 as the Domini 400 Social index, has in its twenty years outperformed the S&P 500.⁵²² Notably in the 2007 – 2009 period of the global financial crisis the Index fell less steeply than the S&P 500 and recovered more sharply in months immediately following the crisis.⁵²³

Companies selected for the KLD400 must have positive social and environmental records according to criteria based on: community relations, diversity, employee relations, human

⁵²² The FTSE KLD 400 Social Index (KLD400) is a float-adjusted, market capitalization-weighted, common stock index of US equities. In selecting companies for the KLD400, KLD seeks to maintain the composition of Index holdings at approximately 90% large cap companies, 9% mid cap companies chosen for sector diversification, and 1% small cap companies with exemplary social and environmental records. Launched by KLD in May 1990, the KLD400 (formerly KLD’s Domini 400 Social Index) is the first benchmark index constructed using environmental, social and governance (ESG) factors. The Domini 400 Social Index was renamed the FTSE KLD 400 Social Index in July 2009. It is a widely recognized benchmark for measuring the impact of social and environmental screening on investment portfolios. Source: FTSE Fact Sheet FTSE KLD 400 Social Index, online at www.ftse.com.

⁵²³ RiskMetrics Group “KLD Social Index Marks twenty Years of Strong Financial returns: Outperforms S&P 500 Using Environmental, Social and Governance Factors”, Press release (RiskMetrics Group, New York, May 4, 2010) online at: www.riskmetrics.com; FactSet Research Systems, Inc. FTSE Group.

rights, product quality and safety, and environment and corporate governance. The companies are evaluated in the context of their industry and sector as well as in relation to the broader market. KLD uses a social screening approach to exclude from the Index companies involved beyond specific thresholds in alcohol, tobacco, firearms, gambling, nuclear power and military weapons. A financial screening approach is used to ensure that companies that do not meet the financial screens (market capitalization, earnings, liquidity, stock price and debt to equity ratio) are ineligible for inclusion in the Index.

Another study identified that there are challenges to performance inherent in the screening approach depending on the number of screens and how stringent the requirements for investment.⁵²⁴ The larger the number of screens and the more rigorously the criteria applied, the smaller the universe of acceptable investments leading fund managers to invest in lower-performing companies or to hold large cash, bond or real estate positions with potentially lower potential returns. At the same time, while extra screens may lessen investment returns, in moderation they may also reduce risk. However, if too many screens are applied, it can lead to a concentration of investment in a narrow universe of acceptable investment that potentially increases risk.⁵²⁵

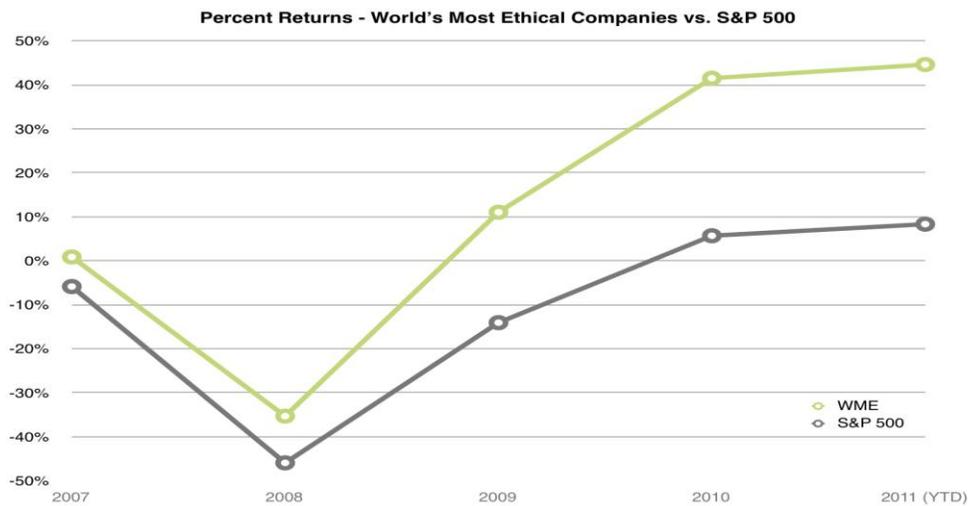
There are other indicators of the positive impact of ethical business conduct. A comparison of returns for companies ranked by the Ethisphere Institute as among the World's Most Ethical companies versus the Standard and Poor 500 in the period during and immediately following the global financial crisis demonstrates clear out-performance by the ranked companies.⁵²⁶ (See Figure 9 following).

⁵²⁴ D.D. Lee, J.E. Humphrey, K.L. Benson, and J.Y.K. Ahn, "Socially responsible investment fund performance: the impact of screening intensity" (2010) *Accounting & Finance*, 50(2), 351-370.

⁵²⁵ See also: Meir Statman and Denys Glushkov "The Wages of Social Responsibility", December, 2008 <http://www.socialinvest.org/resources/research/documents/2008WinningPrize-Moskowitz.pdf>. The study analyzes returns during 1992-2007 of stocks rated on social responsibility by KLD finding a return advantage for socially responsible investors relative to conventional investors. Where, as is typically, social responsibility investments "shun" stocks of companies associated with tobacco, alcohol, gambling, firearms, military, and nuclear operations, the researchers found that such shunning brought a return disadvantage relative to conventional investors. The advantage and disadvantage largely offset each other such that returns are largely comparable to the S&P 500.

⁵²⁶ According to research by the Ethisphere Institute, investment in ethics benefits companies and their shareholders, even in a recessionary periods. The graph compares the "WME Index," comprised of all publicly traded companies in the 2011 World's Most Ethical Company list, against the S&P 500 since

Figure 9 - Percent Returns - World's Most Ethical Companies vs. S&P 500



Source: The Ethisphere Institute, www.ethisphere.com. By permission.

Another survey by The Corporate Executive Board examines approximately 130 companies with regard to the level of integrity within those companies' corporate cultures. The survey found that the companies that scored the highest marks outperformed those with the lowest by more than 16 percentage points when it came to shareholder returns. The top quartile of companies surveyed averaged a 10-year total shareholder return of 8.8 percent, while the bottom quartile averaged a loss of 7.4 percent. These results quantify the financial benefit, or 'integrity capital', to companies and shareholders from promoting a culture of integrity among its workforce.⁵²⁷

2007, the initial World's Most Ethical Companies recognition. The World's Most Ethical Company designation is awarded to the companies that have leading ethics and compliance programs, particularly as compared to their industry peers. The selection process involves data analysis on hundreds of companies based on their responses to an in-depth survey questionnaire regarding their ethics and compliance program, governance and corporate responsibility, as well as documents and information researched and requested by Ethisphere to confirm survey responses. Every company receives a score based on the results of the survey and measured against seven distinct categories constituting a comprehensive sampling of definitive criteria of core competencies. These categories were Corporate Citizenship and Responsibility; Corporate Governance; Innovation that Contributes to the Public Well Being; Industry leadership; Executive Leadership and Tone from the Top; Legal, Regulatory and Reputation Track Record; and Internal Systems and Ethics/Compliance Program. Source: www.ethisphere.com.

⁵²⁷ Matthew Scott, "Is Your Company Building 'Integrity Capital'", *Corporate Secretary*, 2 June 2011. Online at: <http://corporatesecretary.com/articles/11914/your-company-building-integrity-capital>.

The difficult and perhaps near impossible task would be to unravel these results to isolate the causal drivers and identify precisely where the correlation resides. Is it because these companies are successful that their decision makers have the capacity to develop strategy and invest in business innovation that anticipates the importance of something more enduring than quarterly earnings and short term investors? Or, is it because of their appreciation of the significance of long-term relationships with shareholders, stakeholders and communities that they operate their businesses responsibly?

Either way, the best net result is sustainable profit for companies that is not at the expense of the communities or the natural environments in which the companies operate. Arguably this is the modern operation of the free market that Adam Smith envisaged.

Market forces can be used for ethical and profitable outcomes with the foregoing examples providing empirical evidence that the former can coexist and in some cases enhance the latter. This is particularly the case over a longer time frame where enduring success and prosperity prevails over short term and unsustainable gain, particularly when the accounting factors in input and opportunity costs and fully quantifies the negative externalities.

10.3 Enabling Change Through Governance Disclosure

As discussed, there are legal, philosophical and practical impediments to mandatory or prescriptive approaches to governance and corporate responsibility. The drawbacks to voluntary approaches to governance and corporate responsibility are also considerable and include such issues as: low credibility; problem of free riders; low threshold standards; limited sanctions for non-compliance; and pre-emption of more rigorous governmental protective measures.

Faced with the alternatives of impasse or innovation, regulators in numerous jurisdictions have chosen the latter, instead seeing the opportunity for a 'hybrid' approach which in

essence contemplates a ‘marriage’ of the coercive authority of the State with ‘voluntary’ self-regulation, after Foucault’s concept of governmentality.

Governing people, in the broad meaning of the word, governing people is not a way to force people to do what the governor wants; it is always a versatile equilibrium, with complementarity and conflicts between techniques which assure coercion and processes through which the self is constructed or modified by himself.⁵²⁸

It is generally agreed that, fundamental attributes for winning investor confidence include ensuring adequate corporate disclosure, guaranteeing investor rights, and ensuring sound board practices.⁵²⁹ In this light, the choice does not need to be the ‘either/or’ of relying on purely voluntary self-conceived and directed initiatives originating unilaterally from the corporate community on the one hand, or prescribing a rigid one-size-fits-all set of specific and detailed approaches to corporate responsibility on the other.

Instead, the State takes responsibility for constructing a reporting framework: outlining the form; providing guidance as to the substance; defining the nature of accountability with respect to corporate responsibility, and establishing penalties or sanctions for abdication or failure to discharge that responsibility. Then, within those parameters, corporations are responsible for what the finished product ‘looks like’, how it fits within their organization’s strategy and values and for embedding links to management and operational practices. As Sacconi puts it,

“the law can create the conditions under which shareholder’s interest coincides with that of the stakeholders: doing so by imposing certain requisites on the governance and accountability criteria that do not entail replacement of any reference to ‘shareholder value’ ... but instead induce a game to be played by the firm so that this coincidence of the two can be reached endogenously”.⁵³⁰

⁵²⁸ Foucault, M., *About the Beginning of the Hermeneutics of the Self* (Transcription of two lectures in Dartmouth on Nov. 17 and 24, 1980), ed. by Mark Blasius, in: (1993) *Political Theory* Vol. 21, No. 2, 198-227 at 203-4. In Foucault’s concept of governmentality he seeks to draw attention to the emergence of new and distinctive mentalities of government or ‘government rationality’ which involved a calculating preoccupation with activities directed at shaping, channeling and guiding the conduct of others.

⁵²⁹ World Bank <http://rru.worldbank.org/Toolkits/CorporateGovernance>

⁵³⁰ Lorenzo Sacconi, “Corporate Social Responsibility (CSR) as a Model of “Extended” Corporate Governance: An Explanation Based on the Economic Theories of Social Contract, Reputation and Reciprocal Conformism”, University of Trento – Department of Economics LIUC, Ethics, Law and Economics Paper No. 142 (February 1994) at 22. Available at SSRN: <http://ssrn.com/abstract=514522>.

In this way, corporations retain autonomy within the wider regulatory context which Hess refers to as a ‘regulated autonomy’. This is the case where government intervention already operates to regulate certain aspects of corporate operations such as employment conditions, health and safety standards and the implementation of environmental safeguards.⁵³¹

In the context of broader business accountability, government interventions in the form of enabling legislation that requires disclosure on environmental, social and governance matters, but does not prescribe the content of such mandated disclosure, effectively compel organizations to reveal information about their practices to shareholders, investors and the wider community.

In these cases the prescribed minimum standards are enhanced by legislation that provides a legal basis for businesses to pursue economic goals with ethical, social, and environmental responsibility. The combination of traditional regulation and enabling (or ‘soft touch’) approach of mandatory disclosure establishes the policy framework within which companies operating ethically are able to draw attention to their good governance, and socially and environmentally responsible performance, and in doing so challenge others to follow suit.

Internally, such approaches recognize and address management concerns that, absent a legal basis, this broader responsibility may exceed their corporate objects and duty to shareholders thus exposing them to legal challenge. Externally, the measures have the potential to impact reputation and market perception of the quality and responsibility of management thus enabling a more complete assessment of the ‘value’ of a corporation as against its competitors.

⁵³¹ Per David Hess, as referred to by Christine Parker in *The Open Corporation – Effective Self-Regulation and Democracy* (Cambridge University Press, 2002) 217

This potential is a key element of the French government's policy rationale for expanding its corporate responsibility measures in 2002.⁵³² In 2001, the French government enacted the *New Economic Regulation (Nouvelles Regulations Economique)* a wide ranging law that dealt with issues such as competition and labour extending into ethical and non-financial dimensions of business. Decree n. 2002 – 221 pursuant to Article 116 of the *New Economic Regulation*, in 2002 mandated that companies publicly listed on the Paris Stock Exchange's Primary Market include a report on social and environmental issues in their annual reports and requires greater transparency in corporate governance.

The measure aims to promote disclosure that improves corporate transparency on CSR and makes such information publicly available to investors and the public. Its premise is that the mandatory disclosure requirement will encourage companies to give due consideration to policy development and innovation that aligns corporate activity with stakeholders' triple bottom line expectations. This approach has the ultimate objective that, in fulfilling this disclosure requirement, French corporations would be in the vanguard of international corporate reporting for the purposes of increasing competitiveness and responsible investing while at the same time advancing environmental, governance and social responsibility.⁵³³

France is but one of a growing list of governments that mandate disclosure relating to environmental, governance and social issues with a view to encouraging responsible business and investment practices. In the early 1990s, the British government introduced mandatory disclosure under the *Pensions Act 1995* relating to whether and the extent to which pension trustees took into account environmental, governance and social considerations in their investment decisions making the United Kingdom the first OECD country to require SRI disclosure. A subsequent amendment, *The SRI Pensions*

⁵³² In 1977, France became the first country with mandatory annual reporting on non-financial information for companies with more than 300 employees. Susanne Schaller, "The CSR Navigator: Country Profile – France", *Institute for development and Peace*, University of Duisberg-Essen. Online at: http://www.bertelsmann-stiftung.org/cps/rde/xchg/SID-0A000F0A-3C2605A/bst_engl/hs.xsl/prj_5982_5988.htm.

⁵³³ Lucien Dhooge, "Beyond Voluntarism: Social Disclosure and France's *Nouvelle Regulations Economique*" (2004) *Arizona Journal of International & Comparative Law*, Vol. 21 No 2, 447 – 8.

Disclosure Regulation 2000 (Amendment to the *Pensions Act 1995*) took effect July 2000.

The regulation requires trustees of occupational pension schemes to disclose in their Statement of Investment Principles (SIP): “The extent (if at all) to which social, environmental or ethical (SEE) considerations are taken into account in the selection, retention and realisation of investments; and their policy (if any) in relation to the exercise of the right (including voting rights) attaching to investments.”⁵³⁴ As a consequence, occupational pension funds in the United Kingdom are legally bound to state their policies and practices with respect to environmental, social and governance considerations.

This regulatory approach, referred to as ‘enabling legislation’, was an innovation when first introduced. It is a limited, but effective intervention that provides pension trustees with a legal foundation to take environmental, social and governance issues into consideration and a platform for positive disclosures without interfering with trustees’ exclusive right and fiduciary responsibility to determine investment policies in respect of the pension assets. Following the United Kingdom’s changes to the *Pensions Act*, Austria, Belgium⁵³⁵, France, Germany, Italy, the Netherlands, Spain, Denmark, Sweden and Australia⁵³⁶ have all introduced similar legislation.

⁵³⁴ The 1999 amendments to the *Pensions Act 1995* were superseded by 2005 amendments; the substantive text was unchanged. In 2001, France’s Law on Public Pension Reserve Funds brought in similar requirements for pensions funds’ management boards to regularly report on how investment policy guidelines have considered ethical, environmental and social factors. The 2001 Law on the Generalization of Employee Savings Plans mandates that employee fund disclose the environmental, ethical and social considerations that the funds managers must take into account in investment decisions and annually report on how such considerations were addressed. “Corporate Social Responsibility: National Public Policies in the European Union,” European Commission on Employment and Social Affairs”, January 2004. Accessible at http://ec.europa.eu/employment_social/soc-dial/csr/national_csr_policies_en.pdf.

⁵³⁵ The Belgian government now requires a ten per cent allocation to socially responsible investing by all public pension funds which are also required to justify their choice of investment in an annual reporting.

⁵³⁶ In Australia, pursuant to amendments to the 2001 *Australian Financial Services Reform Act* all products with an investment component – including superannuation (pension) funds and mutual funds – must include disclosure of “the extent to which labour standards, or environmental, social or ethical considerations are taken into account in the selection, retention, and realization of investment”.

In 2005, the European Union *Accounts Modernisation Directive* introduced the requirements for non-financial reporting in directors' reports "to the extent necessary for an understanding of the development, performance or position of the business, including environmental and employee information".⁵³⁷ At the time of introduction of the expanded Directors' Report, or 'business review', the European Commission noted that the information contained in the reports should not be limited to the direct financial aspects of the company's business: "[I]t is expected that, where appropriate, this [report] should lead to an analysis of the environmental and social aspects necessary for an understanding of the company's development, performance or position".

The United Kingdom's *Companies Act 2006* requires London Stock Exchange listed companies to report annually on their business activity. This enhanced annual Business Review must contain information on environment, workplace, social and community matters to the extent that they are important to understanding the company's business.⁵³⁸ The Act also introduced a new Operating and Financial Review requiring companies to report all material risks, including those arising from social, environmental and ethical issues. While it was withdrawn after being law for less than a year, there are strong indications that the government may re-introduce similar such legislation.⁵³⁹

It is important to note that both the European Directors' Report and the United Kingdom's enhanced Business Review are information requirements. The information must be provided and the content must be truthful and complete, but it is ultimately for

⁵³⁷ The Accounts Modernisation Directives is the collective term for the 4th and 7th directives on the annual and consolidated accounts of companies (Directives 78/660/EEC and 83/349/EEC respectively) and the Directive on the annual and consolidated accounts of banks and other financial institutions and insurance undertakings. The concept of non-financial reporting and in particular the recognition, measurement and disclosure of environmental issues in the annual accounts and annual reports of companies can be traced back to recommendations made by the European Commission in May 2001.

⁵³⁸ "Policy and Legislation, UK", <http://www.csr.gov.uk>, no date. Online at: <http://www.csr.gov.uk/ukpolicy.shtml>.

⁵³⁹ In June 2010, the UK government announced that it would reform the law governing company reporting, including the reinstatement of the 'Operating and Financial Review' framework for company reporting. It also committed to investigate further ways to improve corporate accountability and transparency. "We will reinstate an Operating and Financial Review to ensure that directors' social and environmental duties have to be covered in company reporting, and investigate further ways of improving corporate accountability and transparency." HM Government, *The Coalition: our programme for government* (May 2010) 10.

the corporate decision makers to decide what type of company and business activities will be revealed and for the consumers of such information to make their independent judgments. That is, whether the disclosure obligation is, for example, an opportunity for a business to make the connection between responsible business practices and operational integrity, or alternatively to inform investors and stakeholders of a lack of engagement on matters relating to the environment, workplace or community.

In a similar vein, Denmark introduced legislation in 2008 that requires the country's state-owned corporations, 1000 largest businesses and institutional investors to disclose annually whether they have corporate responsibility policies and if so to provide details of the content and implementation. Like the European and United Kingdom disclosure requirements, choices as to the existence, content and implementation of such policies are left to corporate decision makers.

Sweden's approach takes the hybridization of voluntary and mandatory measures a step further. Since 2002, the country's 55 fully and partially state-owned corporations have been required to produce annual sustainability reports in accordance with the Global Reporting Initiative's G3 Guidelines. In effect, the Swedish government has incorporated a voluntary international standard within its mandatory disclosure requirement.

By Rochlin's classification, these types of intermediate and hybrid approaches – ones that seeks to align economic with favourable social and environmental outcomes – would fall broadly within the 'internal view' where the "focus is on enhancing the core dynamics of accountability and integrity, [such that] corporate citizenship is designed to reduce (if not eliminate) "harms" and distribute broad benefits from a range of business practices".⁵⁴⁰

Arguably, what they fall short of is achieving the potential envisaged in the 'external view' where the focus is "on developing an approach to citizenship in which companies

⁵⁴⁰ Steven Rochlin, "Principles with Process: Corporate Integrity within a Corporate Citizenship Framework", in George G. Brenkert (ed.) *Corporate Integrity and Accountability*, (Sage Publications, 2004) 207 at 208.

become explicit leaders in working to solve challenging problems of social and environmental justice and equity”.⁵⁴¹ As this latter involves dedicating resources to promoting a vision of the ‘common good’ and traveling into undefined territory to re-chart ‘business as usual’, it arguably takes on the political dimensions resisted by Friedman and others who challenge the notion that corporations have a responsibility that extends beyond the corporate domain.

Without success in this external view, state based voluntary measures as with the civil society originated codes of conduct, guidelines, standards and measures, have their limitations in terms of effective observance.

For example, quality of reporting is becoming an issue under the UK ‘comply and explain’ reporting model. In a review of UK company reporting pursuant to the *UK Corporate Governance Code 2010* published by Grant Thornton in December 2010, 51 per cent of FTSE 350 companies claimed full compliance with the code, but the review found only 16 percent provided sufficient disclosure to support their claim. Without the accompanying explanation of corporate governance practices, investors have incomplete information on which to base their assessments of corporate governance. And for companies, failing to communicate, or meeting only the minimum standard of reporting, to shareholders on governance dilutes the effectiveness of measures taken by companies since they will not be reflected in governance related share price premiums.

Similarly, under France’s Article 116, by law companies must produce missing information at shareholder request and shareholders have the right to sue if they have been harmed by a company’s failure to disclose certain information.⁵⁴² However, subject only to this shareholders monitoring device, the form and detail of reporting is left to French companies and to date with varying results.⁵⁴³

⁵⁴¹ Ibid. at 208.

⁵⁴² Lucien Dhooge, “Beyond Voluntarism: Social Disclosure and France’s *Nouvelle Regulations Economique*” (2004) *Arizona Journal of International & Comparative Law* Vol. 21 No 2, 489-90.

⁵⁴³ Mary Louise Egan et al, “France: *Nouvelle Regulations Economique: Using Government Mandates for Corporate Reporting to Promote Environmentally Sustainable Economic development*”, Nov. 2003. Online at: <http://www.benedickegan.com/pdf/EganMaufeonWolffBenedick.pdf>.

Another study on the effectiveness of the ‘comply or explain’ technique revealed an additional challenge relating to how explanations of non-compliance are consumed by investors. The ‘comply or explain’ approach was intended to provide companies flexibility and the opportunity to engage shareholders on the rationale behind certain governance approaches not in strict compliance with the code. However, the study revealed that investors are reviewing governance reporting only with an eye to identifying companies reporting compliance and are less accepting of explanations when companies choose to explain rather than comply with the code.⁵⁴⁴

It is too early to assess the full effect of such enabling measures, particularly through challenging business cycles, but their existence suggests a constructive role for government by way of supporting well governed companies in addition to the traditional roles of setting and enforcing the minimum legal standards on poorly governed companies and policing the transgressors.

Recent research by the Association of British Investors, showed that companies with the best corporate governance records produced 18 per cent higher returns than those with poor governance records. The research also revealed that a company’s breach of governance best practices reduces its industry-adjusted return on assets by an average of one percentage point per annum. Among other key findings, was that the volatility of company share returns was nine per cent lower for well-governed companies compared to poorly governed companies.⁵⁴⁵

As the preceding examples suggest, the use of intermediate regulatory techniques like ‘comply or explain’ to encourage businesses to adopt responsible business practices tends to be most closely associated with the United Kingdom’s approach to corporate

⁵⁴⁴ S. Arcot, V. Bruno, A Faure-Grimaud, “Corporate Governance in the UK: Is the Comply or Explain Approach Working?” (2010) *International Review of Law & Economics* Vol. 30, no.2, 193-201; and Arcot and Bruno’s earlier, “In Letter but not in Spirit: An Analysis of Corporate Governance in the UK” (2006) available at SSRN: at <http://ssrn.com>.

