

C. S. Shann Turnbull PhD
Principal, International Institute for Self-governance
PO Box 266 Woollahra, Sydney, N.S.W. 1350
Ph: +612 9328 7466; Fax: +612 9327 1497
sturnbull@mba1963.hbs.edu

Streamlining Prudential Regulation Project
André Moore, Manager
Prudential Policy — Superannuation and Insurance Unit
Financial System Division, The Treasury
Langton Crescent, PARKES ACT 2600

Dear Sir

Streamlining Prudential Regulation with Self-enforcing Co-regulation

This submission may be made public. It does not specifically respond to your “Proposals Paper” that is based on the current government strategy to regulation that I submit cannot achieve the stated objects. That is for:

ensuring that Australians are protected by a strong and effective prudential framework without placing unnecessary regulatory burdens on business. In addition to implementing the recommendations of the various reports, the Government has identified further areas where it considers that the prudential regulation framework can be simplified and its flexibility and effectiveness improved.

The current top down strategy cannot meet the stated objectives because the “Law of Requisite Variety” of the science of communication and control “absolutely prohibits any direct and simple magnification but does not prohibit supplementation” of regulation, (Refer to *An Introduction to cybernetics*, by Ross Ashby, page, 268 University Press, London, 1968.)

The Law of Requisite Variety means that the ability to control many variables requires that there are a requisite number of controllers. This is why body contact sports specify equal number of people for opposing teams.

In the case of APRA or AISC it is simply not practical or desirable to increase the staff to obtain requisite variety of staff to control the number of directors, auditors and organizations being regulated. To obtain sufficient variety of controllers, co-regulators are required to supplement them.

Auditors are supposed to carry out the function of a co-regulator but they lack the practical independence to be effective even though they may meet industry and legal tests of independence as explained in a number of my articles such as:

- ‘How US and UK Auditing Practices Became Muddled to Muddle Corporate Governance Principles’, The ICAI Journal of Audit Practice, Volume II, No. 3, pp. 49–68, (July 2005), <http://ssrn.com/abstract=608241>
- ‘How can auditors lie about being independent?’, *Keeping Good Companies*, Chartered Secretaries Australia, November, 58:10, pp. 582–583, 2006.

Streamlining Prudential Regulation with Self-enforcing Co-regulation

- ‘Empowering Auditors’ *Charter*, pp.70–71, Australian Institute of Chartered Accountants, Sydney, November, 2006.

Both the HIH Royal Commission report and the 2004 APRA report on the NAB foreign currency fraud provide evidence that it is not prudent for either APRA or ASIC to rely upon audit reports when Auditors are engaged by the directors being regulated. This means that Auditors cannot fulfill their role as co-regulators with current arrangements.

In any event there are an insufficient number of auditors to provide a requisite variety of co-regulators. To obtain sufficient variety of co-regulators, members of the public that the government is seeking to protect need to be empowered to become co-regulators. Only a small percentage of the public may be interested in volunteering their time and resources to supplement regulation but this can still provide a much more economical, efficient and effective strategy than the current approach.

Ralph Nader has proved how it works with the establishment of Citizen Utility Boards (CUBs) in the US as described by Givens, B. 1991, *Citizens' Utility Boards: Because utilities bear watching*, Centre for Public Interest Law, University of San Diego, School of Law, California.

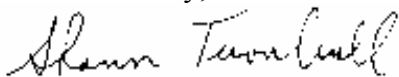
How this bottom up self-enforcing co-regulatory strategy could be introduced on an incremental basis for the Australian Superannuation Industry is explained in my article being published this year in April by the Australian Superannuation Funds Association in their Journal *SuperFunds*. The article (ATTACHMENT I) is part of this submission with its working title: ‘Fiduciary duty of Trustees to introduce self-regulation’.

The bottom up co-regulatory self-enforcing strategy described in the ASFA article is also presented in my submission to the ASX on its review of its Corporate Governance Principles dated December 28, 2006. The submission ‘Corporate Governance Principles based on OUTCOMES not practices’ (ATTACHMENT II) is also attached as part of this submission as it provides additional details of the strategy for corporations in general. It is also relevant to prudential regulation as APRA requires companies to adopt the ASX principles that are counter-productive in providing prudential protection. Additional details of how a co-regulatory strategy could be introduced to improve corporate performance with much simpler regulation is set out in my 2005 submission to the Joint Parliamentary Committee Inquiry into Social Responsibility archived <http://ssrn.com/abstract=800904>.

Both attachments describe how the recommended alternative bottom up self-enforcing co-regulatory strategy could be introduced and tested on an incremental basis. APRA and ASIC could facilitate and promote the approach by providing exemptions from current regulations on the basis superior provisions being put in place as outlined in the two attachments.

I would welcome the opportunity to explain and/or develop these proposals further.

Yours faithfully,



Shann Turnbull PhD
Principal

Streamlining Prudential Regulation with Self-enforcing Co-regulation

ATTACHMENT I

Fiduciary duty of Trustees to introduce self-regulation

Shann Turnbull*

Its time for the superannuation industry to consider how to reverse the current excessive, costly, and questionably effective raft of laws and compliance processes introduced by the government and its regulators.