⁵⁴⁵ Association of British Industries, ‘Governance and Performance in Corporate Britain: Evidence from the IVIS colour code system, ABI Research Paper 7, February 2008 (ABI, 2008). Online at: <http://www.abi.org.uk/Media/Releases/2008/02/40018.pdf>

governance and European countries that have adapted the UK approach. However, the United States has also made use of the technique.

The enactment of the *Sarbanes Oxley Act* imposed a positive disclosure obligation on corporate entities with respect to the existence of an ethics code. Section 406 of the *Sarbanes Oxley Act* requires that SEC reporting companies, including foreign issuers, disclose whether they have adopted a code of ethics that covers their principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions and, if they have not done so, to disclose why not. Companies are also required to report amendments to the code or any waivers of the code, including failures to enforce it, which occurred during the past year.

While the rule does not create a shareholder right of action or any civil liability in the event that a company has not adopted a code of ethics, it does place considerable pressure on companies to adopt a code of ethics in order to make a positive disclosure.⁵⁴⁶ The risk and the irony of this approach, of course, is that companies would move to adopt ethics codes for purely narrow instrumentalist reasons and without any true commitment to ethical conduct. This same risk arose just over a decade earlier when many companies adopted ethics codes in response to changes to the United States Federal Sentencing Guidelines that introduced sentencing criteria whereby companies without mechanisms for preventing and detecting ethics violations, like ethics codes, would receive higher fines than companies with such mechanisms.⁵⁴⁷

⁵⁴⁶ Since section 406 has no safe harbor, technically a company could risk civil liability over its code of ethics if its conduct in respect of the code would constitute a violation of Rule 10b-5, such as failing to disclose a failure to enforce the code against a principal officer.

⁵⁴⁷ The changes to the United States Sentencing Commission's Federal Sentencing Guidelines for Organizations (FSGO) in November 1991 created a powerful incentive for organizations to develop and implement voluntarily safeguards against unethical and criminal conduct. The incentive includes a potentially lighter sentence and reduced risk of being placed on probation if an organization is able to convince a federal judge that its program meets the FSGO definition of an "effective program to prevent and detect criminal conduct". While many American companies introduced codes of ethics, studies showed that the motivation to avoid fines at the corporate level had little connection to the promotion of ethical behaviour in practice. See for example: Joseph L. Bardaracco, Jr. and Allen Webb, "Business Ethics: A View from the Trenches" (January 1995) *California Management Review* 8.

Section 406 of *the Sarbanes Oxley Act* provides that a code of ethics is one that includes standards that promote: honest ethical conduct, full and fair disclosure, and compliance with the law.⁵⁴⁸ However, there is no clear empirical evidence of a direct correlation between the existence of a code of ethics and good conduct, particularly when the codes merely describe the minimum, baseline standards required by section 406 and are not supported by ongoing education and environments that enable and reinforce ethical conduct and decision making.

Nevertheless, the requirement for companies to have codes of ethics does mean that the subject of ethics has greater visibility. Furthermore, the existence of the codes means that there are explicit statements and commitments readily available to internal and external stakeholders –management and employees, shareholders and prospective investors, other corporate stakeholders such as suppliers, customers, regulators, and the public at large – to which companies can be held accountable.⁵⁴⁹ At the very least, then, consistent with other regulatory measures following the disclosure based philosophy, the requirement serves an information function and increases transparency as to company policies and practices, from both an internal and external standpoint.

However, with the comprehensive reviews of the regulatory framework underway in most of the Group of Twenty states, and recognition that many of the causes of the financial crisis were deeply rooted in behavioural and cultural issues, the question arises whether regulators should be addressing these issues even more directly under the auspices of a more proactive outcomes–based approach.

As the United Kingdom’s FSA former chief executive Hector Sant described the task, “regulators should focus on what an unacceptable culture looks like and what outcomes that [culture] drives”.⁵⁵⁰

⁵⁴⁸ 107 P.L. 204, Title IV, § 406, 116 Stat. 745

⁵⁴⁹ Joshua Newberg, “Corporate Codes Of Ethics, Mandatory Disclosure, And The Market For Ethical Conduct” (2005) *Vermont Law Review* Vol. 29, No. 2:253 at 255-256.

⁵⁵⁰ Hector Sants, “Do regulators have a role to play in judging culture and ethics”, June 2010, Speech to the Chartered Institute of Securities and Investment Conference. FSA/PN/101/2010.

The consideration of this issue goes to the heart of the market based system, and the debate over regulatory method, as any such intervention by the continued imposition of additional legal rules and regulations operates to further limit marketplace freedoms. For example, while government interventions combined with shareholder scrutiny and public opinion may put pressure on companies domiciled in democratic states that are most visible due to size, sector or both, and align with the existing practices of responsible or responsive companies, they are likely to fail to influence or impact companies that are unscrupulous in their activities or disclosures. They also fail to exert influence over those domiciled or with operations in non-democratic states.⁵⁵¹ The result is an uneven playing field and asymmetrical restrictions on companies that operate in accordance with the rules and standards which impede those companies' ability to compete with others that operate outside, or satisfy only the minimum standards prescribed by, the law.

The increasingly regulatory solutions in the United States (consistent with past precedent) and to a lesser extent in the United Kingdom and other mainly Anglo-American jurisdictions such as Australia and Canada, suggest a further shift away from traditional perspectives of capital markets as relatively free from government intervention in deference to the discipline of competition and economic efficiency. Arguably, this signals a further blurring of the boundaries between public and private law, and an increased politicization of issues arising from the corporate sphere.

The law has and continues to fill a vital role in a sophisticated, complex, diverse and disparate society. Its longevity might be attributed to the fact that the boundaries traditionally defined by law are, in reality, porous. This has allowed within those boundaries the influences of normative and evolving 'soft law' and non-law standards and practices, as much as the standards defined in law influence what occurs beyond its domain.

⁵⁵¹ These shortcomings were the basis for the British led Extractive Industries Transparency Initiative that sought to establish international standards of transparency in resource related industries to be applicable to companies and governments around the world. The EITI serves as a telling example of the challenges faced by voluntary initiatives with just five compliant members after eight years. Source: *Ethical Corporation* February 2011.

That said, the certainty, definition, predictability and ‘black and white’ of the legal domain must, necessarily, continue to co-exist with the evolving ‘grey zone’ of the normative domain and the fate of the public good lies in the recognition by those who advocate the former of the importance, legitimacy and utility of an ongoing dialogue with the latter.

Having considered the limitations of an exclusively legislated approach to establishing higher standards of conduct, and the opportunities as well as the challenges in market and state based efforts at enabling businesses to adopt higher standards voluntarily, it is important to give some consideration in the next chapter to the nature and source of such higher standards.

11. Governance: Setting New Standards

“I firmly believe that any organization, in order to achieve success, must have a sound set of beliefs on which it premises all its policies and actions.”

Thomas J. Watson Jr.⁵⁵²

11.1 The Problem of Definition

As great as the challenge is to select the means and methods to encourage responsible conduct, effective oversight and good governance, a larger challenge resides in the enduring search for consensus on what constitutes these goals. That is, good according to which standard, effective by whose measure, and responsible from what perspective.

There are numerous articulations of what constitutes good governance, prudent oversight and responsible business conduct, and of what comprises the nature and scope of corporate responsibility. These range from the narrow traditional neo-classical shareholder profit maximization position favoured by proponents of the strictly economic model of the corporation at one end of the continuum, to the wider environmental perspective, and to the social institution model favoured by proponents of social contractarian theory and corporate social responsibility (‘CSR’) at the other.

The diverse interpretations with their embedded cultural, legal and socio-economic influences are a considerable distance from coalescing in a universally accepted and recognized set of standards with sufficient specificity as to be capable of certainty in definition, application and adjudication within an objective legal or a normative framework.

One can argue that such coalescence is a remote possibility in light of the dynamic nature and complex practical and theoretical issues that impede progress toward an absolute end.

⁵⁵² Thomas J. Watson, Jr. *A Business and its Beliefs: The Ideas that Helped Build IBM*, (McGraw-Hill 2003).

Furthermore, this perceived lacunae has contributed to current ambiguity and uncertainty as to what terms such as *good governance* and *corporate responsibility* constitute in practice, as well as polarizing debate over the possibility of reaching consensus or convergence on what can be construed as largely qualitative and subjective appraisals.

In the absence of such certain definition, the influence of the prescriptive, rules and compliance based United States governance model has been dominant in the debate. This prescriptive approach to governance suggests the possibility of aggregating formal observance of multiple rules and regulations into a proxy for quantitative (and qualitative) measurement of technical governance compliance.

Yet even with a vast catalogue of ingredients, steps and procedures for implementing corporate governance, the core of what constitutes *good governance* remains elusive – far easier to diagnose in its absence or failure⁵⁵³. Just as the notion of true independence of mind eludes definition for the purposes of board membership, good governance is an idea and condition that is more than the sum of its parts.

There is ample evidence to show that compliance with the letter and not the spirit of the law fails to achieve the intended objectives and can lead to instrumentalist interpretation and observance, rote standardization, and the so-called ‘tick box approach’ that satisfies the form but is limited in, or devoid of, substance.

The widespread criticisms of the *Sarbanes-Oxley Act* in the United States (and abroad where a number of its provisions had extra-territorial effect) both before and following its adoption attests to the significant additional costs associated with that regime’s heavily

⁵⁵³ For example, the European Commission on June 2, 2010 issued the following background statement to its announcement of the launch of a public consultation on reforming corporate governance in financial institutions: “The financial crisis revealed significant weaknesses in corporate governance in financial institutions: board supervision and control of management was insufficient; risk management was weak; inadequate remuneration structures for both directors and traders led to excessive risk-taking and short-termism; and shareholders did not exercise control over risk-taking in the financial institutions they owned. These weaknesses played a role in the crisis and timely and effective checks and balances in governance systems would help preventing any future crisis”. European Commission, Green Paper: *Corporate governance in financial institutions and remuneration policies* COM(2010) 284 (Brussels, 2.6.2010).

prescriptive approach to corporate governance. In large measure, these additional compliance burdens fell on companies with boards and management that by and large were willfully if not technically compliant and the costs passed on to the shareholders they were supposed to protect without measurable additional protection. Perversely, the *Sarbanes-Oxley Act* enriched the accounting profession whose practices were at the root of the frauds that led to the Act being introduced in the first place.

Governance policies and practices will vary between companies depending on the location, size, type and impact of their operations. Without exception though, it is in the quality of how companies apply, embed and observe established principles of good governance into their strategies and day to day actions and decisions that will evidence the authenticity of an organization's commitment to those principles – wherever the company does business, and regardless of who may (or may not) be watching.

In a complex, increasingly interdependent world, the nature and extent of issues for which a corporation has, or is expected to have, responsibility varies widely according to the nature, size, sector and location of business operations. Yet, despite this variance and in a perceptible shift from the neoclassical business model, there is growing belief that corporations – alongside their responsibility to make decisions that safeguard and maximize the interests of shareholders – have a responsibility to balance fairly the interests of legitimate stakeholders and take account of the legal and ethical expectations that society has for business.⁵⁵⁴

11.2 Values Based Standards of Conduct

Over the last decades of the twentieth century and the early years of the new millennium, market and non-state actors have articulated values-based, higher standards of conduct and responsibility in a proliferation of codes, best practice guidelines, statements of

⁵⁵⁴ According to a recent survey published in *The McKinsey Quarterly* on January 25, 2006, 84% of the 4,238 executives questioned in 116 countries agree that high returns to shareholders should be combined with “contributions to the broader public good”.

principles, individual and multi-partite commitments. According to a 2002 study for the European Commission, most codes originated after 1997 and 1998 was the year with the highest code-production activity.⁵⁵⁵

With their diverse civil society origins outside the traditional government regulatory sphere, these standards vary in their form and substance as well as their application, scope, and authority. Collectively, they constitute a complex and multi-layered quasi-regulatory regime.⁵⁵⁶

At the international level, there are governance guidelines and principles of general application issued by or under the auspices of international institutions such as the OECD with its *Principles of Corporate Governance* and *Guidelines for Multinational Enterprise* and the United Nations which launched the Global Compact, the Global Reporting Initiative and most recently the *Principles for Corporate Responsibility*. Others are associated with a specific sector such as The UN *Principles of Responsible Investment* and the International Corporate Governance Network's global guidelines on shareholder responsibility, or specific issues like the OECD *Convention for Combating Bribery* and the *Ceres Principles*.

Others serve as vehicles for advancing and advocating for the interests of specific stakeholders, for example *The International Labour Organization – Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy*, the *Ethical Trading Initiative Base Code* and Social Accountability 8000. While another body of guidelines represent the interests of key institutional shareholders, collectively or individually, such as for example those issued by the Association of British Insurers

⁵⁵⁵The codes were drafted by collective bodies, such as governmental or quasi-governmental entities, committees or commissions organised by governments or by stock exchanges, business, industry and academic associations, directors associations, and investor-related groups. European Commission, Internal Markets Directorate General, *Comparative Study Of Corporate Governance Codes Relevant to the European Union And Its Member State on behalf of the European Commission* (2002) 2. Online: http://ec.europa.eu/internal_market/company/docs/corpgov/corp-gov-codes-rpt-part1_en.pdf.

⁵⁵⁶ See Sandra Waddock "Building a new institutional infrastructure for corporate responsibility" (2008) *Academy of Management Perspectives* 22:3, 87-108, for a description of the range of corporate responsibility standards influencing corporations.

(ABI), Canadian Coalition for Good Governance (CCGG), and California Public Employees Retirement System (CalPERS).

At the country level, many nations have adopted some or all of the most prominent of corporate governance codes, principles and best practice recommendations issued by non-state institutions to establish standards of conduct to be observed within their jurisdictions and by corporate entities operating abroad.⁵⁵⁷ Most of these are, by their nature, considered to be guidance or at most so-called ‘soft law’ standards, rather than formal, legally enforceable requirements, although the substance of some of these are incorporated into, mirrored, or enforceable in concurrent legislation.

Similarly, many companies incorporate or refer to these non-governmental codes and guidelines in their internal corporate codes of ethics and conduct.

Based on the sample of corporate codes, the most frequent direct references were to the UN *Global Compact* (10), the *OECD Guidelines for Multinational Enterprises* (8) and the UN *Universal Declaration of Human Rights* (6). In total, the codes referred to more than 20 different non-governmental instruments.

Inevitably with such diversity, there are differences, incompatibilities and conflicts. In some instances, the mere existence of certain corporate enterprises – such as the legal manufacture and export of military equipment – to which standards set by, for example, the EU *Code of Conduct on Arms Exports* or the United States *Defense Industry Initiative on Business Ethics and Conduct* apply, is anathema to other standards issuers, such as the FTSE KLD 400 Domini Social Investments index that excludes from the Global Investment Criteria companies deriving significant revenues from the manufacture of military weapons.⁵⁵⁸

⁵⁵⁷ For example, as discussed earlier in sections 1.3, 5.2 and 5.3, the 1999 OECD Principles of Corporate Governance and the Report of the Cadbury Committee on Corporate Governance were influential in the development of corporate governance codes in western European nations.

⁵⁵⁸ http://www.domini.com/GlobInvStd/2Community---Global.doc_cvt.htm#Nuclear last accessed 5 Nov, 2010.

Companies are thus confronted with a confusing array of corporate responsibility standards that are designed by third parties, applied across multiple sectors, and in practice, can obscure rather than advance the underlying principles and objectives that inform them.⁵⁵⁹ As a consequence, there have been challenges and debates over issues such as authority, representation, legitimacy, purpose and possible outcomes from the outset. More recently, as many of the standards have matured from aspiration and rhetoric to concrete tangible action, there are differences of opinion over practical matters such as application, evaluation, measurement and enforceability.⁵⁶⁰

In some cases, consideration of and responses to criticisms has led to improvements and a stronger product capable of more broad-based support.⁵⁶¹ However, to date, the influence of these non-governmental standards individually within target sectors or in relation to specific issues, and collectively in their ability to advance shared objectives based on fundamentally similar values has not translated into globally observed norms of corporate

⁵⁵⁹ David Collins states the importance of cogent and coordinated advocacy for a wider ambit of corporate responsibility conducted in language that resonates with the business as well as the stakeholder community. Different NGOs, academia, and thought leadership and business institutions pursuing myriad diverse and uncoordinated initiatives can end up only muddying the waters rather than providing insight and clarity and enabling understanding of alternative perspectives. D. Collins, "Tylenol Revisited: Friedman and the Current CSR Debate" in George G. Brenkert (ed.) *Corporate Integrity and Accountability*, (Sage Publications, 2004).

⁵⁶⁰ The recently introduced ISO 26000 sustainability standard is an interesting case in point. The International Organization for Standardization made its ISO 26000 a voluntary guidance standard rather than a certifiable management system. "ISO 26000 is not a management system standard. It is not intended or appropriate for certification purposes or regulatory or contractual use. Any offer to certify, or claims to be certified, to ISO 26000 would be a misrepresentation of the intent and purpose and a misuse of this International Standard." (http://www.iso.org/iso/discovering_iso_26000.pdf). The decision to issue a guidance standard was in part a response to concerns expressed by industry representatives over the burden and costs of certification. It was also reflective of the intended purpose of the standard to encourage careful assessment of each business' unique circumstances and strategically sound decisions reflective of those circumstances in setting sustainability goals. Despite this, numerous instances of misuse of the standard have occurred since its launch. Prohibited actions identified by the standard-setting body include: consulting firms attempting to sell ISO 26000 certification services to companies; companies requiring ISO 26000 as a condition to do business; companies claiming ISO 26000 compliance to convey a positive image to consumers; and governments attempting to use the standard to develop social responsibility regulation on the voluntary standard. Source: *Ethical Corporation*, February 2011. See: http://www.iso.org/iso/socialresponsibility_2006-en.pdf.

⁵⁶¹ For example, in 2006 the UN Global Compact launched a comprehensive, web-based tool – OneReport@ Communication on Progress (COP) Publisher – to assist Global Compact participants prepare and publish progress reports on their integration of the ten principles into day-to-day business operations and practices. The COP Publisher was developed jointly by the Global Compact and SRI World Group, Inc., is based on the guidelines outlined in the Global Compact's COP Policy and is available free of charge to participants of the initiative. The aim was to make reporting more streamlined and easier to manage for companies of all sizes, industries and regions.

and institutional conduct. This had led some to question the continued relevance of such initiatives in the absence of clearly demonstrable benefits.

Many of the questions that are being asked about the continued relevance reflect the fact that most of these initiatives do not provide sufficient information to enable an assessment to be made of whether or not they have met their targets, let alone – reflecting the common focus on process rather than performance measures – the social and environmental outcomes that have resulted.⁵⁶²

There are numerous obstacles and resistance to efforts to address such limitations – particularly the absence of international legal status and enforceability – which exist on many fronts. As De George notes, such international agreements, codes and guidelines as to standards addressing a range of areas of corporate activity are still lacking the level of coherence, coordination and monitoring and the robust measurement and audit processes supported by enforcement mechanisms that are needed for them to become fully established, trusted and effective means to compel greater transparency and accountability.⁵⁶³

That said, De George still considers this role for corporations as a model of ethical practices and integrity as having the potential to be an important catalyst for governments in less well developed countries, where standards regarding corporate conduct have tended to be limited or absent, to pass and enforce legislation within their domestic jurisdictions that recognizes and remedies the deficiencies and to develop the necessary infrastructure to support and enable legislative objectives.⁵⁶⁴

Without these legal and institutional frameworks to establish minimum standards with respect to corporate activity in their jurisdictions, those countries will continue to be

⁵⁶² Rory Sullivan, “Corporate Responsibility and Voluntary Measures: Time to Demonstrate Value” Opinion, *Ethical Corporation*, 3 August, 2010. Online at: <http://www.ethicalcorp.com/content.asp?ContentID=7004>

⁵⁶³ Richard De George, “Law, Accountability and Globalization” in Brenkert, George G. *Corporate Integrity and Accountability* (Sage, 2004) 166 at 174-5.

⁵⁶⁴ *Ibid.* at 169-70.

havens for corporations focused solely on profit maximization and impervious to the social and environmental costs. Further, if corporate entities with global operations are able to get away with externalizing the social and environmental costs of harmful activities onto the host country and its citizens it will perpetuate the distorted incentives – posed by the absence of costs imposed on those activities through the legal system – to invest in non or sub-optimal operations (by reference to the long term value calculus) to the detriment of the overall economy.

Thus, while corporate actors in the vanguard of corporate responsibility observe these higher standards in their governance and business practices, and their numbers are increasing in particular parts of the world and specific business sectors, overall observance remains modest and uneven.⁵⁶⁵

In some cases, the argument is that, absent an effective mechanism to enforce compliance, these kinds of commitments are merely ephemeral with voluntary compliance motivated by and lasting only so long as it suits the parties' best interests. This is generally attributed to the inability of the non-state actors to compel or enforce particular behaviour, and a lack of political will to investigate complaints and impose sanctions.

On the other hand, the very fact that explicit expectations of corporate responsibility, accountability and high standards of conduct exist can make a difference in attitudes and behaviour. The case of the OECD Guidelines for Multinational Enterprises is one such case.

A year-long revision to the OECD official guidelines on multinational conduct commenced in July, 2010 engaging businesses, unions, civil society organizations and

⁵⁶⁵ For example, the regional distribution of GRI Reports in 2010 were: 45% Europe; 20% Asia; 14% Latin America; 14% North America; 4% Oceania, and 3% Africa. Compared to 2009, these numbers reflected: a 68% increase in reporting in Brazil (Latin America); a 56% increase in reporting in Switzerland (Europe); a 53% increase in reporting in Canada and 22% increase in the United States (collectively, North America); a 29% decrease in Australia (Oceania); and all reports in Africa originating from South Africa. Source: GRI report Services, *GRI Sustainability Reporting Statistics, 2010*, 2010. Online at: www.globalreporting.org.

governments on ways to improve the guidelines first introduced in 1976. In his comments on the overall impact of the OECD guidelines, Roel Niuewenkamp, Chair of the OECD investment committee working party leading the review credited the guidelines with having “been a big contributor to corporate social responsibility in the world”.

In contrast, however, OECD Watch, a network of 88 non-governmental organizations from 45 countries, reviewed the guidelines much less favourably. It reported that only 5 of 96 complaints brought by ethical campaigners over the past decade resulted in real improvements in corporate behaviour in large part due to a lack of political will evidenced in the failure of the government bodies responsible for investigating complaints, the absence of concrete sanctions and inconsistent implementation by OECD member states.⁵⁶⁶

While such analyses are considered reasonable in a command and control regulatory context where the threat of consequences for non-compliance functions as a deterrent, they are less so when the standards are inherently voluntary and intended to be peer or self-regulated. For example, the UN Global Compact is not prescriptive but based on:

public accountability, transparency and the enlightened self-interest of companies, labour and civil society to initiate and share substantive action in pursuing the principles on which the Global Compact is based’.⁵⁶⁷

For the most specific standards – laws and rules – the primary mechanism of constraint that the system depends on, rightly or wrongly, is the good judgment of the majority of individuals: good judgment in the sense of leading to decisions that do not contravene a law or violate a rule. If this were not the case, the system would fail not only because the potential for contravention vastly exceeds the capacity to enforce, but because there would be insufficient resources to ensure – for every alleged contravention – due process with respect to establishing culpability and the appropriate punishment.

⁵⁶⁶ J. Oldenziel, J. Wilde-Ramsing and P. Feeney, *Ten Years On: Assessing the Contribution of the OECD Guidelines for Multinational Enterprises to responsible business conduct* (OECD Watch, June 2010) 9. www.oecdwatch.org

⁵⁶⁷ *The UN Global Compact Operational Guide for Medium-Scale Enterprises* (UN Global Compact, July 2007) at 3. www.unglobalcompact.org.

More general provisions such as guidelines, standards, or principles, also rely for their main efficacy on the good judgment of those to whom they are directed to conduct themselves accordingly. In this basic sense then, as with laws and rules, such provisions are not purely aspirational and therefore unenforceable. In respect of such standards, the primary obligation to observe arises upon their voluntary recognition, regardless of whether in reality there is remote or no possibility of enforcement. This is, in fact, the very point of distinction between voluntary and self-regulating guidelines and standards on the one hand and imposed mandatory regulations on the other.

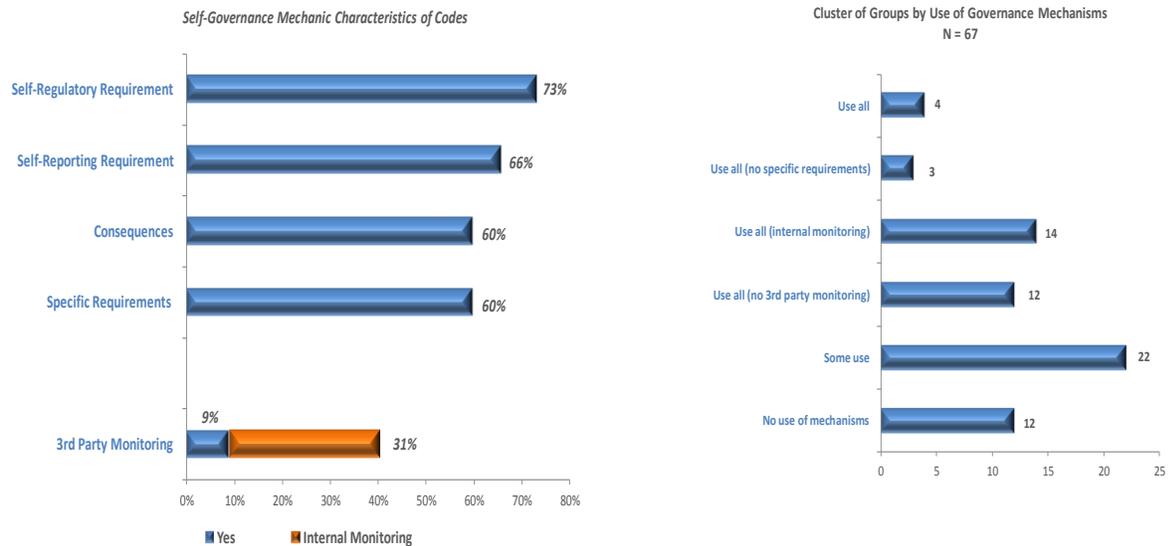
To suggest, as OECD Watch has, that the new guidelines “fall short of what is needed” by virtue of the absence of formal investigative powers and the inability to impose sanction when the guidelines are breached is, in effect, a challenge to the very premise on which the voluntary, non-binding approach in the guidelines is based.

That being said, in practical terms the reality is that the larger the perceived stakes, the greater the need for effective sanctions as a prerequisite to enforcement of the body of rules, standards and statements of best practice that form the corpus of soft law governance regulation.⁵⁶⁸

In this regard, the codes in the research sample provide insight into the emergence of governance mechanisms beyond those of moral suasion and probity.

⁵⁶⁸ Douglas M. Branson, “Teaching Comparative Corporate Governance: The Significance of “Soft Law” and International Institutions” (2000) 34 *GA. Law Review* 669 at 682-84.

Figure 10 - Voluntary Governance Mechanisms



The UN Global Compact has also received criticism for its lack of effective controls. In March 2011 the UN’s Joint Inspection Unit identified shortcomings that it considered serious enough to pose a “reputational risk” to the UN.⁵⁶⁹ The Joint Inspection Unit cited “an absence of adequate entry criteria and effective monitoring system” as undermining the Global Compact’s mission and the credibility of commitments to its principles made by participating companies. In their book, *Globalization and Self-Regulation; The Crucial Role That Corporate Codes of Conduct Play in Global Business*, academics Sethi and Schepers argue that the Global Compact’s lack of assurance mechanisms for progress limits its effectiveness beyond the superficial.⁵⁷⁰

⁵⁶⁹ United Nations Joint Inspection Unit, “United Nations corporate partnerships: The role and functioning of the Global Compact”, Geneva 2010 JIU/REP/2010/9. See also, summary analysis by Stephen Gardner, “UN wants Global Compact reform”, *Ethical Corporation*, May 2011.

⁵⁷⁰ S. Prakash Sethi and Donald Schepers, “United Nations Global Compact: An Assessment of Ten Years Progress, Achievements and Shortfalls”, in S. Prakash Sethi (ed.) *Globalization and Self-Regulation; The Crucial Role That Corporate Codes of Conduct Play in Global Business* (Palgrave MacMillan, 2011) 249 - 275.

In a strongly worded response to the Joint Inspection Unit criticisms, Global Compact representatives cited the expulsion of more than 2,000 companies for failing to report on the integration of the Compact's ten principles into their operations. They added that the Global Compact's primary function is as a platform for dialogue and learning and that "monitoring the performance of over 6,000 businesses around the world falls outside the mandate of the initiative and is not practical".⁵⁷¹

Furthermore, while a key function of the mandatory Communication on Progress (COP) reporting is to share best practice, the Global Compact makes clear that another function of COP report publication is that it subjects the reports to the scrutiny of civil society organizations, investors, media and other stakeholders. These different actors perform a kind of "social vetting" that has "in numerous instances, helped separate true sustainability leaders from those where closer scrutiny revealed that corporate practice fell short of the commitment to the Global Compact principles ... [it] does not operate in isolation, its success depends to a large degree on stakeholder feedback and engagement".⁵⁷²

As Georg Kell, Executive Director of the UN Global Compact stated it,

Each and every time a Global Compact participant communicates on implementing universal principles into their practices, the responsible business agenda is furthered and the legitimacy of our initiative is bolstered.⁵⁷³

At the international level, the increasing competitive pressures between States has led to a form of standards based competition in which attempts to attract investment include promises of such things as lenient labour and environmental standards. The so-called competitive advantage gained by countries participating in this 'race to the bottom' creates resistance in those who do not. This dynamic has the effect of further pushing

⁵⁷¹ United Nations corporate partnerships: The role and functioning of the Global Compact JIU/REP/2010/9 – A response from the Global Compact Office, United Nations Global Compact, Updated 24 March 2011 last accessed 12 May 2011 at:

http://www.unglobalcompact.org/docs/news_events/9.1_news_archives/2011_03_24/gco_jiu_response.pdf

⁵⁷² "Ten Years of Setting the Record straight" (United Nations Global Compact, 4 November 2010).

Online at: UN Global Compact – Home, <http://unglobalcompact.wordpress.com>

⁵⁷³ www.unglobalcompact.org.

foreign direct investment away from those jurisdictions with high standards to those with comparatively lower levels (where the standards are absent or not observed) as profit maximizing multinationals seek to reduce their costs of production.

At the same time, any attempts to impose a universal leveling up meet with resistance from those who are largely situated outside the current nexus of power and who perceive these ‘international’ initiatives as an extension of ‘western’ economic and political influence and control and thinly disguised ways of raising the bar in order to protect the economic dominance of developed States.⁵⁷⁴ Pierre Bourdieu observed that

The universalization effect is one of the mechanisms, and no doubt one of the most powerful, producing symbolic domination ... [and] the tendency to universalize ones mode of living broadly experienced and recognized as exemplary, is one of the effects of the ethnocentrism of dominant groups.⁵⁷⁵

Along with the independent factors, a complex interplay between benefit, fairness, legitimacy, reciprocity and trust poses one of the most significant challenges to the effectiveness of voluntary standards. While the articulation of values based standards can form a common frame of reference and provide the basis for constructive engagement, the standards will only be realized with purposive effect through mutual and continued acceptance and accountability between parties who engage, and a widely acknowledged legitimacy.⁵⁷⁶

⁵⁷⁴ In a recent notable example, Japan opted to assume an active role in the establishment of ISO 26000 “because when the ISO 9000 and ISO 14000 were promulgated, critical matters were determined under Western leadership, with Japan having no choice but to comply with the “given” specifications. Japan is determined not to make the same mistake again by ceding the field to other players.” ‘Corporate Social Responsibility: The Strength of Japanese Corporations’ Hiroshi Hirose, Nippon Keidanren’s Subcommittee on Socially Responsible Management. http://www.keidanren.or.jp/english/policy/csr/economic-trend_200411_p60.html. The concern over regional or economic centrism is not only targeted at the west, for example, it is reported that one of the biggest problems for PRI has been the perception that it is a European construct, with narrow relevance for U.S. institutional investors. But greater shareholder activism at home and the willingness by many institutions to seek offshore managers is forcing the hand of many. Among recent U.S. asset managers to join are T. Rowe Price (about \$400 billion in assets) and Iowa’s Principal Group (\$233 billion in assets). Udavan Gupta, “Principles of Responsible Investment Gets More Traction” *Institutional Investor*, 24 Jan 2011. Online at: http://www.institutionalinvestor.com/green_investing/Articles/2754437/Principles-of-Responsible-Investment-Gets-More-Traction.html

⁵⁷⁵ Pierre Bourdieu, “The Force of Law: Toward a Sociology of the Juridical Field” (1986-7) 38 *Hastings Law Journal* 814 at 846-7.

⁵⁷⁶ This sentiment is captured in the Preamble to the *UN Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights* which refers to “the

The demands for corporate entities, investment and pension funds to voluntarily adopt, implement and disclose socially, environmentally and ethically sound governance and business practices have far outpaced corresponding expectations of the non-governmental and civil society organizations behind many of those demands.⁵⁷⁷

A study conducted by One World Trust's Global Accountability Project (GAP) and released in 2003 showed that the non-governmental organizations surveyed often failed to provide information likely to be material to stakeholders or meaningful assessments of how effectively they have been achieving their stated purposes.⁵⁷⁸ While there is progress on global standards and reporting for non-profit public benefit organizations, the perception lingers that such organizations are to some degree exempt from the expanding corpus of governance and accountability standards they expect from the corporate sector.⁵⁷⁹

The perceived lack of reciprocity and mutual accountability undermines effective engagement on voluntary standards that rely primarily on fairness and trust in the absence

universality, indivisibility, interdependence and interrelatedness of human rights, including the right to development, which entitles every human person and all peoples to participate in, contribute to and enjoy economic, social, cultural and political development in which all human rights and fundamental freedoms can be fully realized". (UN Economic Council – Commission on Human Rights, Sub-commission on the Promotion and Protection of Human Rights E/CN.4/Sub.2/2003/12 Rev.2 26 August 2003). This explicit recognition of the need for fair and inclusive engagement on the many dimensions of development is a response to resistance to international standards that stems from a lack of trust in the system and process from which they emerged. While this most frequently arises in the context of resistance to imposition of standards by west (see for example, A. Escobar, *Encountering Development - The Making and Unmaking of the Third World* (Princeton U.P., 1994), the opposition occurs at both ends of the spectrum. For example, according to Adam Greene of the U.S. Council on International Business, who is co-chair of the U.S. ISO 26000 Technical Advisory Industry Sub-Group, ISO standards have been the root cause of most "technical barriers to trade" cases brought before the WTO. Greene adds that ISO 26000 is a quixotic attempt to find technical solutions to political problems, and will be fertile ground for future WTO cases. Source: J. Roberts, "How Corporate Social Responsibility (ISO 26000) Mandates Undermine Free Markets", The Heritage Foundation, May 3, 2010. Online at: www.heritage.org

⁵⁷⁷ A. Dempsey, "Adding the Stakeholder Value: Governance Convergence in the Private, Public and Not for Profit Sector", in I. Demirag, I (ed.) *Corporate Social Responsibility, Accountability and Governance: Global Perspectives* (Sheffield UK: Greenleaf Publishing, 2005) 43

⁵⁷⁸ H. Kovach, C. Nelligan and S. Burall, *Global Accountability Report I: Power without Accountability?* (London: OneWorld Trust, 2003) The study assessed the accountability of three key actors globally: intergovernmental organizations (IGOs), transnational corporations (TNCs) and international NGOs (INGOs).

⁵⁷⁹ A number of cross-sectoral partnership of non-profit organizations and civil society actors – for example Keystone (formerly ACCESS) www.keystoneaccountability.org – have been working on the development and adoption of such standards.

of the formal authority, general application, and potential consequences for non-observance that motivate compliance with legal standards.

Blair and Stout identify one of two possible states of equilibrium: cooperation or defection, where even a slight change in context that causes a shift in the expectations of others can create a tipping point moving the behavioural state to the opposite extreme. A lack of reciprocity, even in cases where trust is initially present, will prompt parties to switch to a competitive strategy.⁵⁸⁰ That said, studies have shown that, when present, fairness and trust can be powerful motivators, yielding superior results to those that have been coerced.

Studies of organizational response to regulatory stimuli, suggest that even legal compliance is not merely a function of rational strategies for cost saving or instrumentalist approaches to penalty avoidance, but comprises also adaptation and responses to law that can be symbolic or substantive.⁵⁸¹ Symbolic adaptations tend to the appearance and formality of response, for example technical and so-called ‘tick box’ approaches to compliance, whereas substantive or instrumental responses have an impact at a core level.

Different motivations are at work when corporations and like entities voluntarily observe higher standards than the legislated minimum: incentives not penalties, opportunities not costs, sustainable profitability not short-term gain. According to the World Bank, corporate governance codes have effects at both the micro and macro levels; they serve as benchmarks for monitoring and implementing policy and practice within companies and restore investor confidence and trust in markets.⁵⁸²

⁵⁸⁰ Margaret M. Blair and Lynn Stout, “Trust, Trustworthiness and the Behavioural Foundations of Corporate Law” (2001) 149 *University of Pennsylvania Law Review* 1735 at 1776.

⁵⁸¹ Lauren Edelman, “Legality and Endogeneity of Law”, in Robert Kagan, Martin Krygier and Kenneth Winston Lanham (eds.) *Legality and Community: On the Intellectual Legacy of Philip Selznick* (Maryland: Rowan and Littlefield, 1992)

⁵⁸² World Bank: <http://rru.worldbank.org/Toolkits/CorporateGovernance>.

It is the opportunities, not the threat of adverse consequence, that readily align with the strategic objectives that board and management can both endorse from a responsible governance standpoint, and reconcile with the economic purpose and obligations of business.

In the words of Thomas Watson, Jr., former IBM chairman and the son of IBM's founder

Corporations prosper only to the extent that they satisfy human needs. Profit is only the scoring system. The end is better living for us all.⁵⁸³

Despite the numerous obstacles to achieving their objective of influencing sustained behavioural change, these emergent statements of expectations of higher standards of corporate and institutional conduct have made a profound contribution to the evolution of corporate governance discourse and the way that the relationship of the corporation *vis a vis* society is perceived. At the same time, a conflation of economic, political and social developments has caused a shift – or a blurring – of this neatly delineated boundary between corporate and social domains.

The influence of these soft law and non-governmental articulation of standards of conduct for market actors, whether direct or indirect, is evident in a broader construction of the nature and scope of corporate governance and accountability. Even for the majority of corporate entities that operate in compliance with established laws and regulatory requirements, there is a considerable gap between those baseline mandatory thresholds, and the higher standards of accountability, ethics and responsibility that form the basis of this additional corpus of environmental, social and governance metrics and norms by which businesses are now being evaluated and judged.⁵⁸⁴

For these developing normative and soft law standards to achieve real and sustainable influence beyond aspiration and rhetoric, they require the certainty and consistency of a

⁵⁸³ Pace College Advisory Council, New York City, 1967 from IBM Archives at http://www-03.ibm.com/ibm/history/exhibits/watsonjr/watsonjr_quoted.html

⁵⁸⁴ Social, environmental and ethical metrics and norms appear in the evaluation and selection criteria for, among others: ethical and socially responsible investment; government procurement standards; inter-corporate supply chain standards; and third party quality and certification standards.

foundation of strong core principles and rigorous adherence to such notions as fairness, justice and transparency that are fundamental to ‘just’ law⁵⁸⁵ and thus necessary to function as a bridge between the normative, ethical and legal spheres.

Further, since the advent of third party corporate responsibility codes and standards, common language and shared understanding become critical to establishing a sound basis for evaluating, adjudicating, and enforcing sound governance standards in the absence, in advance, or instead of such standards being centrally and formally imposed through legislation.

Even with some move to consolidation and standardization among these varied articulations of corporate governance and responsibility, the sheer diversity of corporate activities, the scope of their impacts and their geographic reach pose enormous impediments to anything beyond an articulation of some core, universally recognized principles of conduct or ‘hyper-norms’ to govern their conduct and operations. This is not to diminish the power of such elemental norms that include being accountable for decisions and actions, behaving honestly and with integrity, obeying and respecting the letter and spirit of the law, operating transparently, and respecting fundamental human rights and the natural environment.⁵⁸⁶

Beyond that, definitive judgment as to what constitutes ‘ethical’, ‘fair’, ‘good’ and ‘right’ conduct will continue to resist authoritative determination, explicit articulation and the presumed certainty of legal prescription. Like Derrida’s notion of *aporia* in his examination of the incalculable, irreducible nature of justice, each new circumstance involves a fresh set of decisions.

⁵⁸⁵ See J. Rawls, *Justice as Fairness*, Erin Kelly (ed.) (Cambridge, Mass.: The Belknap Press of Harvard University Press, 2001) 5.

⁵⁸⁶ In the early 1990s a number of international initiatives were underway seeking to identify a global set of shared norms, values, ideas and goals that would transcend pluralism and diversity. For example: in Canada the 1991 ‘Ad Hoc Interfaith Working Group on Canada’s Future’ *Mutual Responsibility: The Tie that Binds*; the 1993 “Declaration of the Parliament of the World’s Religions”; the 1993 “Interfaith Declaration”; and in 1994 The Caux Roundtable, *Principles for Responsible Business*, online at: <http://www.cauxroundtable.org>. See: John Dalla Costa, *The Ethical Imperative* (Toronto, Canada: Harper Collins Publishers Ltd, 1998) at 129-38 for a discussion of these initiatives and generally regarding the search for a global ethic. Also see infra note 5 regarding the use of the term hyper-norms.

Each case is other, each case is different and requires an absolutely unique interpretation, which no existing coded rule can or ought to guarantee absolutely.⁵⁸⁷

The decision making process is similarly variable. It may fall to the lowest common denominator established by the unilateral actions of rational corporate actors – management and directors – pursuing their self-interest and, in such pursuit, recognizing certain instrumentally appropriate constraints. Or it may be established through inclusive, informed and principled engagement: a dialogue between and responsible choices by those corporate actors, their shareholders, and legitimate stakeholders.⁵⁸⁸

The value of the latter, ethical process is that if certain core principles and values are shared within and between such dialogic communities, they can form a sound basis for engagement in constructive discourse amongst their diverse constituents and respect for the varied interests in society they represent.

In the context of conduct and governance, constructing this basis approaches Black's concept of forming an interpretive community within which to develop rules and standards. That is, creating a context where, the rules and standards are "formed, followed and enforced" with a shared understanding of fundamental "norms, goals, definitions" and values thereby avoiding the challenges presented to traditional rule-making of the potential for "uncertainty and honest perplexity", "the problem of explicitness" and "the opportunistic approach to rules which is the basis of creative compliance".⁵⁸⁹

The codes sample gives an indication that the idea of a shared set of values to guide the conduct and governance of business is becoming more than mere aspiration. In the 67 codes studied, the values most frequently referred to were ethics (59), integrity (40),

⁵⁸⁷ J. Derrida, "Force of Law: the mystical foundation of authority" in D. Cornell, M. Rosenfeld and D.G. Carlson (eds.), *Deconstruction and the Possibility of Justice* (Abingdon: Routledge, 1992) 3-67.

⁵⁸⁸ Somewhat analogously, Adolph Berle in "Modern Functions of the Corporate System" (1962) 62 *Colum. L. Rev.* 433 at 438, felt that the legislation requiring public disclosure introduced in Depression-era reforms combined with a management acting in accordance with a public consensus on appropriate management behaviour would be sufficient to exert social control over corporate power.

⁵⁸⁹ Julia Black, *Rules and Regulators* (Oxford: Clarendon Press, 1997) 6, 30, 31-2, 38.

responsibility (32), openness or transparency (25), honesty or truth (21), fairness or equity (18), accountability (18), and respect (17).

Numerous individuals and organizations from all sectors have engaged in constructing models that seek to capture the form and substance of this evolving relationship between business and society as a first step to understanding its complex dynamic. This greater understanding then forms the basis for constructing an appropriate governance framework for this relationship – legally or normatively described – that recognizes both the interdependence and the need for constraint, that institutionalizes responsibility⁵⁹⁰ and fosters the mutual commitment and accountability that comes from shared purpose.

The concepts of competitive, profitable companies and respect for the social, environmental, economic systems of which they are a part are not necessarily antithetical, nor mutually exclusive. Nor is it axiomatic that companies in partnership with societal stakeholders will always do the right thing.

Nevertheless, as Lydenberg among others has proposed, recognizing the possible co-existence of these three systems would enable the efforts of government, investors, consumers and corporate management to work toward a shared goal – of steering business toward wealth creation and societal benefit – rather than in perceived opposition.⁵⁹¹

Engagement in dialogue is not necessarily a precursor to a commitment to collective decision-making. There are legal, practical and operational limits to the amount and content of information that can be appropriately shared with particular stakeholder groups, particularly information about strategic options under consideration. These limits likewise apply to the extent of input received from stakeholders that organizations can reasonably manage.

⁵⁹⁰ Christine Parker, *The Open Corporation – Effective Self-Regulation and Democracy* (Cambridge University Press, 2002) at 61.

⁵⁹¹ S. Lydenberg, *Corporations and the Public Interest – Guiding the Invisible Hand*, (San Francisco USA: Berrett-Koehler Publishers, Inc., 2005) 139 – 146.

That said, the more open corporate management can be about decision making processes, decisions taken, and their consequences, and the more clearly managers understand and appreciate the perspectives and concerns of affected parties, the more likely it is that problematic situations can be satisfactorily resolved. Open communication and the opportunity for dialogue are socially beneficial, quite apart from their content or the conclusions reached.

The best chance for their successful co-existence and the greatest mutual benefit to companies, their shareholders, stakeholders and society in general is when these diverse constituencies engage in ongoing constructive discourse. The purpose of such engagement is for these constituencies to advance from a common starting point toward a shared understanding of the standards and expectations they have for each other, and equally must be prepared to reciprocate, in order to sustain the integrity of the wider system in which they must find a way to co-exist.

To take full account of the economic, political, and social context in which they operate corporations, and more generally any entity whether public or private, for profit or not for profit need a governance framework that strikes a balance between prescription and formal regulation, and normative or 'soft law' approaches to setting appropriate standards of practice. The framework must be sufficiently flexible for decision maker to determine for their particular entities not only how best to meet the demand for greater accountability, disclosures of socially responsible practices and internal and external governance structures, but how to truly endorse and embed the underlying principles of ethics and responsibility in all aspects of their operations.

In order to provide this kind of flexibility and to be responsive to economic, political and social change as well as technological development, the pursuit of an effective governance framework must go beyond legislators and regulators negotiating and defining the next set of rules and procedures with business constituents and industry stakeholders. It must take account of an ongoing and evolving discourse about the role

and responsibilities of business within society that is taking place in the wider public domain.

Just as the concept of corporate responsibility, the recognition of industry impact on the environment, the impact of business supply chains on local communities, and awareness of the sustainability spread from specialized to mainstream discourse and in doing is changing the way that many businesses operate around the globe, participation in governance discourse is no longer exclusive. However, the nature, fairness and effectiveness of such participation varies according to whether, for example, the conversation is dominated by powerful voices, the forum is restricted, and the language and terms of engagement serve vested interests.

The next chapter explores the role that language and discourse play in creating and shaping expectations of business conduct and governance, opportunities afforded by new communication technologies, and risks to the effectiveness and integrity of the dialogic process if it is not conducted within an explicitly ethical framework.

Part Seven – Beyond Disclosure: Evolution in Governance Discourse

12. Global Institutionalization of Meaning

12.1 Language and Transformation in Governance Discourse

The corporation's unprecedented impact on society and its potentially potent legacy for the future has long been the subject of academic and institutional discussion. What has changed in the last twenty or so years is the ongoing discourse engaging multiple and varied participants (formally and informally, voluntarily and involuntarily) in discussion about the role of the corporation in, its impact on, and its proper relationship with, society. The nature and form of this dialogue is already remarkable in its diversity – from legal prospectus to corporate sustainability report, shareholder proposal to NGO report, activist website to independent blog.

This broadening discourse is accompanied by an expanding lexicon. Accountability, business ethics, corporate citizenship, integrity, governance, corporate responsibility, and the list could go on. The variety of terms being used, sometimes interchangeably, and the resulting myriad of definitions and interpretations of these terms have been at the root of much debate over the relationship of the corporation to society.