The current top down regime needs to be replaced with a bottom up self-enforcing approach using contributors of funds as co-regulators. Without stakeholders being empowered with the will and means to act to look after themselves, service providers, let alone the regulators, do not have the capacity to reliably protect citizens in a manner desired by Parliament.

The ASFA Research Centre reports that compliance costs typically increased from 10% to 20% of total administration costs over the last couple of years. This helps to explain their findings that “Increases in administration costs of 20% or more per year have been recorded.

Members of superannuation funds are now bearing annual compliance costs of \$180 million p.a. This cost would fund the maximum allowable single aged pension for over 13,500 single voters. The cost per member of APRA supervised funds is accelerating as members migrate to the Australian Tax Office regulated Do-It-Yourself (DIY) funds. The excessive cost or regulation has created market forces to make DIY funds the fastest growing industry sector.

Over \$42 million of the compliances cost is a direct payment to the government as a “supervisory levy” to fund APRA and ASIC. Compliance costs incurred by the 500 or so funds supervised by APRA are \$135 million. It is time the industry demanded value for money and an education program for the regulators rather than for those being regulated. In the same way ASIC establishes training outcomes for licensees pursuant to their Policy Statement 146, the industry should establish regulatory outcomes for Parliament to evaluate APRA and ASIC.

The opportunities for achieving benefits for members are significant from introducing a self-enforcing regime. Some large retail funds are spending over \$10 million a year in compliance costs. Every Trustee has a fiduciary responsibility to educate the government on how a more cost effective prudential regime can be introduced. For Funds that lead the way, it could provide attractive marketing opportunities. It would also stop the loss of market share to DIY funds that attract the more profitable high net worth individuals.

The first step is for each fund to report to their members how government compliance costs reduce their benefits. The next step is for the industry to design, implement and test an alternative co-regulatory regime to provide leadership and role models.

The replacement of the current conflicted, unethical and flawed practices described below could be introduced on a case by case basis as more efficacious arrangements were proven. The government and its regulators could create incentives for this process by providing exemptions’ from their compliance regime made redundant by superior less costly self-enforcing means. In this way

Streamlining Prudential Regulation with Self-enforcing Co-regulation

competitive pressures would be created in the private sector to race to the top for achieving improved system integrity.

A bottom up self-enforcing prudential system would change the functions of government as envisaged by former US Vice President Al Gore. Gore saw the role of government as being to “imprint the DNA” of self-regulation into social institutions. DNA provides instructions on how to build the complexity of living things that must become self-regulating to sustain their existence. Nature achieves self-regulation using minimal energy and materials that do not inhibit diversity, competition or the survival of the fittest.

The way in which evolution designs the communication and control architecture of living things has been identified by scientists. The design rules for self-regulation in nature are now used to build self-governing devices like automatic elevators and space robots. But the science of self-regulation does not have to be rocket science. There are just a few basic laws that need to be considered. The problem is a lack of knowledge of how to apply them to financial services.

This problem was noted by Gore in 1996 who pointed out that in the US Congress “you’ll find well over 150 lawyers, but only six scientists, two engineers, and one science teacher among the 535 people in the House and the Senate. As a result, scientific concepts sometimes elude the vast majority of our elected officials”. This problem also exists in Australia. Our Parliament introduces laws that act against the laws of nature, instead of using them to achieve their objectives. As result, ever more prescriptive, costly and less effective regulation is introduced that forces its regulators to become more intrusive.

Scientific concepts also elude regulators that are typically populated by lawyers and accountants rather than system scientists with the knowledge of how to “imprint the DNA” of self-regulation into licensees of Australian Prudential Regulatory Authority (APRA) and the Australian Securities and Investment Commission (ASIC). This may explain why a self-regulatory approach is not envisaged by APRA. Its Deputy Chairman informed ASFA members at their annual conference in 2006 that the role of APRA was to introduce “incremental regulation”. It is incremental increases in temperature that kills frogs in hot water before they can jump out.

It is time for the industry to jump out of the current incrementally increasing over-regulated regime. An invitation to do so was provided by ASIC. Its Chairman proposed to the 2006 Annual Conference of the Financial Planning Association that its members should introduce self-regulation. However, he did not offer any incentive or advice on how this might be done. This indicates that ASIC lacks either the knowledge and/or does not accept the responsibility to “imprint the DNA” of self-regulation into its licensees.

Any sort of self-regulation cannot work unless citizens exposed to deception, risk, abuse, exploitation and fraud can obtain the information, will and power to act to protect themselves. The need to engage members of superannuation funds and clients of financial planners as co-regulators is crucial. This is because Trustees, other service providers and government regulators cannot possibly be aware, let alone control and/or correct, all the factors that can go wrong. It is only common sense. But this common sense is grounded in three fundamental laws of system science. The laws state that the reliability of (i) information, (ii) control and (iii) decision making can be made as accurate as required

Streamlining Prudential Regulation with Self-enforcing Co-regulation

with a requisite variety, respectively, of (i) information channels,(ii) control mechanisms and (iii) decision making centers.

A corollary is that organizations with centralized information, control and decision making cannot reliably control complexity. Decentralised decision making creates what Gore described as “distributed intelligence” that is an inherent feature of co-regulation and so “network governance”. Network governance is described in my public policy pocket book on *A New Way to Govern: Organisations and society after Enron* freely available for downloading through a Google search.