One of the most significant challenges in the area of governance and responsible corporate conduct is not the creation, but the interpretation, of its complex and evolving lexicon. Not only is there a plurality of views as to what constitutes ethical or 'good' corporate conduct and what nature and combination of principles, values, and prescription should motivate corporations to assume a responsibility that extends beyond a narrow profit-seeking path, but there is also an array of overlapping, conflicting and confusing terminology.⁵⁹²

⁵⁹² Chris Moon and Clive Bonny, *Business Ethics: Facing up to the Issues* (London: The Economist in Association with Profile Books Ltd., 2001); Steven Lydenberg, *Corporations and the Public Interest – Guiding the Invisible Hand*, (San Francisco USA: Berrett-Koehler Publishers, Inc., 2005); Simon Zadek, *The Civil Corporation: The new economy of corporate citizenship* (Earthscan Publications, 2001)

It is the living nature of language as a primary means of communication that makes it both adaptive to the remarkable advances in human social relationships and a perpetual challenge for those who seek certainty, predictability and consistency. In this latter regard, while language is core to the institution of law, it is the perpetual battle for control of meaning that has traditionally animated its theory and its practice, and has for centuries established its centrality in virtually all aspects of social interaction.

The fundamental precept of regulation in democratic systems is that it is informed, objective, justified, proportional, and communicated with sufficient certainty, clarity, precision and predictability for its content and requirements to be capable of understanding and compliance on a reasonable person test.

Meaning is thus an essential concept in law. It is achieved through common law, judicial interpretation, practice and the exercise of executive power and the result is an extensive and evolving repository of individual words and specific terms for which there is formal consideration of meaning. Yet even within that legal lexicon where the search for definition is so critical and enduring an objective, there is constant potential for further contest as new circumstances arise that shed different light on past interpretations. Ultimately, the force and effect of law and regulation, whether by formal or informal means, relies on a contestable lexicon wherein meaning remains open to interpretation either literal or in the full context of the spirit and intent behind the particular choice of words.

12.2 Contest or Constructive Dialogue

Whenever a dominant lexicon emerges it is the outcome of hidden contests over control of language. The ascendance of the language of business in the public sector is one example of how a shift in terminology signaled a fundamental change in the culture, practices and values of the institution of government.

A similar shift to the language of business and economics occurred in the corporate social responsibility movement in the 1990's. During that decade, the concept and language of the business case model for strategic planning and evaluation entered the language of CSR's civil society proponents and with it a shift in the evaluative framework from inherent social good to an economic cost benefit model. For critics within the CSR community, this change signalled a capitulation to the forces of capitalism, for others it was justified on the basis that constructive engagement with the business community necessitated the adoption of language familiar to it.

It is common for different actors and stakeholders in the corporate governance discourse to create and impose an alternative vocabulary, or to engage and operate according to a nuanced understanding of specific terms rather than follow the established vocabulary of any given group. Engaging in these contests or debate over semantics, however, risks obscuring the substantive issues and diverts attention away from more constructive dialogue. The significance of language and its ability to enable, obscure or obstruct the important role that informed discourse plays in this area is thus much more than a battle over semantics.

A significant aspect of the battle for control of meaning in the corporate governance arena arises from the resistance to accepting any corporate responsibility beyond that minimum standard expressed or codified in law on the one hand and, on the other, the conviction that corporations – if not directly, then through those who own, direct and manage them – have a higher ethical responsibility on the basis that the law must operate as a baseline not a goal line.

This latter recognizes that there are fundamental, socially determined expectations and standards of conduct that are woven into the fabric of society – Bourdieu's interpretation

of the *doxa*⁵⁹³ – which are blended so seamlessly, and have over time become so implicit, that they are noticed only by their absence or where a disjunction or a flaw is revealed.

The law's comparative success in addressing those gaps or flaws often means that, just as with any repair job, the propensity is to notice the parts that have been mended, rather than the continuing integrity of the rest. The other parts continue to function largely unnoticed and without conscious correction or formalization in law unless and until such time as there is a need for further gap-filling or repair.⁵⁹⁴ So, to base the standard of conduct solely on those parts of the system that have needed repair or where gaps have been revealed and patched is to miss what it is that sustains the integrity of the whole.

Taking this further, as with Bourdieu's concept of the *doxa*, most of what is essential to the preservation of the status quo is located below the level of discourse and opinion. They are the practical understandings, what we know without knowing, what we abide by and adhere to with at best, only a vague and inarticulate sense of doing so.⁵⁹⁵

However, anything that is currently *doxic*, or assumed to be so, could become or revert to the level of discursive argument if conditions of political crisis disrupt the system's *stasia*.⁵⁹⁶ As such, *doxa* is not neutral, but a product of dominant interests shaping the system with their views and interests that, through reification, become embedded in the

⁵⁹³ Bourdieu in his *Outline of a Theory of Practice*, used the term *doxa* to denote what is taken for granted in any particular society. Pierre Bourdieu, *Outline of a Theory of Practice*. R. Nice, transl. Volume 16. (Cambridge: Cambridge University Press, 1997 [1972]).

⁵⁹⁴ Edelman and Stryker discuss the iterative process involving the legal and economic fields: "It is in the social space that legal procedures, norms and concepts work together to shape economic actors and institutions and that economic structures, norms and rituals shape the law. Just as the law shapes the economy, the everyday conflicts of the workplace – and the organizational solutions to those conflicts – are raw materials that the legislators and regulator, a judges use to construct the law. Formal law, including statutes and judicial decisions, depend on what conflicts are brought into the public arena and how those conflicts are framed". Lauren B. Edelman and Robin Stryker, "A Sociological Approach to Law and the Economy" in Neil J. Smelser, Richard Swedburg (ed.) *The Handbook of Economic Sociology* (Princeton, NJ: Princeton University Press) 527-550 at 531.

⁵⁹⁵ Nick Crossley, "On Systematically Distorted Communication: Bourdieu and the Socio-analysis of Publics", in Nick Crossley and John Michael Roberts (eds.) *After Habermas: New Perspectives on the Public Sphere* (London: Blackwell, 2004).

⁵⁹⁶ N. Crossley, "Making Sense of Social Movements", *Buckingham Open University Press*, 2002; N. Crossley, "Global Anti-Corporate Struggle: A Preliminary Analysis" (2002) *British Journal of Sociology* (2002) 53(4) 667-91; N. Crossley, "Even More Social Movements" (2003) *Organization* 10(4) 287-305.

collective subconscious thus achieving a status beyond question or conscious reflection.⁵⁹⁷

The new ISO 26000 guidance on social responsibility standards, is a case in point.⁵⁹⁸ While not a management system standard or capable of third party certification, it seeks to promote common terminology and bring consistency to the operationalisation of social responsibility, identification and engagement with stakeholders and enhancing the credibility of reporting. In this project, ISO both problematized differences in terminology and usage and sought to define the scope of solutions to the problems so identified.

The value of this type of process, according to Gordon, Rose and Miller, is that it produces an intellectual lens for rendering something capable of being governed by making it the subject of thought and rationalization.⁵⁹⁹ However, as Hajer has observed, it also risks privileging particular definitions over others, which can lead to the marginalization of alternative conceptions and approaches as well as the suppression of debate.⁶⁰⁰ The result can be the appearance of conformity that may obscure considerable substantive and qualitative difference.

Stepan Wood has argued that language functions as a powerful tool for the delineation and consolidation of authority. Where specialized vocabularies dominate, investment in achieving fluency is an essential cost of entry that inevitably creates obstacles to those who lack the capacity and the means to gain access.⁶⁰¹

⁵⁹⁷ Nick Crossley, "On Systematically Distorted Communication: Bourdieu and the Socio-analysis of Publics", in Nick Crossley and John Michael Roberts (eds.) *After Habermas: New Perspectives on the Public Sphere*, (London: Blackwell, 2004).

⁵⁹⁸ Online at: http://www.iso.org/iso/socialresponsibility_2006-en.pdf

⁵⁹⁹ C. Gordon, "Afterword" in C. Gordon (ed.) *Michel Foucault Power/Knowledge: Selected Interviews and Other Writings 1972 – 1977* (New York: Pantheon, 1980) 245; N. Rose and P. Miller, "Political Power Beyond the State: Problematics of Government" (1992) *British Journal of Sociology* 43 at 179.

⁶⁰⁰ M.A. Hajer, *The Politics of Environmental Discourse* (Oxford: Clarendon, 1995) 62-3.

⁶⁰¹ Stepan Wood, "Three Questions About Corporate Codes: Problematizations, Authorizations and the Public/Private Divide", in W. Cragg (ed.) *Ethics Codes, Corporations and the Challenges of Globalization* (Cheltenham UK: Edward Elgar, 2005).

The more institutionalized a lexicon and the wider its usage, the greater the inherent influence and power. With these come the increased risk of cooptation of words and their meaning to serve purposes that can be concealed by the appearance of normativity in the absence of traditional mechanisms such as legal definition and judicial interpretation for ensuring that there is legitimacy and transparency in the provenance, as well as adoptive and interpretive process.

These different paths toward meaning – organic through usage or formal through official definition – embody the tension, if not outright conflict, that arises when traditional sources of authority and control are contested or perceived to be at risk. It is just such political conflict, or tension, that has frequently polarized the debate about the responsibility of the corporation within and to society.

As Gourvevitch and Shinn note:

Corporate governance - the authority structure of a firm - lies at the heart of the most important issues of society" ... such as "who has claim to the cash flow of the firm, who has a say in its strategy and its allocation of resources." The corporate governance framework shapes corporate efficiency, employment stability, retirement security, and the endowments of orphanages, hospitals, and universities. "It creates the temptations for cheating and the rewards for honesty, inside the firm and more generally in the body politic." It "influences social mobility, stability and fluidity... It is no wonder then, that corporate governance provokes conflict. Anything so important will be fought over... like other decisions about authority, corporate governance structures are fundamentally the result of political decisions.⁶⁰²

12.3 The Opportunities and Risks of Interdiscursivity in a Digital World

Alongside the economic and political manifestations of globalization, the expansion of information technology and, in particular, the internet as a communication and

⁶⁰² Gourvevitch and Shinn: *Political Power and Corporate Control: The New Global Politics of Corporate Governance* (Princeton NJ: Princeton University Press, 2005) 3.

knowledge medium, is evident in virtually all aspects of society – from macro-economic and political, to local and individual relations.⁶⁰³

Bohman, Ulen, Sunstein and others have argued that beyond communication and knowledge, the internet is a powerful engine of democracy, broadly conceived.⁶⁰⁴

This idea of new technologies as the means to pursue better lives for humankind has been present throughout history and with each new technological advancement. The invention of the printing press in 1440 signaled profound social change and accelerated the democratization of knowledge in Europe. Technology based industrial innovations in the late 1800's such as telegraph, the telephone and the capture and use of electricity further contributed to increased information exchange, business efficiency and public debate.⁶⁰⁵

In 1927, the German author Bertolt Brecht formulated a “radio theory” in which he envisioned the new technology, the radio, as a dialogical instrument for change: “[C]hange this apparatus over from distribution to communication... On this principle the radio should step out of the supply business and organize its listeners as suppliers” as an early precursor to the concept of participatory communication.⁶⁰⁶

Certainly, as Robert Putnam has argued, each of these advances contributed to the transformation of social, economic, and political life across Europe and North America. So, if history is any guide, it suggests that the evolution of language and meaning through

⁶⁰³ The Internet has existed since the 1960s. However, according to the United Nations, its current use throughout the world across different demographics, and incorporation into virtually every aspect of modern human life, has been unprecedented. Source United Nations: *Report of the Special Rapporteur on the promotion and protection of the right to freedom of opinion and expression*, June 3, 2011 http://www2.ohchr.org/english/bodies/hrcouncil/docs/17session/A.HRC.17.27_en.pdf.

⁶⁰⁴ James Bohman, “Expanding Dialogue: The Internet, the public sphere and prospects for transnational democracy”, in *Social Theory – Continuity and Confrontation 2nd ed*, Roberta Garner (ed.) (Broadview Press, Peterborough, 2007); Thomas S. Ulen, “Democracy and the Internet: Cass R. Sunstein, Republic.Com. Princeton, NJ. Princeton University Press, Pp. 224. 2001” *Journal of Law, Technology and Policy*, No. 2, Fall 2001. Available at SSRN: <http://ssrn.com/abstract=286293> or doi:10.2139/ssrn.286293

⁶⁰⁵ Sean Dennis Cashman, *America in the Gilded Age: From the Death of Lincoln to the Rise of Theodore Roosevelt*, 3rd ed. (New York: New York University Press, 1993).

⁶⁰⁶ As quoted in: Thomas Tufte, Paolo Mefalopoulos, *Participatory Communication A Practical Guide*, (The International Bank for Reconstruction and Development/The World Bank, Washington D.C., 2009) at 9.

new digital communication technologies in the late twentieth and early 21st centuries has similar transformational potential.⁶⁰⁷

Increasingly, formal communication via traditional print media –the law’s historical domain – is being overtaken by electronic communication, with the latter the clear forerunner in its ability to convey both powerful words and images virtually instantaneously around the world.⁶⁰⁸ With its speed and capacity for mass dissemination of information, the internet is a vast digital communicative space with the power to reach and the potential to connect and engage worldwide audiences and participants through compelling narrative and powerful images.⁶⁰⁹

The internet has already enabled or accelerated the creation of new forms of human interactions through email, instant messaging, internet forums, and social networking sites and facilitated broad-based exchange of information and opinion via web sites, online publishing, web feeds and newer portals such as Facebook and twitter.

Participation is technically free, provided one overlooks the embedded costs of access and other political, sociological and economic barriers to entry that give rise to the ‘digital divide’.⁶¹⁰ And, unlike the public sphere theorized by Habermas with its distinctions between public and private, the state, society and citizen, work and home, in

⁶⁰⁷ For detailed examination of these issues see: Sean Dennis Cashman, *America in the Gilded Age: From the Death of Lincoln to the Rise of Theodore Roosevelt*, 3rd ed. (New York: New York University Press, 1993); Putnam, Robert D. *Bowling Alone: The Collapse and Revival of American Community* (New York: Touchstone, 2000).

⁶⁰⁸ According to the International Telecommunication Union, the total number of Internet users worldwide is now over 2 billion. Active users of Facebook, an online social networking platform, grew from 150 million to 600 million between 2009 and 2011. Source: International Telecommunication Union, StatShot No.5, January 2011. Online at: <http://www.itu.int/net/pressoffice/stats/2011/01/index.aspx>.

⁶⁰⁹ For a discussion of the dialogic possibility of the internet see, James Bohman, “Expanding Dialogue: The Internet, the public sphere and prospects for transnational democracy”, in Roberta Garner (ed.) *Social Theory – Continuity and Confrontation* 2nd ed. (Broadview Press, Peterborough, 2007).

⁶¹⁰ The OECD defines the ‘digital divide’ as: the gap between individuals, households, businesses and geographic areas at different socio-economic levels with regard to both their opportunities to access information and communication technologies (ICTs) and to their use of the Internet for a wide variety of activities. The identification of this gap is significant because the ability of individuals and businesses to take advantage of the Internet varies significantly across the economically developed world as well as between developed, developing and lesser developed countries. Access to basic telecommunications infrastructures is fundamental to any consideration of the issue, as it precedes and is more widely available than access to and use of the Internet. Source: OECD <http://stats.oecd.org/glossary/detail.asp?ID=4719>.

web-enabled society many traditional boundaries are blurred and the discursive space is not restricted to a narrow *bourgeois* class.⁶¹¹

In the potential of this public web space, as a theoretical construct, we can find Habermas' 'democratic ideal' manifest in the rational discourse of the public sphere. A democratic ideal that envisages multiple voices and perspectives constructively and freely engaged in informed rational discourse across cultural, economic, political and temporal boundaries.

As Habermas has recently expressed it:

Communication via the mass media plays an important role in the normative vision I advocate. A dispersed public interconnected almost exclusively through the electronic media can keep up to date on all kinds of issues and contributions in the mass media with a minimum of attention, even in fleeting moments during the day, in small private circles. People can take affirmative or negative positions on issues, and they do this implicitly all the time. In this way, they contribute to evaluating competing public opinions, if not their articulation. Public communication acts as a hinge between informal opinion-formation and the institutionalized processes of will formation ... [F]or this reason the discursive constitution of the public sphere is important.⁶¹²

In this latter regard, Ang has observed that the emphasis on speed and delivery and immediacy of transmission produces a sense that space and time are irrelevant. Yet that spatial dimension cannot be discounted because those messages conveyed through global mass media will, upon arrival, acquire local meaning and thus be transformed.⁶¹³ Mass communication and 'mass media' are incomplete representations of a process that

⁶¹¹ "In comparison with the past, the epistemic requirements for participating in large scale and potentially transnational communication are lessened, to such an extent that it is widely available beyond elites in wealthy societies." James Bohman, "Expanding Dialogue: The Internet, the public sphere and prospects for transnational democracy", in Roberta Gardner (ed.) *Social Theory – Continuity and Confrontation 2nd* edition (Broadview Press, Peterborough, 2007).

⁶¹² J. Habermas, *Time of transitions*, Ciaran Cronin, Max Pensky (eds.) (Cambridge UK: Polity Press, 2006) 9. Habermas is referring to the political sphere, but his comments equally apply to the economic especially as the boundaries between the spheres continue to blur.

⁶¹³ Ien Ang, "Global Media/Local Meaning" from *Living Room Wars* (New York: Routledge, 1996) reprinted in Roberta Garner (ed.) *Social Theory: Continuity and Confrontation 2* edition (Peterborough: Broadview Press, 2007).

acquires new dimensions once people actively consume the images and messages within their own social spheres.⁶¹⁴

However, in its political reality – its ‘lifeworld’ operation – the public web-space contends with Habermas’ negative corollary to the democratic ideal, that which he refers to as ‘systemically distorted communication’.⁶¹⁵ That is, when the actual communicative interaction takes place in the ‘lifeworld’ it becomes subject to the effects of interpretation, representation and power that operate within and continually influence and shape the ‘lifeworld’ system. These effects distort the communication that occurs within the system⁶¹⁶ and ensure that meaning is never finished or completed.⁶¹⁷

Perceptions, whether conscious or unconscious, are subject to the limitations and distortions produced by our inherited and socially conditional nature. Habermas’ critical theoretical approach to public discourse is to identify its distortions and their root causes and to reflect those distortions and their sources back to the public with a view to mastering and overcoming them, thereby ensuring a place for undistorted communication.⁶¹⁸

However, discovering distortions and their roots in the worldwide web presents many challenges. Much of the content and interaction within this public ‘web space’ has developed organically with its own sets of norms and rules, largely unfettered by the overt traditional influences of law, state-based rules and regulation (at least in the developed western democracies), and many of the formal and normative constraints that

⁶¹⁴ M. Billig, *Ideology and Opinions: Studies in Rhetorical Psychology*. (London: Sage Publications, 1991) as referenced in Nick Crossley and John Michael Roberts (eds.) *After Habermas: New Perspectives on the Public Sphere*, (London: Blackwell, 2004)

⁶¹⁵ J. Habermas, “On Systemically Distorted Communication” (1970) *Inquiry* 13(3), 205-18.

⁶¹⁶ Nick Crossley, “On Systematically Distorted Communication: Bourdieu and the Socio-analysis of Publics”, in Nick Crossley and John Michael Roberts (eds.) *After Habermas: New Perspectives on the Public Sphere*, (London: Blackwell, 2004)

⁶¹⁷ C. Norris, *Deconstruction: Theory and Practice* (London, 1982) as referred to by I. Wallerstein, I “The Modern World System” in Roberta Garner, ed. *Social Theory – Continuity and Confrontation* 2nd edition, (Peterborough: Broadview Press, 2007).

⁶¹⁸ J. Habermas, “On Systemically Distorted Communication” (1970) *Inquiry* 13(3), 205-18.

apply to more conventional print and visual media. The result, and the subject of much ongoing debate and discussion, is both the internet's strength and its weakness.⁶¹⁹

For while the seeming absence of, and resistance to, State based control mechanisms in the internet domain suggests a freedom from conventional archetypes of State power and domination by the influence and interests of corporate, political and social elites – a normative sphere that exists outside the law's definition and control – the content and interpretive processes are the product of what Bourdieu identifies as embedded assumptions and pre-reflective corporeal dispositions outside the channels of consciousness and consent.⁶²⁰ In effect, the perceived freedom of this domain is in fact an alternative condition in which historical state-based sources of control give way to contested, hidden and multiple sources of power.

Recent work by scholars in the growing discipline of 'cyber law' has alerted us to the potential for both the state and corporations to use the internet as a means of social control.⁶²¹ Jameson, taking a Marxist view that technology is an outcome of technological development to serve capitalist interests, considers that the representation of information technology generally and the internet specifically as some vast communications and computer network is merely a distorted figuration of something even deeper, namely the whole world system of multinational capitalism.⁶²²

⁶¹⁹ The internet exposes individuals and institutions to increased and new kinds of risk at the same time as it increases transparency and the promise of greater accountability.

⁶²⁰ P. Bourdieu, *Practical Reason*. (Cambridge: Polity, 1998) 54-5

⁶²¹ The dilemma faced by the ubiquitous search engine provider Google, in China exposed the degree of control that state governments can exert over internet usage by their populous. When Google launched its China-based search engine in January 2006, it was subject to censorship by the Chinese government. In direct conflict with the company's ideals and their motto 'Don't be evil', Google agreed to ban certain search results that the Chinese authorities deemed too sensitive and potentially promoting political dissent. In 2010, following numerous confrontations with the Chinese government over censorship, cyber attacks against mail users and tax matters, Google announced it would withdraw the search engine and business operations from China unless the Chinese authorities agreed to uncensored search results. Some consider that a withdrawal would send a strong message against state censorship: others view it as a victory for the Chinese state in its desire to control access information access.

⁶²² F. Jameson, "Postmodernism or The Cultural Logic of Late Capitalism" in Roberta Garner, ed. *Social Theory – Continuity and Confrontation* 2nd edition (Peterborough: Broadview Press, 2007) 614. Jameson at 616 suggests that the reason for succumbing to the attractiveness and compelling quality of technology notwithstanding is that it appears to offer some sort of available means to grasp a decentralized global network of power and control that is as yet beyond our comprehension.

Certainly, as Robert Monks has said, “[T]he corporate voice is so dominant – so well and perpetually funded – that they are the dominant player in politics and policy”.⁶²³ Business and those who serve its interest have the means to influence the content as well as the outcome of public discussion through their dominant interests in public media outlets and extensive resources to sway the debate even in newer, non-traditional channels such as social media.⁶²⁴

As the American media watchdog, Fairness and Accuracy In Reporting (FAIR) has identified, media corporations share members of the board of directors with an array of other large corporations including banks, investment companies, oil companies, health care and pharmaceutical companies and technology companies.⁶²⁵

While these interconnections conventionally have been valued as a source of business synergy and commercial opportunity, these interconnections can lead to complex power relationships and influence imbalances.

British writer and political activist George Monbiot in a 2002 article for *The Guardian* newspaper described the kind of manipulation of communication that can result from undue influence over the channels of communication and that can lead to Habermas’ systemically distorted communication,

While, in the past, companies have created fake citizens' groups to campaign in favour of trashing forests or polluting rivers, now they create fake citizens [now]. [M]essages purporting to come from disinterested punters are planted on listservers at critical moments, disseminating misleading information in the hope of recruiting real people to the cause. Detective work by the campaigner Jonathan Matthews and the freelance journalist Andy Rowell shows how a PR firm contracted to the biotech company Monsanto appears to have played a crucial but invisible role in shaping scientific discourse.⁶²⁶

⁶²³ Robert A.G. Monks, www.ragm.com

⁶²⁴ Bloggers and other negative sources of negative comment can be shut down, at least temporarily, by businesses intent on aggressively defending their reputations and, according to a recent article in *Ethical Corporation*, there is an emerging service industry that offers to “scrub [businesses] online reputations”. Stephen Gardner, “The Reputation Economy”, *Ethical Corporation*, September 2001, 16.

⁶²⁵ Fairness and Accuracy in Reporting (FAIR) “What’s Wrong With the News?” www.fair.org/index.php?page=101.

⁶²⁶ George Monbiot, “The Fake Persuaders”, *The Guardian*, May 14, 2002.

Commenting on the potential of the internet and social media in particular to counter the ability of large corporate interests to manipulate channels of communication, Richard Heale observes that,

Social media platforms facilitate buyer communication. They integrate social dialogue with marketplace perspectives. Social media challenges the marketing and communication status quo. The power of the buyer is dramatically increased. Transgressions by sellers are swiftly communicated...⁶²⁷

These platforms increase the likelihood that businesses which fail to live up to societal expectations of ethical, as well as legal, conduct will be exposed.

Taking this even further, the Wikileaks phenomenon is an extreme demonstration of the internet's potential to change the nature of accountability and disclosure mechanisms and current understanding of institutional transparency, both voluntary and involuntary.⁶²⁸

Wikileaks' reach is said to extend to private as well as the public sector organizations that have already been exposed.⁶²⁹ For corporations and other business entities, as for public sector organizations, its presence and the powers wielded by individuals who gain access to secure networks through the anonymous digital pathways of the internet present many challenges not only to the effectiveness of proprietary information and confidentiality protections, but also potentially to the limits of loyalty and trust.

⁶²⁷ Richard Heale, "Social media and corporate influence: the case for a thoughtware shift", Web post 24 July 2011. Online at: <http://www.pharmaphorum.com/2011/07/27/social-media-and-corporate-influence-the-case-for-a-thoughtware-shift>.

⁶²⁸ Wikileaks' mission statement reads: "Publishing improves transparency, and this transparency creates a better society for all people. Better scrutiny leads to reduced corruption and stronger democracies in all society's institutions, including government, corporations and other organizations." Wikileaks website: <http://213.251.145.96/About.html>.

⁶²⁹ Wikileaks founder Julian Assange told Forbes magazine in a November 2010 interview that half of the unpublished material possessed by Wikileaks pertains to the private sector. According to Assange, the 'data dump' will lay bare ... firm's secrets on the Web for every customer, every competitor, every regulator to examine and pass judgment on. "... it's also all the regular decision making that turns a blind eye to and supports unethical practices: the oversight that's not done, the priorities of executives, how they think they're fulfilling their own self-interest." Source: Forbes Blogs, online at <http://blogs.forbes.com/andygreenberg/2010/11/29/wikileaks-julian-assange-wants-to-spill-your-corporate-secrets/>.

Rebecca MacKinnon, an internet freedom advocate, has observed that while companies have the legal right to protect proprietary information, where such information conceals “illegal, unethical and immoral behaviour” the possibility of leaks by individuals who feel betrayed or a higher ethical imperative are very real.⁶³⁰

One area that has gained momentum as a significant threat to business reputation and operations since the global financial crisis of 2007-2009 is that of tax. Specifically, whether and how much tax businesses are paying and the ethical and legal issues surrounding the avoidance and evasion of business tax obligations at a time when the general public face stringent austerity measures, including public sector cuts, and rising unemployment.

In the United Kingdom, information about corporate tax practices disseminated through non-governmental organizations such as UK Uncut pose considerable reputational threats to companies that engage in aggressive tax avoidance as well as to those that illegally evade taxation – a distinction that is increasingly blurred in the public’s eyes. For example, a 2011 Harris Poll found that six out of ten Britons believe that “it is wrong for businesses to employ controversial but legal means of reducing their tax contribution.”⁶³¹

On October 27, 2010, less than 24 hours after a call to action via twitter #ukuncut, 70 people staged a peaceful sit in at Vodafone’s London flagship store that shut down its operations. Three days later, close to 30 Vodafone stores were similarly shut down all in protest over a settlement that Vodafone negotiated with the United Kingdom’s HM Revenue and Customs (formerly Inland Revenue Service) in relation to Vodafone’s illegal tax avoidance scheme.⁶³² From this social media driven collective action UK

⁶³⁰ Rebecca MacKinnon, Fellow, New America Foundation, Washington D.C. interview with *Ethical Corporation*, February 2011.

⁶³¹ Harris Poll, *Financial Times*, 11 February 2011.

⁶³² In 2010, the United Kingdom’s HM Revenue & Customs permanent secretary allegedly let Vodafone forgo £4.8bn of tax when settling a tax dispute with the company that started in 2000, when Vodafone acquired German engineering company and mobile phone operator Mannesmann, in what was at the time the biggest takeover ever. Vodafone set up a subsidiary in Luxemburg in order to route the purchase through an offshore company where profits would be taxed at less than 1%. Despite a ruling that the arrangement broke UK anti-tax avoidance rules, Vodafone negotiated a settlement of £1.2bn, less than 60 percent of the 2.2bn the company had provided for in its accounts, and considerably less than some estimates of the

Uncut was born. In March 2007, the London premises of Philip Green's Arcadia retail group, Vodafone, HMV and branches of RBS/Natwest, HSBC and Lloyds/Halifax banks, all accused of avoiding or evading tax, were again the focus of peaceful demonstrations protesting what they considered to be the corporate irresponsibility of benefiting from all the advantages but failing to carry a fair share of the public tax burden.

Direct civil action of the kind witnessed in the United Kingdom and across Europe in response to government austerity measures in the aftermath of bailouts to failed banks and other corporate entities is less common in the United States. Certainly, the latter's culture tends to be more favourably disposed to the accumulation of wealth whether by corporate and other business players, media and sports professionals, or other 'celebrities'.

However, September 17, 2011 saw the beginning of a direct public response in America to perceived excesses, greed, unfettered corporate corruption and the growing economic and social inequity between those in the top one per cent of the country's wealth and the rest of the population. Approximately 5,000 Americans inspired by the people's assemblies of Spain and a call out by Adbusters magazine commenced a symbolic occupation of the financial area of Wall Street.⁶³³ Using twitter, the internet and mainstream media, the occupation nearing its first month at time of writing has garnered attention around the world and shows no signs of abating. The issues at the heart of the demonstration are systemic and complex, and in large part the same as those that policy makers and legislators have been battling over without success since the 2007 – 2009 financial crisis revealed how profoundly the system has been compromised to serve the interests of a few at the expense of the many.

company's actual tax liability. Sources: UK UnCut; Richard Murphy, "Vodafone's tax case leaves a sour taste", *The Guardian*, 22 October, 2010, www.guardian.co.uk; Duncan Robinson, "Protestors target Vodafone over taxes", *Financial Times*, 27 October, 2010.

⁶³³ Micah White and Kalle Lasn, "The call to occupy Wall Street resonates around the world", *The Guardian*, September 19, 2011.

The eventual outcome of the specific protests or the general call for greater accountability and fairness in the capitalist system is unclear. What is certain is that new voices are being heard in the discourse and the information essential to knowledge of corporations and other business entities, their activities, and the influence they seek to wield over matters of public as well as private interest is no longer exclusive. Nor is the information controlled and reliant solely on the linear one-way process of corporate disclosure the credibility of which has suffered from incidences of bias, misleading and self-serving selectivity, and abuse.⁶³⁴

With this reality and the inescapable fact that bias, misinformation and misuse of information is not exclusive to any one sector or segment of society, the future of governance discourse is at a critical juncture. The opportunity exists for it to be a means to engage in an unprecedented level of open and transparent communication and exchange of information about the nature of ethical conduct and the governance practices that enable and support it.

However, unless and until the language of conduct and governance in such discourse reflects the reality of consistent and sustainable commitments to accountability, reciprocity, responsibility and ethical practices, there is a risk that the opportunity will be lost.

⁶³⁴ The requirement for a public company to disclose its code of ethics and to disclose immediately any waivers from the code granted by the company to its top three executives under *Sarbanes Oxley Act* section 406 is but one example where a disclosure requirement is ineffective when left in the hands of certain corporate decision makers. A 2009 study of 200 randomly selected firms over 4 years found only one waiver disclosed pursuant to section 406. However, an overlap of securities disclosure requirements enabled the results to be cross-checked. This revealed 30 instances in the 200 company sample where companies disclosed related-party transactions with CEOs, and CFOs in their proxies, but failed to disclose them when they occurred (either as ethics waivers in 8-Ks or on the corporate website) as required by section 406. These companies violated section 406 by failing to provide timely and transparent disclosure instead making the disclosures through the annual proxy process when the information is easily lost in the volume of other information provided at that time. Another 74 instances revealed what the researchers termed “in spirit” violations where companies failed to include in their codes prohibition of the very type of conflicts of interest that led to the section 406 requirement in the aftermath of the Enron scandal with the result that the waiver requirement does not come into play. This reveals a self-serving circular reasoning at best and a willful evasion of the requirement at worst since section 406 requires “such standards as are reasonably designed to promote— (1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships”. Usha Rodrigues and Mike A. Stegemoller, “Placebo Ethics: A Study in Securities Disclosure Arbitrage” (2010) *Virginia Law Review* Volume 96, Number 1, 1-67.

13. Exploring Institutional Governance Discourse

A morally mature business encourages constant dialogue around common purpose, shared values, good behaviours, and sustainable outcomes. This isn't new thinking, because this is how we function in our personal lives.

Professor Roger Steare⁶³⁵

13.1 Discourse and Institutions

Institutional discourse is not audible in the traditional sense. Instead, one must 'hear' it indirectly in the echo, iteration, and repetition of words and phrases that are found in the system of statements that appear in formal texts and other secondary forms of official communication.

The exploration of institutional discourse by examining a collection of meaningful representative texts is informed by the definition of discourse used by Parker in her work on discourse analysis as "a system of statements which constructs an object".⁶³⁶

As Phillips, Laurence and Hardy explain it, the constitutive – discursive – element within this system of statements by its nature eludes direct study and instead must be examined indirectly through a systematic study of the texts that constitute it.⁶³⁷

In *Discourse and Institutions*⁶³⁸, Phillips, Laurence and Harvey outline an approach to understanding the social construction and institutionalization of meaning that takes this discursive view of institutions with a specific focus on the role of texts as institutional discourse. Their model situates these texts at the juncture where meaning construed

⁶³⁵ Corporate Philosopher and Professional of Organizational Ethics, June 2010

⁶³⁶ I. Parker, *Discourse Dynamics: Critical analysis for social and individual psychology*. (London: Routledge, 1992) 8.

⁶³⁷ Nelson Phillips, Thomas B. Laurence and Cynthia Hardy, "Discourse and Institutions" (2004) *Academy of Management Review* Vol. 29, No. 4 635-652.

⁶³⁸ *Ibid.* at 636.

through discourse within and among institutions merges with action, and action is in turn interpreted and institutionalized through the production, dissemination and embedding of text-based discourse.

Critical to the analysis is the effort to understand collections of texts as part of a greater continually evolving body of meaning that, through these processes of creation, consumption, dissemination and interaction become constitutive of a broader social reality.

That is, the process becomes iterative, in that institutions producing the texts are themselves influenced by and ultimately constituted by this ‘system of statements’.

There is a mutually constitutive relationship among discourse, text, and action: the meanings of discourses are shared and social, emanating out of actors’ actions in producing texts; at the same time, discourse gives meaning to these actions, thereby constituting the social world.⁶³⁹

Rather than limiting this examination to the confines of organizational theory or specific institutional fields, Phillips and his colleagues propose this model as one which lends itself to the wider examination of discourse that translates across institutional boundaries and that contribute to the “social production or organizational and inter organizational phenomena”.⁶⁴⁰ The latter, they explain is

...a complex process where changes in discourses outside the [institutional] field, or tangential to it, affect discourses more central to the fields in unexpected ways. Such interdiscursivity means that the institutional field is susceptible to the influence of changes in broader discourses. Hence, change in institutional fields may be unpredictable and wide ranging.⁶⁴¹

Behavioural norms and standards evolve organically over time. As a consequence, it is virtually impossible to pinpoint a particular moment in time, or a specific catalyst that signifies a major shift in prevailing attitudes and behaviours. However, it is possible to detect evidence of change through analysis of the content and tone of discourse over a

⁶³⁹ Ibid. at 637.

⁶⁴⁰ Ibid at 636.

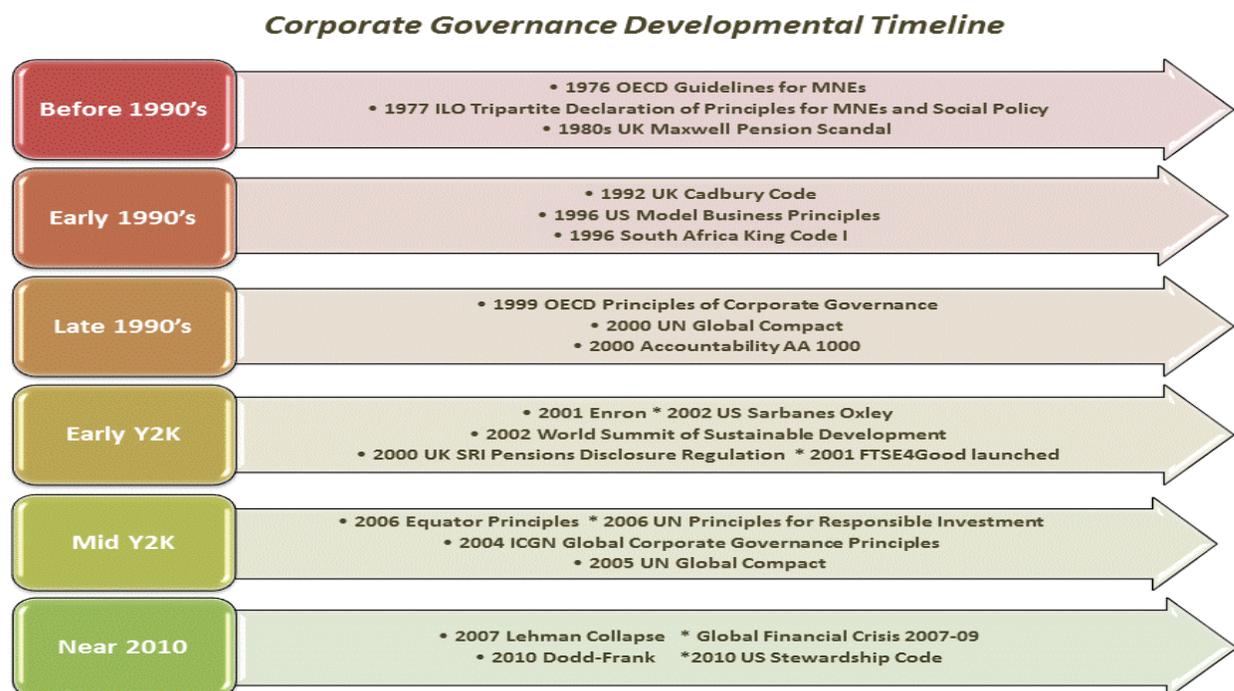
⁶⁴¹ Ibid at 647.

particular period of time. Formal or institutional discourse in particular lends itself to this kind of analysis for the obvious reason that there is formal static record and also for the fact that given the nature of the entities involved in such discourse there is less likelihood for such discourse to be a reflection of fleeting notions or transient ideologies.

The emergence of values-based governance standards such as those discussed in Chapter Eleven served as an important catalyst in the content of governance discourse through their explicit articulation of the link between responsible commerce and the mutuality of interests of businesses and the communities that enable and support them.

Specifically they enabled a shift in the focus of discussion from profit maximization and narrow measures of economic efficiency and success that externalized social and environmental costs, which emerged in the 1970s and took hold again in the latter part of the twentieth century, to a wider assessment of value informed by, rather than separated from, values. This, in turn, emboldened companies already seeking to pursue business objectives responsibly to do so explicitly within an emerging framework of soft law guidelines and standards and, particularly in Western Europe, enabling legislation.

Figure 11 - Corporate Governance Developmental Timeline



What this suggests is the powerful normative impact of sustained discussion, conducted at the highest levels, on the attitudes, behaviours and decision making processes in a vast and, initially at least, largely self-regulating business sphere.

The nature and the content of this discussion has continued to evolve from the days of early activist NGOs making demands on individual corporations to contemporary efforts at mutual engagement and in some cases partnership aimed at achieving greater responsibility, transparency and wider accountability.

13.2 The Corporate Voice

13.2.1 Voices in the boardroom and the ‘tone at the top’

Numerous studies have shown that to drive a sense of universal integrity deep within an organization, the organization must explicitly acknowledge and address the importance and value of the individuals within it, and to consciously and actively engage them in the creation of an organizational culture that embodies and reflects a shared set of values and reciprocal expectations that resonate with them.⁶⁴²

That said, the prevailing culture in organizations is generally determined at the highest levels, specifically by the board of directors and senior executives who have the formal authority to articulate the values and standards of the corporation and otherwise set the ‘tone at the top’, both internally and externally.

In his work on building a sustainable reputation of corporate integrity, business strategist Peter Firestein believes it is essential “for leaders to develop a finely tuned moral ear” and to maintain a sense of proper conduct regardless of business circumstance.⁶⁴³

⁶⁴² See infra note 315.

⁶⁴³ Peter J. Firestein, “Building and Protecting Corporate Reputation”, *Strategy and Leadership*, 2006.

In a 2010 UK survey by PriceWaterhouseCoopers (the UK PwC survey), 80% of individuals responsible for managing fraud, corruption and integrity risk in their organizations responded that consistent and frequent communication from leadership is important in creating an ethical culture, but 43% responded that the ‘tone from the top’ was undermined by leadership action conflicting with ethical messages.⁶⁴⁴

Of the 36 corporate codes in the sample: 14 stated their application to the conduct of officers and employees, 13 applied at all levels of the organization from board through to employees, whereas 9 codes were directed to employees only.

The individuals occupying board positions are also the official public face of and speak for the organization. Board members’ pictures and biographies appear in corporate annual reports, on official corporate websites, and in annual proxy circulars. As a consequence the selection and composition of this select group of individuals can speak volumes.

In turn, the boards’ selection and evaluation of the chief executive can send powerful messages about the type of organization and the values to which it ascribes. These may be positive or negative, depending on the choice. For example, the profiles of chief executives associated with recent scandals provide a catalogue of character traits that run contrary to the fundamental pre-requisites for ethical leadership, calling into question the manner and purpose of the appointment and the nature of leadership that the board had envisaged.⁶⁴⁵

⁶⁴⁴ PriceWaterhouseCoopers, “Tone from the Top: Transforming Words into Action”, June 2010, Online at: <http://tinyurl.com/4f754ef>

⁶⁴⁵ In his research on ‘Moral DNA’ using the moral character profile test ethicability™, Roger Steare found in the psychological profiles of 1,000 business leaders significantly lower scores on humility and empathy than human norms. Roger Steare, *ethicability*® (Roger Steare Consulting Limited, 2009) www.ethicability.org. Roger Steare and Pavlos Stamboulides “Who’s doing the right thing? Ethicability® Moral DNA Report 2008” (Roger Steare Consulting Ltd., 2009). Robert Hare’s Psychopathy Checklist (PCL-R) used in the identification of psychopaths yields high scores in eight character traits common to corporate executives. Robert Hare, *Without Conscience* (New York, London: The Guilford Press, 1993). Belinda Board and Katarina Fritzson showed similar findings in from personality testing of high level executives in “Disordered personalities at work” (2005) *Psychology, Crime and Law* Volume 11, Issue 1, 17-32. See also, Jim Collins, *How the Might Fall* (Collins Business Essentials – Harper Collins Publishers, 2009).

The tone at the top is also communicated through conduct. Board membership, or directorship, is a privilege with all the societal and moral obligations and responsibilities that go with privilege. As such, board members have a responsibility to embody the standard required of them as the individuals who are entrusted with shareholders' funds and the stewardship of the organization. In this regard, they have an obligation to discharge their fiduciary responsibility in a manner consistent with the law as well as societal norms and expectations of individuals who exercise authority.⁶⁴⁶

It is not sufficient for boards to behave in a manner which merely avoids criminality, fraudulent practices and actions, and other forms of illegal activity. This applies to only a relatively narrow range of conduct that, while an absolute minimum threshold of behaviour, does not establish an appropriate benchmark for standards of ethical conduct. If at times in doubt, the widespread public criticism of the boards of directors connected to Enron and other high profile corporate scandals at the beginning of the century, followed by extensive regulatory intervention into corporate governance, made this clear.

The Supreme Court of Canada's decision in the Bell Canada Enterprises case (*BCE Inc. v 1976 Debentureholders*, 2008 SCC 69, the BCE case) reconfirmed the position that in Canadian law, the directors' fiduciary duties are owed to the corporation, not to its shareholders.⁶⁴⁷ The court stated that the fiduciary duties concept, where the corporation is an ongoing concern, "... is not confined to short-term profit or share value."⁶⁴⁸ In discussing the business judgment rule, the court said: "It reflects the reality that directors

⁶⁴⁶ In this connection, the review of WPP's Code of Business Conduct revealed an interesting shift in application. WPP reproduces its Code of Business Conduct in its annual Corporate Responsibility Report. In the Corporate Responsibility Reports for 2006, 2007, and 2008 the Code of Business Conduct states: "We the directors and employees of all companies in the WPP Group ('the Group'), recognise our obligations to all who have a stake in our success including share owners, clients, employees, and suppliers". The 2009/10 Corporate Responsibility Report made the claim that "[O]ur Code of Conduct was strengthened during 2009 to incorporate principles from the CR policy" yet the 2009 and 2010 versions of the Code of Business Conduct state: "We the officers and staff of all companies in the WPP group ('the Group') recognise our obligations to all who have a stake in our success including share owners, clients, staff and suppliers". Neither the Code nor the Corporate Responsibility Report makes reference to or provides explanation of the omission of the directors from the 2009/10 Code.

⁶⁴⁷ *BCE Inc. v 1976 Debentureholders*, 2008 SCC 69, at par. 66.

⁶⁴⁸ *Ibid.* at par. 38.

... are often better suited to determine what is in the best interests of the corporation. This applies to decisions on stakeholders' interests, as much as other directorial decisions."⁶⁴⁹

Distinct from the corporate entity, shareholders of public companies have plenty of remedies available if they object to the actions of the board. They can sue personally using the oppression remedy, requisition a shareholder meeting and fight a proxy battle to replace the board. They can launch a derivative action, at the expense of the target, with court approval. While the litigation route is often lengthy and costly, there have been some recent incidents in Canada in the context of mergers and acquisitions that demonstrate that courts can respond very quickly. This was the case when the British Columbia Court of Appeal affirmed the BC Securities Commission decision in the Lions Gate appeal of the regulator's decision in the midst of a hostile takeover bid.⁶⁵⁰

By contrast, the ability of stakeholders to have their concerns addressed are less certain, varying according to the nature of their interest, the jurisdiction in which they and the corporation are situated, and the extent to which the corporation has a policy of considering and engaging with stakeholders in its policy and decision making processes. As a consequence, the capacity and willingness of boards to recognize legitimate interests of stakeholders through their adoption of formal policies and corporate codes of conduct that explicitly refer to a wider set of interests and accountabilities provides insight into the manner in which the corporation will conduct business.

The gap between word and deed is a powerful source of cynicism in modern society, and failures by companies to live up to their stated commitments to standards of conduct can cause long lasting damage. It is therefore important that these formal commitments add up to something more than mere words or tokenism. This requires a real capacity to

⁶⁴⁹ Ibid. at par. 40.

⁶⁵⁰ BC Court of Appeal decision in *Lions Gate Entertainment Corp. v. Icahn Partners LP*, 2010 BCCA 231 dismissing Lions Gate's appeal of the British Columbia Securities Commission decision to cease trade a shareholder rights plan implemented by Lions Gate Entertainment Corp: Icahn Partners LP, Icahn Master Fund LP, Icahn Partners Master Fund II LP, Icahn Master Fund Partners III LP, High River Limited Partnership, Icahn Fund S.àRL and Daazi Holding B.V. (collectively, the "Icahn Group") and Lions Gate Entertainment Corp. 2010 BCSECCOM 214

understand and evaluate the implications and consequences of corporate policy and actions in the light of these standards and to make the often challenging decisions necessary to ensure the corporation remains aligned to its commitment.

One approach to building this capacity that has gained considerable attention, if not as much progress, is to increase the diversity of the individuals who occupy positions on corporate boards of directors. There is a growing body of research that supports the proposition that diversity of management and breadth of perspective within organizations can mean better ideas, more informed decisions, and stronger performance. Similarly diverse boards have been shown to offer expanded perspective and in so doing to improve the quality of corporate deliberations and policy making.⁶⁵¹

With these considerations in mind, some companies and institutional investors as well as regulators and civil society are articulating the benefits of greater diversity and the importance of independence of thought and judgment necessary for sound and accountable decision making at the board level.