Bottom up co-regulation does not require all stakeholders to become active. There are many examples of how a few activists will contribute their time, skill and money to protect not only their own interests but the interests of the vast majority of free riders. One example in the US are the Citizen Utility Boards set up by Ralph Nader to protect consumers from being exploited by the monopoly power of utilities providing communication, power and other infrastructure services. Australian examples are the Telecom users association, green activists, the Australian Shareholders Association and Members of UniSuper’s Shareholders Consultative Committee (SCC).

It would be very much in the interest of Trustee/Directors of superannuation and/or other financial service providers to facilitate the creation of their own proprietary Stakeholder Advisory Forums (SAFs). SAFs could be used to inform, educate, support, promote and protect Stakeholders while also being used as a marketing tool. They would provide feedback information on markets, marketing, products and competitors to provide a basis for improving operations.

Just as importantly there are many ways in which SAFs could take over the monitoring and supervisory roles that regulators currently require undertaken. These could provide substantial cost saving especially if the regulator in return provided appropriate exemptions’ from their compliance regime.

However, for SAFs to introduce self-enforcing self-regulation their members would need to be elected to achieve excellence on a competitive basis by the constituency they both represent and are accountable to like some members of UniSuper’s SCC. To allow the UniSuper auditor to become a more reliable co-regulator their Trust Deed would need to be changed so that it was the SCC who controlled the Auditor not the Trustee/Directors.

The current regulatory regime makes auditors unreliable as co-regulators because they are engaged and remunerated by the people whose accounts and/or operations they judge. No Judge in a court of law would be allowed to be engaged and paid by those being judged. Yet this unethical arrangement is mandated by APRA. It creates untenable conflicts of interests not just for the Trustee/Directors but also for the Auditor that both are supposed to avoid. It makes auditors accountable two masters, the Trustee/Directors and the fund members.

Another advantage of a SAF engaging the auditor is that it eliminates the misleading and deceptive conduct of Auditors describing themselves as “independent” when they are controlled by the people they are judging. This conduct is not only condoned by ASIC but forced upon Auditors by APRA who require a committee of Trustees/Directors rather than of members to control the auditor. APRA promotes this unethical and contradictory prudential behavior indirectly by requiring listed companies to adopt the ASX Corporate Governance Guidelines.

Streamlining Prudential Regulation with Self-enforcing Co-regulation

This state of affairs illustrates how APRA, ASIC and the ASX Guidelines are blindly following international group think that allows fads, fashions and falsehoods to be perpetuated to debase, demean and destroy their effectiveness. Another example is the reliance regulators place on so called “independent” directors.

Various experiments have proven beyond reasonable doubt that non-executive directors cannot be relied upon to have “independence of mind” when their pay, privileges, and power is dependent upon others. In any event, non-executive directors cannot act independently if the constitution of their organization does not provide them with independent information to act, the will to act and the power to act. Empirical research indicates a negative correlation between performance and independent directors. This is consistent with common sense as the more independent directors become than the less knowledge and authority they have to direct and monitor a business.

APRA, ASIC and the ASX mandate extensive and expensive disclosure on a contingency basis that some of the information might be useful in some circumstances for some people at some time who might also have the will and capability to act to protect themselves. As a result far too much information is disclosed to too many people who do not have the will, knowledge or capability to act upon it. The establishment of SAFs on a competitive self-enforcing basis would allow substantial reduction in the volume of publicly disclosed information but at the same time increase its scope and integrity while providing much richer private disclosure to co-regulators to yield superior investor protection and performance.

These apparently paradoxical results arise because it would be the SAFs who would become responsible for publicly disclosing information on a need to know basis rather than on a contingency basis. Conflicts of interest created for Director/Trustees reporting on matters for which they are accountable would be removed to reduce the need for audited information. The public disclosure obligation on directors is reduced as is also the volume of information publicly disclosed. On the other hand, Directors/Trustees obtain superior information from SAFs to carry out their role with forewarnings of any problems before government regulators and the media can blow the whistle.

The take home message is that financial service industry, including the “voice of super”, needs to educate the government on how its regulators can carry out their roles much more efficiently and effectively to increase benefits for the majority of voters. Also, that it is a duty of all trustees and advisers to inform their members or clients on how their benefits are being diminished by over-regulation and that there is a better way. An opportunity exists for industry leaders to provide role models of self-enforcing self-regulation as a basis for reversing incremental regulation with incremental de-regulation.

oooOOOooo
28122006/2016

*Dr. Shann Turnbull is the principal of the International Institute for Self-governance, <http://www.aprim.net/associates/turnbull.htm>

Streamlining Prudential Regulation with Self-enforcing Co-regulation

ATTACHMENT II

C. S. Shann Turnbull PhD
Principal, International Institute for Self-governance
PO Box 266 Woollahra, Sydney, N.S.W. 1350
Ph: +612 9328 7466; Fax: +612 9327 1497
sturnbull@mba1963.hbs.edu

Mr. Eric Mayne, Chief Supervision Officer & Chair
ASX Corporate Governance Council
c/- Regulatory and Public Policy Unit
Level 7, 20 Bridge Street
Sydney, NSW, 200

December 28th, 2006

Dear Eric

Corporate Governance Principles based on *Outcomes* not Practices

Further to our discussions at the Australian Institute of Company Directors Seminar on December 7th and our exchange of e-mails of December 8th I have extended my suggestion to base the ASX Corporate Governance Principles on outcomes not practices for all the current Principles.

In summary I have proposed that new Principles be used to pioneer a regulatory regime grounded in the Science of Governance to provide a process for introducing self-enforcing self-regulation. This would reduce excessive, intrusive, costly and ineffectual corporate laws, regulations, regulators and listing rules. Instead of the current 10 ASX Principles with 27 so called “Best Practices” I am suggesting only three Principles to produce 9 outcomes.

An outcome based approach would avoid the problem raised at the AICD seminar of Corporate Governance rating agencies evaluating corporations on “tick a box” compliance to so called “Best Practices”. The rating agencies then create market forces for asset allocation on a basis that can be: (a) counterproductive, and (b) inhibit the development of practices that can provide superior outcomes in protecting and furthering the interest of shareholders, stakeholders and the public.

The science of governance is based on the laws of nature. Evolution has demonstrated that self-enforcing self-governance is based on adopting “network governance” not yet found in listed companies¹. The first step is to provide a definition of “Good Corporate Governance”.

Defining “Good Corporate Governance”

Corporate governance is about the exercise of power. The ASX Principles do not define “Good Corporate Governance”. Yet they recommend in considerable detail and in a prescriptive manner that requires 75 pages how to achieve what is not defined. This demonstrates the adage “When you do not know where you are going then any road will take you there”.

¹ An introduction to “Network Governance” is provided in my public policy pocket book commissioned by the London based New Economics Foundation. Refer to *A New Way to Govern: Organisations and society after Enron*, available at http://ssrn.com/abstract_id=319867.

Streamlining Prudential Regulation with Self-enforcing Co-regulation

As a result, some of the current practices recommended to achieve the ASX Principles exacerbate conflicts, problems and the ability of corporations to protect and further the interest of investors, stakeholders and the public.

The practice of appointing so called “independent” directors and establishing audit committees have failed to protect investors and stakeholders in a number of unexpected high profile corporate collapses. Nor is there compelling empirical research or conceptual analysis to defend their adoption for achieving positive outcomes let alone being good and even best practice. The ASX claims of promoting “best” or even just “good” practice lacks credibility to demean, debase and destroy the integrity of the ASX Corporate Governance Principles.

One way of defining “Good Corporate Governance” is to base it on the ability of corporations to maximize their ability to operate on a socially acceptable self-governing basis to minimize the need for government and its regulators to become involved.

The empirical test of good governance then becomes the degree that the interests of investors and stakeholders can be protected and enhanced with simpler laws, regulations and listing rules while also reducing the cost and intrusiveness of regulators for both the government and corporations.

The ASX is licensed by the government to establish rules for companies to become publicly traded to protect and further the interests of investors and the public. The need for Corporate Governance Principles indicates that the ASX listing rules are defective in achieving the public policy outcomes for which the ASX is licensed.

The extent and detail of the 75 pages of the ASX Corporate Governance Principles illustrates how they reduce rather than improve good governance as defined above because they increase rather than reduce regulation, efficiency, effectiveness and costs.

The science of corporate governance²

The ASX listing rules, like much of Australian corporate law and regulations are focused on practices rather than outcomes. An outcome based approach could substantially reduce the volume of law, regulations and listing rules and eliminate the need for Corporate Governance Principles. This claim is based on the science of governance whose law of regulation “absolutely prohibits any direct and simple magnification but does not prohibit supplementation” of regulation³.

The role of the ASX listing rules must therefore be to “supplement” corporate law and regulators as a co-regulator. Corporate law, regulations and ASX listing rules could be substantially simplified by recognizing the related mathematically based law of requisite variety⁴. This states in effect, that to obtain specified outcomes for many variables the regulator must obtain a requisite variety of controllers. The law means that it is impractical for the government, the ASX or a corporate board to

² The science of governance is also referred to as “system science” or “cybernetics”. It is the science of control and communications in the animal, machine/device or social organization. The author introduced ‘The science of corporate governance’ in an article with this name published in *Corporate Governance: An International Review*, 10:4, 256–72, October, 2002, available at http://ssrn.com/abstract_id=316939.

³ Ashby, R. 1968, *An introduction to cybernetics*, Methuen, London, p.268.

⁴ The Law of Requisite Variety is sometimes referred to as Ashby’s Law, refer to p.206, Ashby 1968 cited above.

Streamlining Prudential Regulation with Self-enforcing Co-regulation

reliably control the outcomes of a complex organization unless a requisite variety of co-regulators are established to provide requisite variety of control. Network governance naturally arises when corporations establish their own co-regulators. Co-regulation introduces distributed intelligence, with superior control, feed-forward and feed back communication channels to reduce risk, add value and obtain competitive advantages.

The purpose of corporate regulation and regulators is to protect investors and corporate stakeholders. A requisite variety of controllers to protect and further the interest of corporate investors and stakeholders can only be achieved by engaging them as co-regulators. This approach is consistent with improving the ability of directors to control operations to reduce costs and risks and improve efficiency, competitiveness and shareholder value.