In the United Kingdom a lobby group – the 30% Club – was created in 2010 by chairmen of some of the UK’s largest companies with the goal of increasing the proportion of women on corporate boards to 30% by 2015 without the imposition of formal quotas. In pursuit of this goal, it has spearheaded an initiative involving representatives from some of the country’s most powerful institutional investors with more than GBP1,000bn in stock market assets to put the investment case for more diverse boards to company chairman and management teams of FTSE companies.⁶⁵²

⁶⁵¹ Reports and studies include: ‘Enhancing Stakeholder Diversity in the Board Room’, ‘The Erfurt meetings’ series, No 1, March 2008, European Citizens’ Seminars e.V. (Erfurt, Germany) publishers. Women Matter, McKinsey and Company, 2008. Adams and Ferreira, “Women in the boardroom and their impact on governance and financial performance”, *Journal of Financial Economics* 94 (2009). Wooley, Chabris, Pentland, Hasmi and Malone, ‘Evidence for a Collective Intelligence Factor in the Performance of Human Groups’, *Scienceexpress*, 30 September 2010. *Female Leadership and Firm Profitability*, Finnish Business and Policy Forum – EVA 2007. *The Bottom Line: Connecting Corporate Performance and Gender Diversity*, Catalyst, 2004.

⁶⁵² <http://www.30percentclub.org.uk/>

In the United States, CalPERS and Calstrs, the countries' two largest public sector pension funds have funded the creation of an electronic databank called the Diverse Director Datasource, or 3D, containing details of potential board appointees to widen the pool of talent from which board appointments have typically been drawn.⁶⁵³

Many European countries have introduced initiatives aimed at encouraging companies to include more diverse voices, in particular those of women, in their board room deliberations. In Norway, the government introduced a requirement that corporate boards have forty per cent female representation. State-owned enterprises had to comply by 2006, and public companies had to satisfy the requirement beginning in 2008.⁶⁵⁴ France recently adopted similar legislation in late 2010. The legislation requires that France's larger corporations increase the number of women in higher management positions and that within six years have women in 40 per cent of boardroom positions.

In a more principles based approach, Australian companies are now required to disclose the company's progress related to board-established gender objectives as well as disclose the number of female employees in the entire organization, in senior management, and on the board.⁶⁵⁵ In the United Kingdom, companies are now required to "pay due regard to the benefits of diversity on the board, including gender" when searching for and appointing directors.⁶⁵⁶

The 2010 changes to the UK Corporate Governance Code 2010 included changes intended to encourage boards to be well balanced and avoid "group think" in their deliberation and decision making. The new principles addressing the composition and selection of the board include Revised Supporting Principle B.2 intended to encourage nomination committees to include the board's gender mix in the factors that are explicitly taken into account when considering the need for new appointments. The principle now

⁶⁵³ www.gmi3D.com

⁶⁵⁴ See: *Ministry of Children, Equality, and Social Inclusion, "Rules on Gender Representation on Company Boards*

⁶⁵⁵ Australian Securities Exchange, "Changes to Corporate Governance Principles and Recommendations" (June 30, 2010).

⁶⁵⁶ Patrick Hosking, "Corporate Governance Code: A Woman's Place is in the Boardroom," *The Times*, May 28, 2010.

reads: “The search for board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender”.⁶⁵⁷ Further changes to take effect in October 2012 will require companies to disclose their policy on board diversity.⁶⁵⁸

Most recently, the European Union released its Green Paper on Corporate Governance in May 2011. The issue of board diversity – extending to professional skills and experience and nationality as well as gender – is included in its consultation.⁶⁵⁹

The appointment of women and of other under-represented segments of the population, potentially also sends a strong signal to stakeholders and the wider community that the company is a reflection of the wider community in which it operates. This can build, among other things, a greater sense of identification, opportunity and trust both inside and outside the organization. In an increasingly diverse society, mutual understanding, respect, and consideration for the perspectives of others is extremely important to the building of trust. This is particularly so when increasing diversity is matched by increasing interdependency.

Notwithstanding the compelling rationale, the progress toward more diverse boards is progressing slowly and the percentage of women on corporate boards to date and absent requirements remains low relative to the percentage of women in the general population, and in the workforce.

⁶⁵⁷ www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf. Revised Main Principle B.1 of the Code emphasizes the need for a balance of skills, experience, independence and knowledge of the company. The Financial Reporting Council has noted that the number of women on company boards remains very low. According to the 2009 Female FTSE Board Report, women account for only 12 percent of all directors in FTSE 100 companies, and seven percent in FTSE 250 companies. One quarter of FTSE 100 companies have no women on the board at all. Sealy, Vinnicombe and Doldor; *The Female FTSE Board Report 2009*; Cranfield University; 2009

⁶⁵⁸ While the new provision will not take effect until 1 October 2012, the FRC is encouraging companies to voluntarily disclose information in their next intervening annual reports. The changes follow on the recommendations by Lord Davies in his government commissioned report “Women on Boards”, published 24 February, 2011.

⁶⁵⁹ European Commission Green Paper, *The EU corporate governance framework*, COM(2011) 164 (Brussels 5.4.2011). See discussion in section 5.3.

In Canada, for example, the percentage of women in the workforce has been over 45% since 1995 and in 2010 women comprised 47.3% of the workforce. Yet, despite this extended period of female participation in the workplace, the representation of women that hold directorships in the boardrooms of Canadian companies remains at less than 15%.⁶⁶⁰ While it has been suggested in the past that the positions that women hold in organizations are predominately non-management and as a consequence they are less likely to possess the appropriate attributes and experience for board membership, this is increasingly an invalid defense of the status quo. For example, in its last year of publication, the fourth issue of the Women in the Lead Directory contained the biographies of 800 Canadian women qualified to assume senior level executive positions and appointments to boards.⁶⁶¹

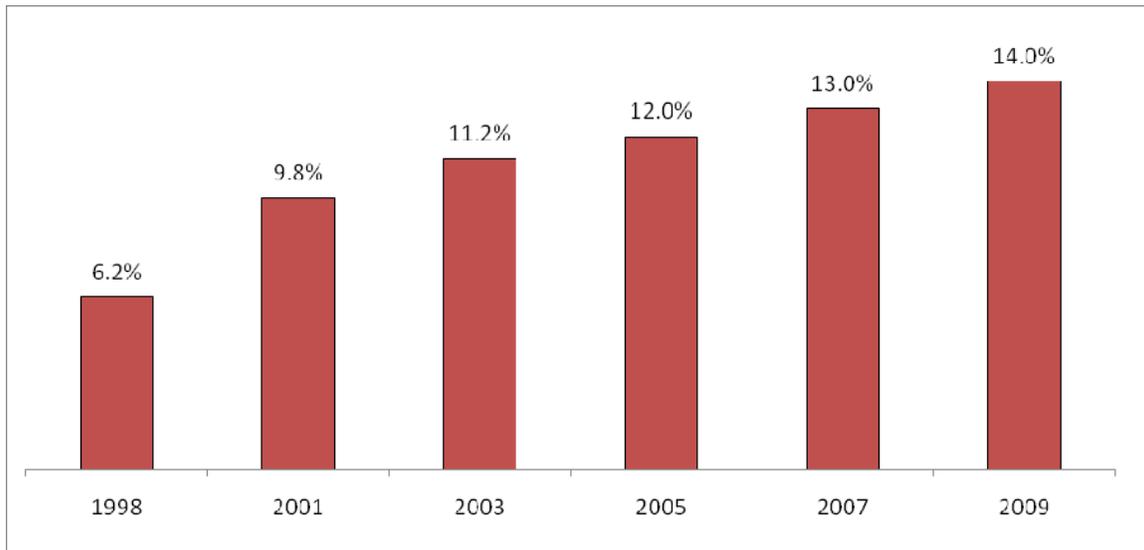
In a similar vein, in 2008 the Institute of Corporate Directors Canadian registry of formally educated and other highly skilled professionals had profiles of more than 100 women, comprising 21% of the registry.⁶⁶²

⁶⁶⁰ Catalyst.org. Source: Statistics Canada, CANSIM, "Table 282-0009: Labour force survey estimates (LFS), by National Occupational Classification for Statistics (NOC-S) and sex, unadjusted for seasonality, monthly

⁶⁶¹ Resumes submitted by applicants to the directory are reviewed by an independent advisory committee according to strict criteria regarding qualifications, experience and other factors. www.womeninthelead.ca

⁶⁶² www.icd.ca

Figure 12 - % of Financial Post 500 Board Seats Held By Women in Canada



Source: Catalyst, 2009 Catalyst Census: Financial Post 500 Women Board Directors, www.catalyst.org. By permission.⁶⁶³

13.2.2 Executive pay in the spotlight

One of the most direct expressions of a corporation's value systems is in how it chooses to spend company, or shareholders', money and on what basis it evaluates the merits of the expenditure. In this regard, the issue of executive compensation has become one of the lightning rods of corporate governance and one of the most vocal arenas in which corporations are engaged with shareholders, as well as the wider public and political sphere.⁶⁶⁴

The difficulties experienced by the Dutch bank ING in early 2011 over its proposed executive pay packages are a telling example of the public sentiment against perceived inequities in compensation levels.⁶⁶⁵ When ING proposed bonuses for executives,

⁶⁶³ Catalyst 2011 Sources: Catalyst, 2009 Catalyst Census: Financial Post 500 Women Board Directors (2010); Catalyst, 2005 Catalyst Census of Women Board Directors of the FP500 (2006); Catalyst, 2001 Catalyst Census of Women Board Directors of Canada (2001)

⁶⁶⁴ Also see discussion in sections 3.3 and 5.3.

⁶⁶⁵ Richard Wachman, "Customers force Dutch bank bosses to abandon bonuses", the Observer in *The Guardian Weekly*, April 1, 2011.

thousands of customers of the Amsterdam-based bank connected through social networks to threaten mass withdrawals in protest. This threat of direct action created a sufficiently credible risk that there would be a partial run on the bank to cause ING's chief executive, Jan Hommen, to agree to waive his proposed \$1.7 million bonus and direct other ING directors to do the same. In addition, Hommen has promised no bonuses until the bank has repaid all state aid, something which it expects to do by 2012.

The situation also triggered a political storm in the Netherlands where parliamentarians and moderate public opinion shared the view that banks like ING and ABN AMRO that received state aid after the 2007 – 2009 financial crisis, should not pay bonuses to executives. The outcome could be a blanket ban on bonuses to financiers at institutions in receipt of taxpayer bailouts – a clear example of the state responding with regulation in the face of business crossing the line of socially acceptable conduct.

A 2011 ICM poll shows that 72% of the public think high pay makes Britain grossly unequal whilst 73% have no faith in government or business to tackle excessive high pay. The poll shows that, from a range of options, the majority of the public (57%) wants top pay linked clearly to company performance, while half (50%) want shareholders to have a direct say on senior pay and bonus packages.⁶⁶⁶

13.2.3 Risk, responsibility and ethics

Risk management in the past focused on what the auditors identify as 'financial risk'. In the last decade, the risk management responsibility of boards of directors has significantly expanded to encompass ethical considerations. Such consideration include the risk of: potential loss of reputational capital due to ethical transgressions; future liability for environmental mismanagement, damage, sanctions, and remediation; operational impact of reduced or lost licence to operate – both legal and social; limited or more costly access to capital and insurance; and negative impact on performance and

⁶⁶⁶ Source: The High Pay Commission, *More for Less: what has happened to pay at the top and does it matter*, Interim Report of The High Pay Commission, May 2011. Online at: <http://highpaycommission.co.uk/blog/interim-report-more-for-less-launched>

future competitiveness of high employment turnover and a diminished ability to attract and retain high calibre board members, management and staff.

This broader understanding of risk reflects an evolving understanding of the increasingly complex systems and interdependent networks within which business decisions and actions take place and the myriad implications and consequences of different choices. By taking these into account, deliberations within business organizations enter into the realm of ethical decision making. That is, having regard to the means chosen as well as the ends pursued.⁶⁶⁷

Lapses in ethics and integrity pose considerable risks to organizations from both a purely financial and non-financial standpoint. In financial terms, such lapses risk costs of clean up, compensation, reparation, fines, loss of current and future business, employee turnover, regulatory investigation and the potential for more stringent reporting requirements, increased insurance premiums, increased borrowing costs, as well as share price volatility. The so called ‘non-financial costs’, that in reality are indirect financial costs, include loss of reputation, public trust and goodwill, increased barriers to entry such as difficulty obtaining government and licensing approvals, loss of community support and social licence to operate, and challenges in access to capital and sourcing financing from first tier lenders.

While boards and senior management have responsibility for high level policy and strategic decision making, day to day decision making is the domain of managers and individual employees. In this regard, the authenticity of the tone at the top and stated commitments to ethical business practice will influence the extent to which employees

⁶⁶⁷ Ethics encourages the consideration of the questions ‘for what end?’ and ‘by what means?’. The ethical decision making process uses intellectual frameworks to encourage individuals to think deeply about means and ends. Comprehensive texts on the application of ethics to business decision making and action see: Crane and Matten, *Business Ethics: A European Perspective. Managing Corporate Citizenship and Sustainability in the Age of Globalization*, 3rd ed., (Oxford: Oxford University Press, 2010); C. Fisher and A. Lovell, *Business Ethics and Values*, 2nd ed., (Harlow, UK: Pearson Education, 2006); P.W. MacLagan, *Management and Morality*, (London: Sage, 1998). Regarding ethics in business decision making as regards stakeholders, see: T. M. Jones, “Instrumental Stakeholder Theory: a Synthesis of Ethics and Economics”, (1995) *Academy of Management Review* 20[2], 404-437.

are encouraged and supported in their efforts to take into account the ethical dimensions and consequences in their own and with respect to others' decisions and actions.

Of the 35 corporate codes of conduct and ethics policies reviewed 31 explicitly deal with matters of environmental, social and governance risk, and 23 contain sections specifically dealing with internal reporting, and requirements to proactively report legal or code concerns, violation or suspected violations. The very fact that these matters appear in published codes and policies signals a change in the way in which corporations approach matters of risk and in their expectations of employees with regard to raising concerns. Granted, the introduction of mandatory measures regarding whistle blowing and whistleblower protections over the past decade are a material factor in any change in approach. However, the language used in these codes refers to individual and collective responsibility and the importance of acting proactively to report and seek early resolution of concerns or issues in the ordinary course of work before the situation escalates.

For example, The Coca Cola Company Code of Conduct 'Acting With Integrity Around the Globe' states:

We all have an obligation to uphold the ethical standards of The Coca-Cola Company. If you observe behavior that concerns you, or that may represent a violation of our Code, raise the issue promptly. Doing so will allow the Company an opportunity to deal with the issue and correct it, ideally before it becomes a violation of law or a risk to health, security or the Company's reputation.⁶⁶⁸

This approach contrasts with the idea of whistle blowing as taking place through external channels, and as a consequence associated with notions of disloyalty and the actions of individuals who are themselves the problem. In this environment whistle blowing is often a last resort effort to raise awareness of problems or transgressions after internal reporting mechanisms have failed or the organizational culture has discouraged or silenced concerns.⁶⁶⁹ In such cases, the issues have usually escalated to a point where the focus is

⁶⁶⁸ The Coca Cola Company, Code of Conduct *Acting With Integrity Around the Globe* at p.8

⁶⁶⁹ The Enron whistleblower Sherron Watkins and the Worldcom whistleblower Cynthia Cooper are recent high profile examples. See, respectively: Sherron Watkins and Mimi Swartz *Power Failure: The Inside Story of how Enron's Culture of Greed Led to the Biggest Bankruptcy in American History* (New York:

on the particular incidents or transgressions, rather than the underlying conditions or cultural roots of the problem which necessitated a sounding of the alarm through external channels.

Whistleblower protections and external channels for raising concerns remain very important in a system that is committed to principles of accountable, ethical and lawful conduct. However, these remain reactive, extreme and, in the worst case, crisis-based ways to address problems within organizations. Alongside these external measures, there is a role for organizations in fostering internal cultures that make ethical values, individual and collective accountability, and trust explicit priorities.

In this regard, 87% of respondents to the 2010 PwC UK survey responded that culture contributes to the mitigation of risk around fraud, corruption and unethical behaviour. Additionally, 61% responded that an ethical culture improves the quality of decision making.⁶⁷⁰

13.3 Investor/Shareholder Voice

13.3.1 Shareholder stewardship

Institutional investors have played a major role in the emergence of truly global money flows, notably through their large-scale cross-border investments, channeling the excess liquidities of pension funds of G8 and OPEC countries towards both Western and emerging markets, contributing to the development of a truly integrated and thus more efficient global financial sphere.⁶⁷¹

Doubleday, 2003) and Cynthia Cooper, *Extraordinary Circumstance: The Journey of a Corporate Whistleblower* (New York: Wiley, 2008).

⁶⁷⁰ PriceWaterhouseCoopers, “Tone from the Top: Transforming Words into Action”, June 2010, <http://tinyurl.com/4f754ef>

⁶⁷¹ See: M. Nicolas Firzli, “Asia-Pacific Funds as Diversification Tools for Institutional Investors”, *Analyse Financiere* No.31 (April/May/June 2009) 30.

As a consequence, the institutional investment community – particularly large pension funds – can play an important role in fostering sound governance, accountability and corporate responsibility in the companies in which they invest, and in building consensus on what constitutes (or should constitute) responsible investment within the context of fiduciary obligations and responsibilities.⁶⁷²

Engel outlined a corporate ethic based on a central notion of responsible ownership in 1979.⁶⁷³ In his model, corporations are responsible for: the voluntary disclosure of information necessary for appropriate law making; restraint from seeking to influence the processes of law making and enforcement; and full compliance with the law. In his view these are the necessary elements to legitimize the other, profit-making, responsibility. The role of active shareholders is to assure ethical compliance, and through this to achieve alignment between corporate activity and the broader public good.

Robert Monks, a leading advocate for shareholder activism in corporate governance, has long argued for increased shareholder control over the governance of corporations, specifically by the large pension funds and other institutional investors with liabilities that similarly mature over the longer term.⁶⁷⁴

Monks basis his argument on a number of reasons, the first of which is the issue of scale. These funds now own a significant proportion of the world's equity. The second is that as fiduciaries they possess a greater accountability than other wielders of corporate power to their beneficiaries – employees, residents of communities who would suffer the adverse

⁶⁷² Paul Myners: “I regard our strong funded pensions system, our highly-developed equity culture and the professionalisation of investment in the UK as key national assets. That is certainly how they appear, rightly, from the perspective of many other countries of Europe”. *Institutional Investment in the United Kingdom: A Review* (HM Treasury, 2001) (‘The Myners Review’). Accessible online at: http://archive.treasury.gov.uk/pdf/2001/myners_report.pdf.

⁶⁷³ David Engel, “An Approach to Corporate Social Responsibility” (1979) 32 *Stanford Law Review* 1.

⁶⁷⁴ For the development of his position on the role of long term or institutional shareholders, see: Robert A.G. Monks, *The Emperor's Nightingale: Restoring the Integrity of the Corporation in the Age of Shareholder Activism* (Massachusetts: Addison-Wesley Reading, 1998); Robert A.G. Monks, *The New Global Investors: How Shareholders Can Unlock Sustainable Prosperity Worldwide* (Oxford: Capstone Publishing) 2001; Robert A.G. Monks, “Corporate Governance – Past, Present and Future”, November 2010. Online at: <http://blogs.law.harvard.edu/corpgov/2010/03/04/corporate-governance-past-present-future/>.

consequences of negative externalities and who have an interest in potential costs that may be imposed on the corporation in order to compensate those who are harmed. The third is that as “universal owners” their portfolio performance is crucially linked to the macroeconomic performance of the global economies in which they invest, over the long term.⁶⁷⁵

As fully diversified investors in all or most of the equity market, Monks contends that any ‘externalization’ is illusory in that there will be no net benefit from the externalizing by one corporation because any gain that results is offset by the losses sustained by non-externalizing corporations. The effect of this is that they cannot “externalize” human, social, environmental and political harms caused by unfettered corporate pursuit of profit, because there is virtually nowhere external to their direct or indirect interests.

Despite this explicit consideration of non-financial harms, Monks is clear to make the distinction that this model is not “about ‘social investing’, but rather best business practices – the maximization of long term value.”⁶⁷⁶ As such, it follows Smith’s conception of the relationship between capitalism and the public interest and von Hayek after him, with the latter arguing that the corporate goal of earning the highest possible *long term* return on their capital benefits society as a whole by allocating resources to the companies that can make the best use of them.⁶⁷⁷

The independence, freedom from conflict of interest and long-term view of the public pension fund suits it to be the ‘responsible investor’ Monks feels is needed to restore the necessary balance and require an appropriate level of accountability within the corporate power dynamic to achieve the socially beneficial goal of long-term value.

⁶⁷⁵ For a full discussion of this concept as introduced by Hawley and Williams, see: Hawley and Williams, *The Rise of Fiduciary Capitalism* (Philadelphia: University of Pennsylvania Press, 2000). The authors introduce the concept of the “universal owner”, an institution representing many individual beneficiaries and investing in many companies, which therefore has a broad interest in issues of social importance such as education and the environment.

⁶⁷⁶ Robert, A.G. Monks, *The Emperor’s Nightingale: Restoring the Integrity of the Corporation in the Age of Shareholder Activism* (Reading, Massachusetts: Addison-Wesley, 1998) 117.

⁶⁷⁷ Friedrich von Hayek, “The Corporation in a Democratic Society: In Whose Interest Ought It and Will It Be Run?” as referred to by James Wallace in “Value Maximization and Stakeholder Theory: Compatible or Not?” (2003) *Journal of Applied Corporate Finance* Vol. 15.3 at 121.

Even assuming the possibility of this model, the issue remains as to which values and standards would inform this particular class of shareholders' judgment regarding the companies that will make 'best' use of capital with a view to their long term interest, and of what constitutes acceptable corporate conduct. Furthermore, allowing that consensus could be reached on such values and standards, they would need to be articulated *ex ante* in such a way that they would set a clear and coherent baseline and provide practical strategic guidance for day to day managerial decision making aligned with the long-term goal.

Just how this particular class of shareholders could be legally differentiated and then expected (and permitted) to act with some degree of cooperation in pursuit of an intangible future goals while still unclear, is less so than in the past with the advent of collective expressions of the institutional investor voice.

13.3.2 Meeting investor expectations – more than the single bottom line

The growing recognition of the importance of responsible business practices and its value in terms of managing investment risk has translated into pressures on companies from investors to deliver high level performance according to measures that are increasingly extending beyond traditional financial measures to encompass environmental, social, governance and other 'non-financial' measures.⁶⁷⁸

The focus on corporate conduct and the need for companies to demonstrate the integrity of their businesses through effective governance, greater internal and external accountability and by sustaining positive relationships with peers, shareholders and the wider community raises many challenges for business. These challenges are also

⁶⁷⁸ See discussion in Chapter 10. Consider also the growth in the number of sustainability indices from fewer than five in 2000 to 51 in 2009. These include: the FTSE4Good series; the NASDAQ OMX GES Sustainability Nordic Index; the Johannesburg Stock Exchange Socially Responsible investment Index; and Wiener Borse VONIX Sustainability Index. Source: World Federation of Exchanges, "Exchanges, ESG and Investment Decisions", September 2010. Online at: <http://www.world-exchanges.org/topics/studies-and-surveys/2010-exchanges-esg-and-investment-decisions>

catalysts and opportunities for positive and sustainable change in organizations provided that ethical, responsible governance practices and increased collective and individual accountability are the standards within business as well as in the wider societal context in which companies, their shareholders and stakeholders co-exist.

Commitment to, and effective communication of, good governance practices will prove to be a significant factor in developing the long standing and mutually beneficial relationships between companies and their investors that will support best practice and enable companies to pursue these opportunities. In this regard, clarifying and working toward substantial congruence between evolving investor expectations – particularly of those taking a leadership role in corporate governance and advocacy – and the changing business context is critical.

As Monks himself concedes “there can be no universal definition of shareholder and no articulating of purpose or interest that will apply to all components of this class at all times”,⁶⁷⁹ however there is a constituency within the universe of shareholders that have broad alignment based on the duration, philosophy and broad purpose of their investment.

The International Corporate Governance Network (the ICGN) was formally established in 1995 as a collective voice and information sharing forum for institutional shareholders.⁶⁸⁰ At that time, corporate governance as part of the investment process was still in the vanguard. However the nearly 40 institutional shareholders involved in establishing the ICGN recognized the need for shared information and a unified means to exert influence on an international scale in order to strengthen their influence in the corporate governance of investee companies and corporate governance standards, generally, around the world. Its global governance guidelines were adopted in 1999,

⁶⁷⁹ Robert A.G. Monks, “Corporate Governance – Past, Present and Future”, November 2010, <http://blogs.law.harvard.edu/corpgov/2010/03/04/corporate-governance-past-present-future>.