However, law makers, regulators, stock exchanges and corporations have yet to apply scientific knowledge to achieve public policy outcomes⁵. One small step in introducing a rigorous approach to corporate control by directors, stock exchanges, regulators and law makers would be to illustrate it through the ASX Corporate Governance Principles specifying outcomes instead of practices.

Corporate Governance Principles

The current 10 ASX Corporate Governance Principles are based on disclosing the existence or otherwise of 27 so called “Best Practices” as listed in Appendix I, some of which are prescribed with extensive details in guidelines and notes.

The efficacy and so creditability of the ASX “Best Practices” are open to question because:

- (a) Some have been in place when corporations have unexpectedly failed in a spectacular way;
- (b) Some practices are not used by some spectacularly successful corporations and
- (c) Some practices are counter productive, such as having:
 - (i) External auditors engaged and remunerated by the directors whose accounts they are required to judge to create a conflict of interest for both as well as removing the purpose of the law mandating an external auditor to report to shareholders;
 - (ii) So called “independent” directors who must necessarily lack intimate knowledge and authority over the business to monitor and direct its activities. Empirical research⁶ has not provided compelling evidence that so called independent directors can either protect a company from failure or enhance its performance. In fact there is evidence to the contrary described in note 6. As noted by Clarke in his 2006 paper available at <http://ssrn.com/abstract=892037> “important elements of the concept of and rationale for independent directors remain curiously obscure and unexamined”

The existence of the ASX Corporate Governance Principles has exacerbated the reporting obligations of companies that already report more information than can be usefully applied by most people most of the time. This is in addition to the reporting obligations of Corporation Law with many of its mandated

⁵ Why “scientific concepts sometimes elude the vast majority of our elected officials” was explained by Vice President Al Gore who noted that of the 535 members of the US Congress only nine had any technical education. Refer to his speech of February 12, 1996 available <http://clinton3.nara.gov/WH/EOP/OSTP/html/vp-aaas.html>.

⁶ A negative correlation was found between performance and independent directors by Bhagat and Black in their research reported in ‘The Non-correlation Between Board Independence and Long-Term Performance’, *Journal of Corporation Law*, Vol. 27, Pp. 231-273, 2002 available from <http://ssrn.com/abstract=133808>.

Streamlining Prudential Regulation with Self-enforcing Co-regulation

disclosures provided on a contingency basis that some people, at some time, in some situations, might in some circumstance have the power to act and that they might also have the will to act to protect their interests and/or further the interests of others. As a result of the excessive information provided with this contingency approach to disclosure, many shareholders no longer request access to company reports.

The volume of corporate disclosure could be substantially reduced through corporations establishing co-regulators providing information on a need to know basis to those people who have will and power to act as proposed and described in my 2005 submission to the Australian Joint Parliamentary Committee Inquiry into Social Accountability available at <http://ssrn.com/abstract=800904>.

This is not the place to outline how to introduce co-regulation as identified in my PhD Thesis and more specifically considered in my scholarly papers based on its research listed in the footnotes⁷. Trial and error is required to develop the most efficient, economic and efficacious outcomes. However the development of such an approach is inhibited, and in some cases frustrated or even prevented, by the current ASX Principles, listing rules, Regulations and Law.

By defining outcomes rather than practices the ASX Principles could be used to pioneer a co-regulatory approach. Corporations could be given exemptions from listing rules, regulations and the law to provide an incentive to develop a more economic, efficient and efficacious self-enforcing co-regulatory regime. Exemptions could be conditional upon corporations adopting replaceable rules in their constitutions to formally engage shareholders and stakeholders as co-regulators. The ASX listing rules already require certain provisions to be included in the constitutions of corporations as a condition of them being publicly traded. So co-regulation would represent an extension of this practice.

In this limited context of relying on outcomes rather than practices, the ASX would only require three Corporate Governance Principles as set out below:

1. Establish an outcome of transparent and timely *accountability* for performance of the company and its officers with processes for initiating change to enhance performance as described below;
2. Establish an outcome of published *performance* standards of the company and its officers to protect and further desirable outcomes for its investors, stakeholders and public.
3. Establish processes to identify, avoid, manage and/or mediate *conflicts* of interest between officers, agents of the company, or officers and shareholders or strategic stakeholders in a way that provides transparency and accountability for the integrity of the processes.

It is relevant to note that the none of the 27 ASX “Best Practices” would meet the test of these three Principles because they do not provide an *accountability* mechanism to shareholders and stakeholders “for initiating change to enhance performance” or “to protect and further desirable outcomes” for them.

After all the purpose of having regulators, ASX listing rules or published Corporate Governance Principles is to protect and further the interests of shareholders and stakeholders. If they are not related to an outcome in this regard then there is little justification for their introduction.

⁷ The PhD Thesis of the author is available at <http://ssrn.com/abstract=858244>. A number of the author’s relevant papers can be downloaded from links at <http://ssrn.com/author=26239>, refer to: ‘Corporate Governance Reform: Increasing competitiveness and Self-regulation’ available at <http://ssrn.com/abstract=41383>; ‘Competitiveness and Self-regulation’ available at <http://ssrn.com/abstract=45321>; ‘Self-regulation’ available at <http://ssrn.com/abstract=630041>.

Streamlining Prudential Regulation with Self-enforcing Co-regulation

Only shareholders and stakeholders know what is best for them so they should be engaged in establishing *accountability* to them, *performance* for them and managing *conflicts* with them. It is through formal mechanisms of engagement with shareholders and stakeholders and/or their representatives that creates network governance to facilitate improved self-governance and so “good corporate governance” as defined above.

Identifying Outcomes

The fundamental problem of all publicly traded corporations is that their constitutions provide directors with excessive and inappropriate powers with absolute power to manage their own conflicts interest (Refer to Appendix II). This inconvenient truth⁸ is compounded by the power of directors not being subject to continuous close monitoring to allow timely identification of abuses, with processes for continuous correction on a self-enforcing basis. Hence the need for the three Principles suggested above.

The solution is to provide a constructive division of powers to engage shareholders and stakeholders as co-regulators to reduce and/or eliminate some of the conflicts, duties, responsibilities, work load, liabilities and insurance cost of directors. In this way network governance reduces the complexity of tasks undertaken by individuals and promotes team production by merging governance with management. The integrity of governing complex operations is improved because there is a matching complexity in the communication and control architecture of organizations⁹.

How these outcomes might be best achieved should be left to each company. In this way alternative proposals could be developed for providing superior safeguards for shareholders and others than those currently required by the ASX, ASIC and APRA. In turn regulators could provide an incentive for developing safeguards with superior integrity and effectiveness by granting exceptions from compliance with their requirements. ***In this a way process would be established for developing a self-enforcing co-regulatory regime with less laws, regulations, and rules but with greater protection and benefits for investors, stakeholders and the public.***

The reliance on non-executive directors that are described as “independent” to identify and correct abuse of power, including the approval of excessive remuneration is not realistic unless the corporate constitution provides each director with:

- (a) information independent of management to act and
- (b) the will to act and
- (c) the means to act.

Suggestions how each of these necessary, but not necessarily sufficient conditions for avoiding an abuse of power are provided in a number of my articles listed in foot note 7. The widely promoted idea that individuals can have an “independent state of mind” cannot be relied upon without the three conditions stated above for the reasons identified by Professor Stanley Milgram as to why good people can do bad things¹⁰.

⁸ It could be an “inconvenient truth” for employees under the control of ASX directors to consider the proposals in this submission because it could attenuate the powers of ASX directors while increasing their accountability.

⁹ Refer to my paper ‘Governing the management of complexity’ available at <http://ssrn.com/abstract=436380>.

¹⁰ Refer to Stanley Milgram (2004), *Obedience to Authority: An Experimental View*, New York: HarperCollins.

Streamlining Prudential Regulation with Self-enforcing Co-regulation

The ability of directors to become self-nominating, self-remunerating with accountability more to each other than to shareholders and stakeholders is an outcome that can allow director behavior to become self-seeking, self-indulgent, self-rewarding on a self-perpetuating basis. This can deny competition for excellence and competitive advantages to protect and further shareholder and stakeholder interests. These problems are largely avoided by various practices found in the Australian public sector that could be used as role models for the private sector to adapt and develop on a competitive basis to achieving superior outcomes.

Companies could be invited to explain how they achieve outcomes to avoid and/or manage in a transparent and accountable way the conflicts of interest of self-nomination, self-remunerating and self-accountability. Companies could be invited to publicly disclose:

- (1) How does the board avoid or manage the conflicts of interest of self-nomination?
- (2) How does the board avoid or manage the conflict of interest in determining its own remuneration?
- (3) How does the board avoid perceptions of conflicts of self interest in the methods adopted to achieve outcomes (1) and (2)?
- (4) How does the board avoid controlling the process of being held accountability for not achieving points (1), (2) and (3) and on their performance in general?

For shareholders to meaningfully evaluate their directors and intelligently vote on their re-appointment and remuneration they need to be able to hold them to account to act with due “care and diligence” as required by Section 180 of the Corporation Law. To achieve this outcome shareholder need to evaluate how directors carry out their core roles in directing, monitoring and controlling the business to minimize risks and identify opportunities. Stakeholders and the public also need to protect themselves so they also have an interest in disclosure of the processes by which directors continuously keep themselves informed on a systematic and comprehensive basis on the Strengths, Weaknesses, Opportunities and Threats (SWOT) of their management and the business.

The outcome required by shareholders is to hold directors accountable to carry out their fundamental duties by being informed:

- (5) How directors evaluate the SWOT of the management team and also of the company on a continuous, systematic, comprehensive and reliable basis without relying only on the information provided by management?
- (6) How do director determine on a continuous, systematic, comprehensive and reliable basis when their trust in management might be misplaced?

External auditors are mandated by law because the law recognises the possibility that directors might “cook the books” in how they make themselves accountable to shareholders. As the published accounts must be approved by the Board, any independent directors must also be included in being accountable to shareholders. This means auditors should not be controlled by independent directors.