⁶⁸⁰ The origins of the ICGN can be traced to “the convergence of corporate governance initiatives in North America and Europe during the mid 1980s”. The creation of an international collaborative network was first put forward in 1994 at a meeting of international institutional investors convened by the United States’ Council of Institutional Investors and the ICGN was formally founded on 29 March 1995 in Washington DC. Online at: www.icgn.org/history.

shortly after and complementing the OECD *Principles of Corporate Governance* issued the same year. As global guidelines, the Principles are intended to be of general application to corporate entities around the world, irrespective of legislative background or listing rules.

The ICGN organization now comprises more than 500 members in 49 countries, the majority of whom are institutional investors who collectively represent funds under management in the region of US\$18 trillion.⁶⁸¹ According to the ICGN, high standards of corporate governance include effective dialogue between companies and their shareholders and these high standards in turn are “a prerequisite for companies to compete effectively and for economies to prosper”.⁶⁸² Alongside the role, function, and expectations of the board of directors, risk management, audit, disclosure and transparency, the *ICGN Global Corporate Governance Principles* emphasise the importance of ethical corporate culture and ethical standards of behaviour in the governance.⁶⁸³

The *Principles for Responsible Investment* (the PRI) was launched under the auspices of the United Nation in 2006 with 56 initial signatories comprising asset owners, money managers and others who endorsed the six principles and pledged to tailor their own processes to reflect the PRI philosophy. That number has grown exponentially to over 880 signatories (including some of the world’s largest financial institutions, pension funds, and service providers) representing about \$25 trillion in assets. Investor signatories publicly commit to adopt and implement the six principles where consistent with their fiduciary responsibilities. In this latter regard, the Principles also explicitly acknowledge that having regard to environmental, social and corporate governance issues achieves better alignment between the interests of beneficiaries, investors and society.

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes

⁶⁸¹ www.icgn.org

⁶⁸² *ICGN Global Corporate Governance Principles*, Preamble. Online at: www.icgn.org

⁶⁸³ *Ibid.* at Principle 3 – Corporate Culture.

and through time). We also recognise that applying these Principles may better align investors with broader objectives of society.⁶⁸⁴

The increasing influence of the Principles alongside the growth in subscription to the PRI philosophy is credited with coordinating and expanding the dialogue around integrating environmental, social and governance responsibility integration to levels approaching mainstream.⁶⁸⁵ Recent statistics show that 80 percent of the Global Fortune 250 now report on ESG issues and increasingly these factors are part of the basis on which investors analyse and assess the risk of prospective investments.⁶⁸⁶

Shareholders' communications to investee companies through the proxy resolution process also provide tangible indications of a growing belief on the part of institutional investors that a company's social and environmental policies correlate strongly with its approach to risk management and potentially, therefore, to its financial performance. In the 2011 proxy season, resolutions on corporate responsibility issues made up approximately 40 percent of all of shareholder proposals subject to a vote at meetings taking place January through June, 2011 as compared to approximately 30 per cent in the same period of 2010. In both years proposals relating to social and environmental policies represented the largest category of shareholder proposals.⁶⁸⁷

⁶⁸⁴ UNPRI, *Principles for Responsible Investment*. Online at: <http://www.unpri.org/principles>.

⁶⁸⁵ Katie Gilbert. "Principles for Responsible Investment Drives ESG Into the Mainstream", *Institutional Investor*, 04 Feb 2011, http://www.institutionalinvestor.com/global_markets/Articles/2761857/Principles-for-Responsible-Investment-Drives-ESG-Into-the-Mainstream.html.

⁶⁸⁶ GMI, the corporate governance research firm formed from the three-way merger of GovernanceMetrics International, The Corporate Library and Audit Integrity, recently launched its GMI Analyst platform that provides corporate stakeholders with ratings of public company ESG risks. The service covers more than 20,000 corporations, comprising most large and mid cap firms with some smaller cap companies, and provides specific, research based ESG risk assessment for 4200 of those companies. The assessment considers more than 50 proprietary ESG metrics as well as the UN Principles for Responsible Investment. Source: Governance Metrics International <http://www2.gmiratings.com/info.php?id=7>. Institutional Shareholder Services (ISS) incorporates the findings of its parent MSCI's ESG Research arm in the proxy assessments provided through its ESG Solutions service. Source: ISS ESG Solutions <http://www.issgovernance.com/esg>. Glass Lewis, another proxy advisory firm, has a risk monitor that incorporates an ESG risk tracking element.

⁶⁸⁷ Statistics from Ernst and Young LLP Corporate Governance Database referred to in Steve Starbuck and Ann Brockett, "Shareholders Press on CSR Risks 2011 proxy season", *directorship.com* (July 28, 2011). Online at: <http://www.directorship.com/shareholders-press-boards-on-csr-risks>.

It was expected that the number of proposals would reach 50 per cent, however a significant number of corporate responsibility resolutions were withdrawn by proponents following substantive dialogue between the proposing shareholders and companies, company action on the subject issue, or both. This latter may suggest an increasing willingness by companies to engage with shareholders rather than to leave proposals to a proxy vote in light of very high levels of support, averaging more than 40 percent of votes cast for proxy proposals on social and environmental issues.⁶⁸⁸ See Figure 17, below.

Figure 13 - Historical Support for Proxy Proposals on Social and Environmental Issues

Historical support for social/environmental proposals by threshold

	2006	2007	2008	2009	2010	2011
>50% support	1%	2%	1%	1%	1%	3%
>40% support	3%	5%	2%	6%	9%	12%
>30% support	9%	16%	15%	18%	27%	32%
>20% support	26%	31%	30%	38%	44%	54%
>10% support	39%	48%	40%	48%	52%	60%

Source: Directorship.com, “Shareholders Press on CSR Risks”, July 2011. By permission.⁶⁸⁹

13.3.3 Ownership and beyond

The idea that a shareholder of a corporation should have a more active voice in corporate decisions enters into the arena of long-standing debate over what is properly a right of ownership and what falls within the purview of those responsible for the governance, management and control of a corporation.

In the United States the former is based on a theory of shareholder primacy – where the shareholder is the principal and the board of directors (and in turn the management they oversee) are strictly agents whose role is to maximize profit in the firm and let the value

⁶⁸⁸ Ibid.

⁶⁸⁹ http://www.directorship.com/media/2011/07/Table_Social-Resp.jpg

accrue to the shareholders.⁶⁹⁰ This theory, while long-established in economic models of the corporation, arguably fails to reflect the legal reality of the corporation as a separate legal entity overseen by a fiduciary board of directors with responsibilities and duties established in law to a broader constituency with a range of interests including, but not limited to, shareholders.⁶⁹¹

In Monks' view this governance debate has become one of corporate power which he believes now seems mostly to be in the hands of a less than optimally accountable executive and board structure.⁶⁹²

As discussed earlier in Chapter Six, in jurisdictions such as the United Kingdom and Western Europe, large institutional and private shareholders, individually and collectively have long established roles in the corporate governance framework.

In Canada, amendments to the shareholder rights provisions of federal corporate law introduced in 2001 made significant changes to the law governing shareholder proposals and communication in Canada.⁶⁹³ The main changes included allowing beneficial shareholders to file shareholder proposals and removing the exclusionary grounds that

⁶⁹⁰ Shareholder primacy rules provide for shareholder voting rights (including the right to elect directors); the fiduciary duty of directors to the corporation and its shareholders; and shareholder right of action to enforce managerial fiduciary duties, either individually or a derivative basis. Lynne L. Dallas, *Law and Public Policy* (Durham, NC: Carolina Academic Press, 2005) 486. They have basis in concepts such as: shareholder property rights; 'ownership' (Melvin A. Eisenberg, "The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm" (1999) 24 *J. Corp L.* 819, 826); shareholders as the holders of residual, unfixed, ex post claims on corporate assets and earnings (Stephen M. Bainbridge, "Privately Ordered Participatory Management: An Organizational Failures Analysis" (1998) 23 *Del. J. Corp. L.* 979, 1068-69); and the firm as a "nexus of contracts" (Lynne L. Dallas, "Two Models of Corporate Governance: Beyond Berle and Means" (1988) 22 *U. Mich. L. R Reform* 19: 49-50, 30).

⁶⁹¹ A majority of American States have adopted so-called constituency statutes. In most of these, managers are permitted (but not required) to take consider the interests of non-shareholder stakeholders, thus expanding the constituency of interests that managers may factor into decision making. See for example: 15 Pa. Cons. Stat. Sec. 1715 (a), (b) (West 1995).

⁶⁹² Robert A.G. Monks, "Corporate Governance – Past, Present and Future", November 2010, Online: <http://blogs.law.harvard.edu/corpgov/2010/03/04/corporate-governance-past-present-future>. For a full discussion, see: Robert Monks and Allen Sykes, *Capitalism without owners will fail: A policymakers guide to reform*, Centre for the Study of Financial Innovation, November 2002.

⁶⁹³ Bill S-11 changes to the *Canadian Business Corporations Act*. The *Canada Business Corporations Act* (CBCA) is the principal federal corporate statute largely modeled on modern business statutes in the United States. Most provinces and territories in Canada also have their own corporate legislation, based largely on the CBCA.

company could previously rely on for refusing to circulate proposals that were long viewed by activists as unfairly restricting their ability to put forward proposals and communicate with other shareholders.⁶⁹⁴ These changes enabled large institutional investors in Canada, including but not limited to pension funds, to take a more active—and proactive – role in the governance of Canadian corporations, both individually and collectively, than the system previously allowed.⁶⁹⁵

In the United States, the notion of institutional investor activism as a panacea for the problems of agency and management self-dealing has had its place in the governance landscape.⁶⁹⁶ The predictions for activist institutional investor driven positive change largely failed to manifest in the last decades of the last century and instead, the activist investor role was overtaken by hedge funds and private equity that exacerbated the speculative, short-term culture that dominated markets over that period.⁶⁹⁷

Despite this, the role of long-term institutional investor is once again at the forefront of governance discourse from policy recommendations to substantive regulatory change aimed at improving the governance landscape in the United States, as well as in the United Kingdom and elsewhere. The 2011 World Economic Forum report *The Future of Long-term Investing* included in its six recommendations, the recommendation that more

⁶⁹⁴ The former exclusionary provisions allowed corporations to refuse to circulate a shareholder proposal if the corporation decided that the purpose of the proposal was primarily to promote general economic, political, racial, religious, social or similar causes.

⁶⁹⁵ For example the initiative leading to the formation of the Canadian Coalition for Good Governance (CCGG) in 2002 was spearheaded by the Ontario Teachers Pension Fund. The CCGG now numbers 47 members representing nearly \$2 trillion in assets under management for Canadian investors. It has published guidelines and position papers on: topics such as: Majority Voting; Executive Compensation; governance Monitoring, Voting and Shareholder Engagement; Say on Pay; and Governance Best Practice. www.ccg.ca

⁶⁹⁶ See examples of US governance scholarship in the 1990's such as: Bernard Black, "Agents Watching Agents: The Promise of Institutional Investor Voice" (1992) 39 *UCLA Law Review* 811 and John J. Coffee, Jr., "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 *Columbia Law Review* 1277.

⁶⁹⁷ Among its findings, the report of the European Union High-Level Group chaired by Jacques de Larosière mandated by the European Commission to review financial supervision, stability and cooperative oversight following the financial crisis, found that these funds may not have been a prime source of events leading up to and during the financial crisis but that their activities amplified cyclical movements in the market with real costs for wealth, economic growth and employment. The report further concluded that their activities were not sufficiently transparent and the associated risks not sufficiently addressed by the existing regulatory and supervisory arrangements.

engaged ownership of public companies by shareholders should be encouraged by policymakers and long-term investors.⁶⁹⁸

In the United Kingdom the government, building on the long history of institutional investor engagement on matters associated with corporate governance and accountability, formalized the code on shareholder responsibility published by the Institutional Shareholders' Committee in November 2009 in the *2010 UK Stewardship Code*.⁶⁹⁹ In doing so it applied the regulatory technique that resembles Dunsire's 'collibration' – a limited strategic intervention by government to use existing tensions between, in this case, market actors to achieve a policy objective by altering the conditions of engagement.⁷⁰⁰

The Preface to the Code states its aims “to enhance the quality of engagement between institutional investors and companies and to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities”.

The Code is administered under the auspices of the United Kingdom's Financial Reporting Council (FRC) and is intended to complement the UK Corporate Governance Code for listed companies as revised in June 2010. It employs a similar combination of principles with specific guidance and a 'comply or explain' requirement with the additional element that the FRC retains on its website a list of those investors that have published a statement on their compliance or otherwise with the Code, and requests that investors notify the FRC when they have done so.

⁶⁹⁸ *The Future of Long term Investing* (World Economic Inc. USA, 2011).

⁶⁹⁹ Final version at <<http://www.frc.org.uk/corporate/investorgovernance.cfm>> accessed 13 August 2010.

⁷⁰⁰ In his discussion paper, 'Manipulating Social Tensions: Collibration as an Alternative Mode of Government Intervention', Max-Planck-Institut für Gesellschaftsforschung Discussion Paper 93/7, August 1993 Andrew Dunsire first defines his concept of “collibration” as an intervention by government to use the social energy created by the tension between two or more social groupings habitually locked in opposition to one another to achieve a policy objective by altering the conditions of engagement without destroying the tension, unless deliberately. See also, A. Dunsire, “Modes of Governance” in: J. Kooiman (ed.), *Modern Governance: new government-society interactions*. (London: Sage, 1993) 21-34 at 29. J. Kirkbride and S. Letza, “Regulation, Governance and Regulatory Collibration: achieving an “holistic” approach” (2004) *An International Review* Volume 12, No. 1.

The Code provisions explicitly address the responsibility of investors to: act in the best interests of all clients or beneficiaries; actively monitor the companies in which they are invested and where appropriate to engage constructively with companies, acting early in the case of identified concerns and according to clear established guidelines regarding active intervention; work collaboratively with other investors where appropriate and particularly in cases of corporate or wider economic risk; and to vote shares held with due deliberation, including registering abstention, and with transparency to investee companies and to the extent possible to those to whom they are accountable, including clients and ultimate beneficiaries.

In the United States, SEC staff, at the request of the Investor Advisory Committee of the SEC, in June 2010 issued interpretive guidance on how boards can pursue dialogue with investors without breaching fair disclosure regulations.

On January 25, 2011, in the footsteps of jurisdictions such as the United Kingdom, Australia, Netherlands, Sweden and Norway⁷⁰¹, the United States Securities and Exchange Commission adopted rule amendments to the *Securities Exchange Act of 1934* concerning shareholder approval of executive compensation and ‘golden parachute’ compensation arrangements. The amendments were to implement the relevant section 951 of the *Dodd-Frank Act*. Section 951 contains provisions relating to shareholder approval of executive compensation and ‘golden parachute’ compensation arrangements.⁷⁰² The amendments also impose various disclosure requirements including additional disclosure regarding ‘golden parachute’ compensation arrangements with certain executive officers in connection with merger transactions.

The SEC's new rules specify that say-on-pay votes required under the Dodd-Frank Act must occur at least once every three years beginning with the first annual shareholders'

⁷⁰¹ See infra note 88.

⁷⁰² Securities and Exchange Commission 17 CFR Parts 229, 240 and 249 [Release Nos. 33-9178; 34-63768; File No. S7-31-10] RIN 3235-AK68: ‘Shareholder Approval of Executive Compensation and Golden Parachute Compensation’. See also: SEC Release 2011-25 ‘SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act’. Online at: <http://www.sec.gov/news/press/2011/2011-25.htm>.

meeting taking place on or after January 21, 2011.⁷⁰³ Issuers are required to hold a ‘frequency vote’ at least once every six years in order to allow shareholders to decide how often they would like to be presented with the say-on-pay vote. Following the frequency vote, a company must disclose on an SEC Form 8-K how often it will hold the say-on-pay vote. Smaller reporting companies are not subject to the first two requirements described above until their first annual or other meeting of shareholders occurring on or after January 21, 2013.⁷⁰⁴

Other *Dodd-Frank Act* reforms aimed at an enhanced shareholder role through the proxy access mechanism are premised on the notion that an empowered and increased investor voice will inject a needed democracy and with it improvements to the governance and accountability of corporations. While proxy access as a mechanism of governance is not a new idea in the United States, and for many an issue already addressed through State company law, the proposals have met with the usual opposition and support.

The provisions of the Dodd-Frank financial reform bill that would have introduced majority voting with the effect that directors would need to gain the support of most of their investors were withdrawn following intensive business lobbying in 2010.

A further proposed area of reform under the *Dodd-Frank Act* involves so-called “proxy access”. Directors of public corporations are nominated and elected each year through a process called proxy voting. “Proxy access” is the expression used to describe the view that major shareholders should be given the right to make their own nominations to the board of directors, rather than being presented with a list of board nominees prepared by the nominating and governance committee of the board – sometimes in consultation with

⁷⁰³ ‘Say on pay’ votes comprise a shareholder advisory vote to approve the compensation of executives and a shareholder advisory vote on golden parachute arrangements in connection with merger transactions.

⁷⁰⁴ Section 951 of the *Dodd-Frank Act* amends the *Securities Exchange Act of 1934* by adding Section 14A, which requires companies to conduct a separate shareholder advisory vote to approve the compensation of executives, as disclosed pursuant to Item 402 of Regulation S-K or any successor to Item 402. Section 14A also requires companies to conduct a separate shareholder advisory vote to determine how often an issuer will conduct a shareholder advisory vote on executive compensation. In addition, Section 14A requires companies soliciting votes to approve merger or acquisition transactions to provide disclosure of certain ‘golden parachute’ compensation arrangements and, in certain circumstances, to conduct a separate shareholder advisory vote to approve the golden parachute compensation arrangements.

management. The latter system is based on the theory that the board is best suited to determine the individuals that have the specific qualifications and expertise needed on the board. Those who advocate for proxy access believe that because the board of directors serves as the representatives of shareholders, shareholders should have the right to nominate their own representatives. Access to the nomination process, also counters the tendency to self-selection exhibited by some boards and in others the risk that the nomination and selection process is essentially captured by the Chief Executive Officer.

The proposals regarding shareholder nominations to boards of directors have at their core a game-changing potential that, arguably, runs counter to the notion of an independent, fiduciary board responsible for the oversight of the corporate entity and the protection of shareholder interests, as a majority concerned with legal protections for minority interests.

If shareholders that pass the threshold test are effectively empowered to place their candidate or candidates on the proxy, and the individual or individuals are elected, the question arises as to whose interests they serve. Will they be able to distance themselves from their nominating base in order to act with the true independence of mind required of board members? Or, will they to all intents and purposes function as an advocate for the interests of their particular shareholder constituency?

In an ideal world, both the selection of individuals by shareholders and those individuals' capacity to function on the board would be free from influence and self-interest. In reality, there is a very strong likelihood that the selection and nomination process and the dynamic of the board will be heavily influenced by vested interests. One can argue that it is ever thus, however to effectively enshrine in new legislation with the stated aim of greater democracy and accountability a means by which the existing independent board governance function can be distorted or even co-opted is a potentially regressive step

exacerbating the third agency problem – that between dominant and other shareholders.⁷⁰⁵

Furthermore, shareholder representatives on boards arguably runs the risk of reducing the economic efficiency of the board as a unitary decision making body. It also runs the risks associated with having a dominant or controlling shareholder, such as weakened minority shareholder rights and the consequential discounting of share prices.

In the United Kingdom, the rights of shareholders to effect change in the boardroom is achieved in a different way. A special meeting may be called by five percent of voting shareholders for the purpose of securing majority support for a proposal to remove any or all of the board. There is no requirement for the requisitioning or voting shareholders to show cause merely to show that the majority of voting shareholders agree to the proposal. This has the benefit of avoiding the potential of litigation or controversy that would arise if shareholders were required to provide or to prove explicit reasons for the removal, while effecting change in the board composition and ensuring a mechanism to hold management accountable for its recommendations for board membership.⁷⁰⁶

Other proposals for governance reform centered on active institutional share ownership suggest solutions that reexamine the relationship and responsibilities of shareholders to the corporations in which they invest while at the same time addressing the challenge that shareholder nominated directors poses to board independence and fiduciary responsibility to all shareholders. For example, a model developed by Richard Le Blanc and Edward Waitzer of the Rotman Business School proposes to place greater responsibility on longer term shareholders within the corporate governance framework through changes to the director nomination process.

⁷⁰⁵ In the event, these provisions were struck down by the United States Court of Appeal for the District of Columbia Circuit, No. 10-1305 *Business Roundtable and Chamber of commerce of the United States of America v. Securities and Exchange Commission*, July 22, 2011.

⁷⁰⁶ S. 168 *Companies Act 2006*

In their model, Le Blanc and Waitzer suggest that corporations would extend director nomination privileges to a constituency of “shareholder-trustees” identified by level and duration of shareholding and, importantly, a willingness to commit to fulfill duties of care and loyalty to the long-term interests of the corporation over their own interests in their exercise of the nominating power. This latter condition establishes the shareholder-trustees as limited purpose corporate fiduciaries, effectively obligating them to exercise due diligence in the identification and selection of prospective directors and ongoing monitoring of director performance from the perspective of the long-term governance needs of the corporation.⁷⁰⁷

Ultimately, providing institutional investors a greater role and voice in the conduct and governance of business will only serve to rebalance the inequities and risks imposed on society by failures of corporate responsibility if the institutional investors hold management, and themselves, to a broader accounting.

History has shown that investors become more vocal when they feel their interests are not well served by the businesses in which they are invested. This roughly translates into the principle that investors are generally content, or passive, when they are seeing equity gains and a steady income and become more active when there are losses, poor relative performance, or an actual or perceived misalignment between their interests and those of management. The payment of huge bonuses and golden handshakes during bear markets are an obvious example of red flags to embattled shareholders, regardless of investment horizons.⁷⁰⁸

⁷⁰⁷ Richard W. Leblanc and Edward J. Waitzer, “A New Way to Empower Shareholders – For the Long Term”, *Financial Post*, June 7, 2010.

⁷⁰⁸ Although in my experience longer term investors have a tendency to understand the need to retain and motivate capable management and employees through bad times as well or more than good, provided the bad times are not of their own making.

Part Six – Closing

14. Ethics as First Order Regulation: Principles, Process and Responsibility

*“In an ideal, better world moral conduct and integrity would be the driving force, not [the fear of] the consequences for wrongdoing.”*⁷⁰⁹

Aristotle

14.1 A First Principles Approach

The discussion in chapters three and four in particular and throughout the ensuing pages seeks to illuminate the challenges, limitations and unintended consequences of defining and addressing ‘the problem of governance’ in a reactive fashion. That is, by creating a framework from which to approach the problem of governance based on the outcomes and symptoms of governance failures and lapses and then, within that framework, seeking to engineer solutions.

Albert Einstein is reported to have said, “[T]he significant problems we face cannot be solved by the same level of thinking we were at when we created them”.⁷¹⁰ What this suggests is that in order to find solutions to ‘the problem of governance’, one must define and frame the approach to the problem at a level that is removed from the empirically based analysis of ‘what went wrong’.

It is well established in philosophy that ‘the problem of governance’ is the last in a triad of overarching issues that starts with ‘the problem of knowledge’ followed by ‘the problem of conduct’.⁷¹¹

⁷⁰⁹ Attributed to Aristotle.

⁷¹⁰ According to Alice Calaprice editor of the *The New Quotable Einstein* (Princeton New Jersey: Princeton University Press, 2005) 292 the quote is thought to be a paraphrase of Einstein’s 1946 observation that “[A] new type of thinking is essential if mankind is to survive and move toward higher levels”.

⁷¹¹ Daniel N. Robinson, *Great Ideas of Philosophy* 2d (Chantilly, VA: The Great Courses, 2004).

The first issue, the ‘problem of knowledge’ addresses the nature, source and meaning of information and how that translates into knowledge. It includes the consideration of empirical knowledge derived from experience and observation, but extends beyond that to engage with fundamental truths and principles that appear to be innate, or to have an existence *a priori* empirical knowledge, and arguably are necessary presuppositions for empirical knowledge. These include the principles of logic and mathematics.

The second issue, the ‘problem of conduct’ attends to the consideration of how one ought to behave. Ethics provides the framework as well as a set of tools, or principles, to assist in this inquiry.