The Australian public sector provides a role model for the independence of private sector auditors. Unlike the Private Sector, Public Sector Auditors are not appointed or controlled by the organization being audited, or even by the Minister accountable for the organization, or by the Government but by Parliament. This makes it practical for public sector auditors to have a much wider scope than private sector auditors. They can undertake performance audits to consider such matters as economy, efficiency, effectiveness, probity, propriety and performance against key indicators.

Streamlining Prudential Regulation with Self-enforcing Co-regulation

Private Sector auditors also carry out a governance¹¹ role according to the Caparo case decided by the House of Lords in 1990. In considering the purpose of an audit Lord Justice Oliver stated that it was: to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided¹².

It is not reasonable to expect auditors can carry out this role when they are engaged and paid by the directors whose accounts they are judging whether or not the directors are described as “independent”.

Instead of ASX Principles promoting the use of audit committees to manage the external auditor they could invite companies to explain:

- (7) How do directors avoid or manage the conflict of Auditors serving two masters – shareholders and directors (including those classed as independent”) to negate the purpose of the law appointing external auditors to express judgment independently of the directors as to if the accounts are true and fair when directors engage and pay the auditor for their judgment?

There are a number of different outcomes that so called “independent” directors might be expected to achieve that could be better achieved in different ways, especially as some of the outcomes could introduce conflicts for some types of independent directors. So instead of the ASX Principles specifying the appointment of independent directors and the conditions for making them independent it would be much simpler to invite companies to report any arrangements or processes they have in place to achieve the outcomes they expect so called “independent” directors to achieve such as:

- (8) Hiring, directing, controlling, retaining, remunerating and/or dismissing executive directors independently of any power, status and influence, remuneration or other benefits that executive directors may bestow on the non-executive directors;
- (9) Protecting the interest of minority investors in one or more ways such as:
 - (a) Dominant shareholders seeking power and influence rather than profit;
 - (b) Dominant shareholders (obtaining other unfair advantages);
 - (c) Dominant executives (seeking power and influence rather than profit);
 - (d) Dominant executive directors (over paying themselves);
 - (e) Dominant other directors (leading the company astray);
 - (f) Protecting the company from unfair related party transactions;
 - (g) Protecting the rights of employees (could be conflict with shareholder interests);
 - (h) Protecting the rights of other stakeholders (which could be conflict with shareholders);
 - (i) Protecting the company from breaching the law or regulations.

Because individuals instinctively obey authority, as shown experimentally by Professor Milgram (refer to note 10), it may be difficult for your Council to accept my critique of the ASX Corporate Governance Principles because they are supported by the authority of other similar codes adopted in the UK, the OECD, World Bank and put into law by some countries like the US. However, it also identifies how Australia can become a world leader in providing competitive advantages for its listed companies and a role model for reducing the intrusiveness of governments in market economics. In

¹¹ External US audits were modeled on the UK 1929 prospectus requirement and so are only economic audits as explained in my article ‘How US and UK auditing practices got muddled to muddle corporate governance practices’, *The ICAI Journal of Audit Practice*, Volume II, No. 3, pp. 49–68, (July 2005), available at <http://ssrn.com/abstract=608241>.

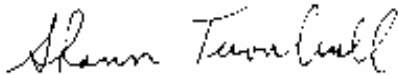
¹² Refer to page 16 of the judgment available at http://oxcheps.new.ox.ac.uk/casebook/Resources/CAPARO_1.pdf.

Streamlining Prudential Regulation with Self-enforcing Co-regulation

this way the ASX Corporate Governance Council and its Principles can not only achieve its mission to avoid the Australian Government following overseas practice of introducing more prescriptive laws but a process for reducing existing government regulation.

I recommend that some elements of my proposals be introduced in your forthcoming revision of the ASX Principles as they provide both a long term objective that should be welcomed by all parties and the means for getting there in a manner that can be tested on an incremental basis. I would be pleased to assist in this regard and provide such further details and information as you and your colleagues might wish to obtain.

Yours faithfully



Shann Turnbull PhD
Principal, International Institute for Self-governance

Attached:

Appendix I How 9 outcomes subsume 27 ASX Corporate Governance “best practices”
Appendix II Table 1, Corrupting powers of a unitary board

APPENDIX I

How 9 outcomes subsume 27 ASX Corporate Governance “best practices” (And 10 ASX Principles can be replaced with three Principles for: “Accountability”, “Performance” and “Conflicts”)

All 10 ASX Principles are listed below with all, or part of, their 27 “Best Practices”. After each ASX Principle and Practice there is a square bracket to indicate which outcome numbered above from 1 to 9 is relevant to subsuming the practice. Some square brackets contain a zero to indicate that the Practice is not relevant to the three Principles for Accountability, Performance and Conflicts.

ASX Principle 1 – Lay solid foundations for management oversight [5, 6]

1.1 Formalise and disclose the functions reserved to the board and those delegated to management. [5]

ASX Principle 2 – Structure the board to add value [1, 5, 4, 8, 9]

2.1 A majority of the board should be independent directors [8 to 9]

2.2 The chairperson should be independent directors [8, 9]

2.3 The chairperson and the chief executive should not be the same person [8, 9]

2.4 The board should establish a nomination committee [1]

2.5 Provide the information indicated in Guide to reporting on Principle 2 [4]

ASX Principle 3 – Promote ethical and responsible decision – making [1, 2, 3, 4]

3.1 Establish a code of conduct to guide the directors, the chief executive officer and any other key executives [3, 4]

3.2 Disclose the policy concerning the trading in company securities by directors, officers and employees [3, 4]

Streamlining Prudential Regulation with Self-enforcing Co-regulation

3.3 Provide the information indicated in Guide to reporting on Principle 3 [4]

ASX Principle 4 – Safeguard integrity in financial reporting [5, 6, 7]

4.1 Require the chief executive officer and chief financial officer to state in writing to the board that the company's financial reports present a true and fair view [5, 6, 7]

4.2 The board should establish a audit committee [5, 6, 7]

4.3 The structure of the audit committee should be as specified [5, 6, 7]

4.4 The audit committee should have a formal charter [5, 6, 7]

4.5 Provide the information indicated in Guide to reporting on Principle 4 [0]

ASX Principle 5 – Make timely and balanced disclosure [4, 5, 6]

5.1 Establish written policies and procedures designed to ensure compliance with ASX listing Rule disclosure requirements and to ensure accountability at a senior management level for that compliance [4, 5, 6]

ASX Principle 6 – Respect the rights of shareholders [1 to 9]

6.1 Design and disclose a communications strategy to promote effective communications with shareholders and encourage effective participation at general meetings [1, 2, 3, 4, 5, 6, 7, 8, 9]

6.2 Request the external auditor to attend the annual general meeting and be available to answer shareholder questions about the conduct of the audit and the preparation and content of the auditor's report. [7]

ASX Principle 7 – Recognise and manage risk [5, 6, 8]

7.1 The board or appropriate board committee should establish policies on risk oversight and management [5, 6]

7.2 The chief executive officer and the chief financial officer state to the board in writing... [8]

7.3 Provide the information indicated in Guide to reporting on Principle 7. [0]

ASX Principle 8 – Encourage enhanced performance [5, 8]

8.1 Disclose the process for performance evaluation of the board its committees and individual directors, and key executives [5, 8]

ASX Principle 9 – Remunerate fairly and responsibly [2, 3, 4, 5, 8, 9]

9.1 Provide disclosure in relation to the company's remuneration policies to enable investors to understand (i) the costs and benefits of those policies and (ii) the link between remuneration paid to directors and key executives and corporate performance [2, 3, 4, 8]

9.2 The board should establish a remuneration committee [2, 3, 4, 8]

9.3 Clearly distinguish the structure of non-executive directors' remuneration from that of executives [2, 3]

9.4 Ensure that payments of equity-based executive remuneration is made in accordance with thresholds set in plans approved by shareholders [4, 9]

9.5 Provide the information indicated in Guide to reporting on Principle 9. [0]

ASX Principle 10 – Recognise the legitimate interests of stakeholders [5, 6, 9]

10.1 Establish and disclose a code of conduct to guide compliance with legal and other obligation to legitimate stakeholders. [0]

APPENDIX II

Table 1, Corrupting powers of a unitary board

As presented in my paper ‘Why unitary boards are not best practice: A case for compound boards’, presented to the First European Conference on Corporate Governance, Belgian Directors’ Institute, November 16th, 2000, Belgium's National Bank Brussels, available at: <http://ssrn.com/abstract=253803>.

Directors have power to:

- A. Obtain private benefits for themselves (and/or control groups who appoint them) by:**
- (a) Determining their own remuneration and payments to associates
 - (b) Directing business to interests associated with themselves
 - (c) Issuing shares or options at a discounted value to them selves and/or associates
 - (d) Selling assets of the firm to one or more directors or their associates at a discount
 - (e) Acquiring assets from one or more directors or their associates at inflated values
 - (f) Trading on favoured terms with parties who provide directors with private benefits
 - (g) Using firm resources and/or their status in other ways.
- B. Maintain their board positions and private benefits by:**
- (a) Reporting on their own performance and influencing “independent” advisers by:
 - (i) Selecting auditors and other “independent” advisers
 - (ii) Determining their fees
 - (iii) Controlling the process by which auditors are appointed by shareholders
 - (iv) Terminating the appointment of auditors and other “independent” advisers
 - (v) Paying additional fees for work which is not required to be “independent”
 - (vi) Determining the terms of reference on which “independent” advice is provided
 - (b) Determining the level of profit reported to shareholders by:
 - (i) Selecting the basis for valuing or writing off trading and fixed assets
 - (ii) Determining the life of assets and so the cost of depreciation
 - (iii) Selecting the basis for recognising revenues and costs in long term contracts
 - (iv) Selecting accounting policies within accepted accounting standards
 - (v) Selecting, controlling and paying “independent” valuers and determining the basis on which valuations are to be carried out
 - (c) Not disclosing full pecuniary or non-pecuniary benefits even if required to do so
 - (d) Determining how any conflicts of interest are managed
 - (e) Filling casual board vacancies with people who support their own positions
 - (f) Nominating new directors who support them at shareholder meetings
 - (g) Controlling the nomination and election procedures and processes
 - (h) Controlling the conduct of shareholder meetings
 - (i) Appointing pension fund managers for the firm who also provide them proxies
 - (j) Voting uncommitted proxies to support their own election
 - (k) Not allowing the firm to compete with related parties who can vote for them.