With a first principles approach, the ‘problem of governance’ necessarily follows the resolution of the other two. This is because it is only once the capacity to acquire knowledge, to frame questions and to seek answers is established, that one can turn to specific questions regarding the manner of ethical, or good, conduct. The knowledge of what constitutes ethical conduct in turn provides the basis upon which to plan or direct the course of action and to resolve conflicts at the level of conduct, in other words, the basis for governance.

In the regulatory context, a first principles approach to the conduct and governance of business operates to widen the regulatory lens from a narrow historically, institutionally, and culturally determined focus. It allows regulators to step back from debate over the level of intervention and the choice of method to direct, control, or limit certain behaviours. From this vantage, the regulatory perspective can encompass the fundamental values and the original purpose that public regulation was intended to serve as well as the outcomes and ends pursued.

This wider perspective also accommodates a range of the most effective means to achieve and protect the public goods of efficient, trustworthy capital markets in a dynamic environment. It broadens the regulatory discourse to include consideration of alternative forms and sources of regulation – beyond the constraints imposed through traditional

nation-based rules and legislation – from which will emerge the opportunities to develop methods beyond those conventionally associated with government legislators and regulatory authorities. For examples, it facilitates innovations such as the enabling legislative approaches in France, the United Kingdom and other jurisdictions that require companies to have due regard to the benefits of diversity on boards.

A return to first principles provides an opportunity to establish the level and extent of engagement between regulator and regulated parties and the nature and content of discourse that will ensue. An engagement that might, as Hector Sant former Chairman of the United Kingdom’s FSA has suggested, include proactive interventions by regulators where the culture and ethics of a firm or business sector are at odds with societal expectations of ‘right behaviour’.⁷¹²

It allows also regulators to explore approaches to corporate governance that originate from different theoretical conceptions of the corporation, such as the stakeholder oriented model in Germany and France and to acknowledge and accommodate the persuasive influence of values based guidelines and standards issues by non-governmental and quasi-governmental entities.

At its most fundamental level, a first principles approach takes one back to the beginning.

14.2 Deconstructing Governance

The term governance, from the Latin *gubernare* ‘to steer, with the base verb from the Greek *kubernan* ‘to steer’⁷¹³, conveys a sense of both direction and action. In practice, an entity’s governance is both constitutive and dynamic, or in other words, the constant state of its being and the changing state of its doing.

⁷¹² Hector Sants, “Do regulators have a role to play in judging culture and ethics”, June 2010, Speech to the Chartered Institute of Securities and Investment Conference. FSA/PN/101/2010. In this speech, Sant cites studies by behaviouralist and ethicists such as Roger Steare and established industry and professional codes that describe what is expected, or in other word ‘right behaviour’.

⁷¹³ *The Oxford Dictionary of Word Histories* (Oxford University Press, 2004).

This binary aspect is frequently at risk of being overshadowed or lost altogether, in the ongoing debate and pursuit of what constitutes good governance. On the one hand, making the constitutional dimension of governance the sole focus of attention risks an overemphasis on formal structures, processes, and organization leading to a rigid, inward perspective that may ultimately limit the capacity to act. Efforts to achieve effective governance by attempting to predict and enumerate exhaustively and for every possible circumstance, the action and conduct required are reaching for an unattainable goal, even if the time and resources were available.

Equally, emphasis only on the operational dimension runs the risk of losing control and direction in the absence of the means to ensure responsibility and accountability for decisions and actions taken.

Instead, effective governance depends on a set of elemental and irreducible principles that establish a strong foundation, provide a clear sense of purpose, and create a framework that enables rather than constrains decision makers. It must also allow those decision makers flexibility in the face of complexity and unpredictability without comprising integrity or the responsibility for their choices and the consequences of their actions. Without these, governance is a hollow set of authoritarian dictates and formal structures and processes devoid of intention.

Effective governance, however, is not necessarily good governance. For governance, whatever the institutional setting, is a qualitatively neutral term. It connotes neither good nor bad, nor anything in between. Furthermore, the measure of goodness itself is highly subjective and contestable. There are countless examples throughout history and in every sphere of governance that have satisfied quantitative assessments of effectiveness and highly subjective standards of goodness largely based on the degree to which it has served powerful vested interests.

As the discussion in the preceding chapters has sought to demonstrate, there is a perceptible shift in the measures and standards by which governance is assessed and in

the associated discourse as to its qualitative dimension. So, if the goal then is not just effective formal governance, but *good governance* according to this wider construction, it is necessary to look to sources other than narrow economic efficiency, influence and power over people and resources, and profit at the expense of society and the environment.

14.3 Establishing the ‘Good’ in Governance

Ethics comes from the Greek (he)ethike(tekhne) ‘(the science of) morals with its base in the Greek ethos meaning ‘nature, disposition’.⁷¹⁴ Nature and disposition are the essence of conduct, and a moral nature or disposition is the foundation of good conduct that in turn the basis of good governance.

Fundamental norms of ethical conduct generally include: fairness and honesty; inclusiveness; integrity; justice; and transparency. These norms are embodied in principles that require consideration of those whom are, or may be, affected by the implications or consequences of an action, deed or word.

The expression of overarching statements of ethical principles and the underlying norms, or values, creates an explicit, shared frame of reference. This common referent can guide and inform the nature, process, terms and standards of engagement that enable the pursuit of shared understanding and informed discourse, as well as help to achieve consistency and common standards of accountability that constitute a safeguard against dishonest and unethical behaviour. Such processes and standards are core to the establishment of the trust necessary for constructive dialogue and effective engagement that can ultimately lead to good governance.

A decision and accountability framework built on these foundations does not lead to one definitive outcome or binding precedent, but a resolution that is defensible in process and

⁷¹⁴ *The Oxford Dictionary of Word Histories* (Oxford University Press, 2004).

substance and has legitimacy from the inclusiveness and diversity of perspectives from which it derives.

Ethics pertains to situations where “the right thing to do” is in question, and the outcome of the decision affects other people. The ultimate goal is not only a decision as to how to proceed, but a shared understanding of how the decision satisfies the ethical test. It builds this shared understanding through openness to the truth, acceptance of responsibility, and a commitment to setting things right.

Thus, while governance is about how organizations conduct themselves generally, and the rule of law is largely about setting the necessary minimum societal constraints on such conduct, ethics is primarily about understanding implications and consequences, adopting a social perspective, and making choices within (and in the normative domain beyond) the legal baseline, and the principles that go to ensuring those decisions and the actions that follow are ethically sound, fair and defensible.

14.4 Ethics and Governance: A Question of Problematization

The conceptual challenge that has long been identified as the ‘problem’ of ethics as a reference for corporate governance and the regulation of business conduct is actually a function of the fact that it has been perceived as a problem in the first place.

Phillips contends that this is in part a function of how organizational ethics scholarship has translated classical theory into models of so-called business ethics ranging from utilitarian business ethics, Kantian business ethics, Aristotelian business ethics, and social contractarian business ethics that, from a practical perspective, inadequately meet the complex obligations of business organizations.⁷¹⁵

The role of ethics in relation to the conduct and governance of corporate entities and the individual agents that animate them has been problematized as the absence, in the ethical

⁷¹⁵ Robert Phillips, *Stakeholder Theory and Organizational Ethics* (Berrett-Koehler Publishers, 2003) at 7.

process, of the certainty of absolute answers, the authority of precise instructions or specific direction, and the guarantee of infallible decision making.⁷¹⁶ That is, an adherence to ethical principles will not lead directly to authoritative, black and white determinations of right and wrong, nor provide the nominal protections of purely formal or technical compliance with requirements, referred to colloquially as ‘box-ticking’.

This conventional problematization reflects a legal positivist perspective, one that emphasizes the connection between the fact of law and the role of authority and imposed rules over content and process in achieving governance outcomes.⁷¹⁷ This perspective can lead to a perception of ethics in relation to governance that fails to appreciate the strength of precisely that with which it finds fault – the dialogic process and the underlying principles. Instead, ethics can and should be understood and valued as a socially constituted dialogic process and decision making framework that is neither intended to yield *ex ante* fixed and certain prescriptions of right and wrong, nor reliant on the dictates of authority.

The very fact that ethics operates in the normative domain enables decision makers to anticipate and adapt to change far more quickly than if they relied on and acted exclusively according to formal rules, prescribed processes and controlled inputs. The recognition that this has the potential to yield tangible practical benefits, shifts the focal point of any exploration of the relationship between ethics, governance, and the law to the value in taking an ethical approach to ‘regulatory’ dialogue – whether legal or norms-based, internal or external.

⁷¹⁶ See for example the discussion of the limits, or ‘boundedness’, of ethics and morality in economics in Thomas Donaldson and Thomas W. Dunfee, “Toward a Unified Concept of Business Ethics: Integrative Social Contracts Theory” (1994) *The Academy of Management Review* Vol. 19, no. 2: 252, at 256 - 259.

⁷¹⁷ H.L.A Hart in his positivist theory of law contended that legal norms function as peremptory and independent of content. Peremptory in that such norms displace the deliberative process whereby all reasons are articulated and weighed against possible courses of action. Independent of content in that its authority derives from the status of the issuer, not the content of the reason. The result being that individual reasons for action are subordinate to the legal rule and that rule is and of itself sufficient reason to act as directed. For further discussion see “Economic Rationality in the Analysis of Legal Rules and Institutions” by Lewis A. Kornhauser in M. P. Golding and W.A. Edmundson (eds.) *Philosophy of Law and Legal Theory* (Blackwell Publishing Ltd, 2005).

Ethically based decision making is a continually evolving process. The potential value of this social resource lies in the very fact that it is adaptable to changing circumstances, develops over time, and the outcome of the process will be that which the situation and the due consideration of the nature and consequences of decisions requires. Further, it necessitates that each new circumstance receive fresh application of, and deliberation according to, fundamental ethical principles in different spheres and circumstances.

As a regulatory mechanism, ethics provides a decision making discipline and framework that enables decision makers to advance defensible positions suited to circumstances, freeing them from conflict with the regulatory primacy of imposed pre-determined rules aimed at efficient solutions, certain outcomes and definite answers. In the latter case, static sets of rules can prove to be limited or weakened in the face of complexity – such as choosing between equally legal or not strictly illegal alternatives that nonetheless have varying consequences and negative externalities and involve conflicting responsibilities to a range of stakeholders. Furthermore, a system that operates through blind reliance on fixed responses reduces, or eliminates altogether, the exercise of responsibility and the capacity to respond in the face of novel situations or uncertainty, or to take appropriate remedial action in the face of crisis. This in turn leads to a lack of accountability and heightened levels of risk.

It is not possible to legislate for integrity or to mandate ethical behaviour through edicts from the top and the imposition of objective, top-down processes and procedures. Instead, it is the individuals within an organization who safeguard organizational integrity through their actions and behaviour, not just in prescribed and pre-determined circumstances, but also and more importantly in the grey areas of unanticipated and new situations where they must take responsibility, apply the tools of good decision making, and demonstrate their accountability.

The discipline of engaging in a decision making process governed by ethical principles builds the capacity to consider a range of approaches and possible outcomes that goes beyond compliance with the minimum required by law. In such circumstances, the ability

to demonstrate that decisions taken or stances on particular issues are the result of the application of established ethical norms and principles combined with due and prior consideration of the circumstances – variables such as time, place, social and physical context – and of the implications and potential consequences of a range of possible choices on those affected is powerful evidence of both integrity and accountability.

Research into the business benefits of corporate responsibility have found evidence that businesses with decision making models that embed proactive identification and consideration of the impacts, consequences and associated risks and rewards of particular courses of action have a greater capacity to make informed strategic choices, to take responsibility for them, and to more effectively manage and learn from the outcomes.⁷¹⁸

Habermas in his work on ‘discourse ethics’ contends that the construction of publicly binding norms can only claim rational legitimacy to the extent that the process is one of open discourse, free argument and the exchange of reasons between all parties affected by them.⁷¹⁹

In this construction, the plurality of considerations, interpretations and potential resolutions are the substance of a necessary dialogic process. The *purpose* of the dialogic process is to discern the essential meaning, implications and consequences for those who are engaged and affected (directly or indirectly), rather than deferring to a single authority or resorting to an authoritative source (such as the law) in order to identify possible solutions. The *process* is about developing the attributes necessary to reach shared understanding at least to the extent that it enables recognition and acceptance of a range of approaches leading to defensible outcomes. In this way, the nature of the decision making process can become as important as the outcomes of those decisions,

⁷¹⁸ BITC and the Doughty Centre for Corporate Responsibility, “The Business Case for being a Responsible Business” (Business in the Community and the Doughty Centre for Corporate Responsibility, Cranfield School of Management, March 2011).

⁷¹⁹ For Habermas’ exploration, development and application of his concept of discourse ethics, see: J. Habermas, *Moral Consciousness and Communicative Action* (Cambridge: Polity, 1992) and J. Habermas, *Justification and Application* (Cambridge: Polity, 1993).

particularly where there is no absolute standard against which to measure or judge such outcomes.

More often than not the myriad rules and prescriptions of ‘command and control’ governance regulation and also the principles of lighter approaches, become divorced from the core purpose they serve. That is, where the requirements are expressed without clear articulation of the fundamental underlying issues and objectives behind them, the systems and processes that develop to implement and comply with the requirements follow the letter without regard to the spirit: eventually it is the systems and processes that become the focal point not the reasons for them.

Ethics potentially offers a more complete form of business conduct regulation than any externally imposed set of rules, regulations or internalized norms. This is because ethics provides a set of consistent, foundational principles – including, fairness, honesty, inclusiveness, integrity, responsibility, transparency, and accountability – that inform decisions as to conduct, independent of circumstances. More than that, it provides a flexible framework that supports considerations not only of ‘what’ action to take, but also engages individuals in a process that involves the more fundamental questions of ‘why’, ‘how’ and, indeed, ‘whether or not’ of action.

15. Conclusion

15.1 Commitment and Action

Business conduct, governance and accountability have received unprecedented worldwide attention following a spate of transgressions that have occurred on a scale, and with repercussions, that seem to extend each time further than the previous.

This attention has prompted both public and private sector leaders to revisit yet again the ‘problem of governance’ amidst a changing corporate landscape punctuated by: increasingly activist shareholders; more vocal and influence-wielding stakeholders; and a worldwide demand for businesses to demonstrate greater social, as well as financial, responsibility and accountability.

In the United States, the political response is repeated passage of swift, wide-reaching prescriptive legislation in response to a call for action from the highest level of government. Other nations, such as the United Kingdom, have resolved to strengthen but continue with hybrid system of norms, principles and rules directed at the behavioural and cultural roots of business conduct.

Process aside, ethical corporate leadership and responsible business practices by businesses – in their domestic and overseas operations – are becoming a public expectation. Meeting this expectation is being recognized as a potentially vital ingredient for long-term commercial success and value creation.⁷²⁰

⁷²⁰ The 2011 Edelman Trust Barometer© locates “transparent and honest business practices” in nearly equal position to product quality in rankings of reputation factors and a 2007 Weber-Shandwick poll found that the corporate executives surveyed estimated that 63% of their companies’ market value is due to reputation. Sources: Edelman 2011 Trust Barometer, Trust has Tangible Benefits” (video), <http://www.youtube.com/watch?v=viXTQBBy258>, January 2011; Weber-Shandwick, “Safeguarding Reputation: Strategies to Recover Reputation”, Issue No. 1. Online at: http://webershandwick.com/resources/ws/flash/Safe_Rep_Reputation.pdf, March 2007. A recent report from the UK’s Business in the Community and the Doughty Centre for Corporate Responsibility, Cranfield School of Management has found evidence that responsible business has direct financial benefit to companies over the longer-term. Businesses’ capacity to link responsible or sustainable corporate actions

The corporate and financial scandals of the last decade and a half have prompted more *explicit* recognition of the importance of ethical and responsible business conduct by the business and investment communities themselves. Increasingly, successful business and responsible conduct are viewed as mutually reinforcing rather than mutually exclusive.

Business leaders and companies that operate according to high standards of conduct and integrity, and with a commitment to positive action, recognize this changing landscape as an opportunity to influence and shape the standards for corporate best practice. In doing so, they stand to differentiate themselves and their businesses from competitors and peers who choose to react only when standards are prescribed, and only to the minimum extent necessary to satisfy mandatory compliance obligations.

However, realizing the value in a commitment to adhering to standards beyond any prescribed minima and compliance-driven regime goes beyond words. It needs to inform strategy, decision making and actions throughout organizations. True confidence in business integrity comes not from tacking on something additional or peripheral to the primary business objective – being profitable and successful – but from the commitment to make higher standards of conduct an integral part of how business goals are pursued. Without this, any number of codes of conduct, laws and regulations will not guarantee against misconduct, or worse.

The responsibility for improving confidence in and within the business sector is not solely that of business or government, but instead must be shared. Constructive cross-sector engagement on policies, processes and desired outcomes is critical to ensuring that greater financial, environmental and social accountability and increased observance of worldwide standards of governance ‘best practice’ enhance, not hinder, the fair

on the one hand and the measurement or quantification of the financial impacts on the other is still developing, however since the study was first conducted in 2003 there is a significant body of research showing direct financial benefits that include: better access to capital, lower penalty payments, cost savings, enhanced investors relations and increased shareholder value. BITC and the Doughty Centre for Corporate Responsibility, *The Business Case for being a Responsible Business* (Business in the Community and the Doughty Centre for Corporate Responsibility, Cranfield School of Management, March 2011).

competitiveness and sustainable profitability of businesses in domestic and international markets.

In a complex, ever more interdependent world, the nature and extent of issues for which a company has, or is expected to have, responsibility varies widely according to the nature, size, sector and location of business operations. In each case, a company's governance – a reflection of the organization's ethos – will be manifest in its recognition and handling of these issues and the measure of its integrity, honesty and trustworthiness in the marketplace, in the workplace and in the communities in which it operates.

The advent of vastly more dispersed corporate activity – to such an extent that it is possible to escape conventional legal and social boundaries in order to pursue and exploit market and opportunities – has realized the possibility of commercial licence without restriction. Yet modern communication technology, for all that it has enabled this market evolution, has also served to shrink that unfettered zone of activity – re-establishing those behavioural bounds through powerful social mechanisms of knowledge sharing, constructive challenge, calls to account, public boycott and shaming, lost reputation, and revoked licence to operate that are demonstrated to impact both wider and more narrow, economically defined interests.⁷²¹

15.2 Ethics as a Meta Regulatory Framework for Governance Discourse

The meta concept invokes complex systems thinking – that is, understanding interactions within systems as 'living'/dynamic interconnections between changing and evolving constituent parts. A meta framework is 'a framework of frameworks' operating *at the meta level* as an overarching conceptual framework for all stakeholders to agree on, and *at the operating level* as an organizing structure for any number of constituent

⁷²¹ Numerous studies have shown that the fear of damage to reputation, negative publicity, or non-legal sanctions is a strong incentive for compliance, see for example: Coombs, W.T. "Protecting organizations reputations during a crisis: the development and application of a situational crisis communication theory" *Corporate Reputation Review* 10(3) 163-176 at 164. E. A. Posner, *Law and Social Norms* (Harvard University Press, 2000); D. Charny, "Nonlegal sanctions in commercial relationships" (1990) *Harvard Law Review* Vol. 104, No.2, 373-467.

frameworks for engagement, practice and operation and for regulation, evaluation, measurement, and adjudication.

While a meta framework exists conceptually as an umbrella or overarching structure and/or process for managing and understanding other constituent structures and processes, the overall integrity of the whole structure (meta framework) exists independent of its constituent or component parts.

Exploring ethics as a meta-regulatory framework for evolving governance discourse, engages the proposition that the search for an optimal framework for regulating business conduct and governance is best pursued at a meta-level rather than at an operating level, where divergence and diversity in regulatory strategy and practice is as much a function of cultural and historical factors and artefacts, as of institutional choices.

Ethics operating at the level of a meta-framework, that is a ‘framework of frameworks’, serves to regulate the governance regulatory discourse. It does so by providing a set of *ex ante* principles and an embedded discipline for fair, inclusive and thorough consideration of the implications and consequences of actions before choices and decisions are made. These, in turn, strengthen the accountability and defensibility of the processes and outcomes of regulatory and self-regulatory choice by making explicit the endogenous and exogenous constraints needed to ensure balance and integrity in the larger system.

The expression of overarching statements of ethical principles and values can also create an explicit, shared frame of reference. These principles and values can guide and inform the nature, process, terms and standards of engagement that enable the pursuit of shared understanding and informed discourse as well as help to achieve consistency and common standards of accountability that constitute a safeguard against dishonest, unethical behaviour. Such processes and standards are core to the establishment of the trust necessary for effective engagement and constructive dialogue, let alone the fair and efficient functioning of markets.

This more cohesive and holistic approach to the regulation of conduct and governance within a socio-economic context is more likely to lead to mutually beneficial outcomes than either a rigid set of prescriptions, or the largely unfettered pursuit of myriad unilateral objectives without regard for the wider societal implications or impacts.

For example, governance discourse between business and stakeholders, if conducted within an explicitly ethical framework, can facilitate the exchange of commercially and socially valuable knowledge without the risk that participants will use power asymmetries to make unfair demands, exploit others to their own advantage, or control outcomes.

For boards of directors an ethical frame of reference can strengthen decision-making processes by enabling a wider consideration of potential opportunities as well as more informed and defensible judgment of the materiality of risks through a greater understanding of the implications and consequences of decisions on the rights and interests they affect.

Finally, explicit reference to the principles of ethics as an essential element of regulation, by whatever means, effectively transcends or precedes secondary debate over regulatory form and the ensuing contest over the primacy of one method or another. Further, it greatly enables the consideration and adaptation of different and new regulatory approaches. The value in this is not so much as a means of bridging regulatory ideological divides, as an acknowledgement that those approaches allow for the broadest interface between the substance of norms, rules, and legal discourse and the greatest potential for achieving societally desirable and durable outcomes notwithstanding diverse cultural, institutional and structural contexts.

With the aim of identifying and actively giving fair and full consideration to the implications and consequences of decisions and actions on those affected by them – particularly those most vulnerable – the latter route embodies the process of informed dialogue and responsible choice at the heart of the pursuit of ethical conduct.

We must get beyond debating whose definition, beyond choosing which narrow lenses through which to view each issue or circumstance, and beyond taking unilateral and one-size fits all approaches. What is needed is more recognition of the value of governance discourse in and of itself as a means to engage different perspectives and through the dialogic process build a normative framework that enables and supports ethical business conduct and good governance.

The practical examples of the preceding pages give substance to the notion that there is value in taking into account the perspectives and values of the regulated as well as the regulator (as custodian of the public interest), shareholders and the boards who represent their collective interests, internal and external social stakeholders. There is benefit to conscious consideration of what is important and material to the relationships between these different groups. However, if language and actions are disconnected, if they fail to resonate with stakeholders, or both, there is a good chance they will be viewed with distrust and skepticism at best and destined to fail at worst.

If society explicitly acknowledges honesty and fairness as fundamental values, and the regulation of conduct and governance is expressly acknowledged as an essential part of efficient and trustworthy markets, it follows that there can be acceptance of the need to impose principled restraints on the abuse of power and other distributive and social inequities that, unfettered, would lead to elite participation and benefit enjoyed by the few at the expense of the many.

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Appendix One – List of Notable Scandals

Australia:

One.Tel 1991

Bermuda:

Global Crossing 2002

Tyco 2002

Canada:

Nortel 2003

Italy:

Parmalat 2003

Netherlands:

Royal Ahold 2003

Royal Dutch Shell 2004

United Kingdom:

South Sea Company 1720

Polly Peck 1990

Robert Maxwell/Mirror Group 1990

Bank of Credit and Commerce International 1991

Barings Bank 1995

United States:

Mississippi Company 1719

Railroad Scandal 1841

Northern Pacific Railroad 1873

Ponzi Pyramid Scheme 1920

Kreuger & Toll 1929

Middle West Utilities Holding Company 1929

National City Bank 1929

Wall Street Stock Market Collapse 1929

McKesson & Robbins Company 1938

Saving and Loan Scandals 1980s

Drexel Burham Lambert 1989

Enron 1991

Adelphia 1992

ImClone Systems 2002

Qwest Communications 2002

WorldCom 2002

AIG 2004

Bernard L. Madoff Investment Securities LLC 2008

Lehman Brothers 2010