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**The Theory and Practice of Government De-regulation<sup>1</sup>**

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“Regulatory Interactions with Regulatees”

**ABSTRACT**

This paper describes how governments and regulators could introduce selective de-regulation based on exempting corporations from existing practices when they amend their constitutions to provide superior outcomes for investors and other stakeholders. An example is presented on how a company efficiently raised new equity through constitutional changes that also allowed the regulator to exempt it from the compliance processes and costs of changing auditors. System science is used to argue that the introduction of self-enforcing co-regulation based on outcomes rather than practices could introduce competition for developing the most efficient and effective regulation by both companies and regulators.

**Key words:** Co-regulation, Corporate constitution; Corporate Governance; De-regulation, Network governance; Self-enforcing; Stakeholder forums; System science, Watchdog boards.

**JEL Classifications:** D74; G38; K22; L22.

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# The Theory and Practice of Government De-regulation

## 1. Introduction

This paper describes a strategy for governments and their regulators to introduce de-regulation based on selectively exempting corporations from existing practices when they amend their constitutions to provide superior protection for investors and other stakeholders. The paper draws upon the experience of the author in introducing deviations from national norms in the governance architecture of an Australian start-up company. This allowed: (i) high risk equity finance to be raised when it might not otherwise have been provided and, (ii) the Australian regulator to grant exemption from the usual processes and costs in changing the auditor.

To raise funds from US shareholders that might not otherwise have been invested, Australian incorporated JAC Tractor Limited (JTL) changed its corporate constitution to provide superior protection for investors. While a number of non-standard provisions were introduced the two core innovations were the establishment of: (i) Arrangements to remove or manage director conflicts and (ii) Processes for directors to obtain information independently of management on the ability and performance of management and the firm. Both outcomes subsumed the need for a number of practices promoted by Corporate Governance Codes (CGCs) such as the need to appoint: independent directors; a board Audit Committee; separate the chairman from the CEO, or the need for Auditor rotation.

System science is introduced to explain why bottom up self-enforcing regulation is required to supplement the traditional top down approach to improve the efficiency and effectiveness of regulation. Besides providing outcomes of superior investor and other stakeholder protection, corporations can be relieved of compliance costs of non-relevant regulations. As argued by Turnbull (2007), laws and regulations based on outcomes rather than practices provide a way to reduce the operations, size and so cost of regulators. An outcome based approach provides a basis for creating competition between companies to introduce innovative practices that provide: (i) improved communications, sensitivity and responsiveness in managing relationships with employees, customers, suppliers and other stakeholders; (ii) superior protection for stakeholders, including directors, (iii) exemption from selected regulations, (iv) reduced compliance costs with (v), competitive advantages for the business.

The need for CGCs provides evidence of the inadequacy of corporate laws, regulations and listing rules to achieve desired outcomes. Outcome based regulation provides a way to simplify the role of Regulators as the Regulatees becoming responsible for designing how public outcomes are achieved. The role of government would change consistent with the natural laws of governance as envisaged by Gore (1996) so that governments would act indirectly through “imprinting the DNA” of organization to be self-regulating like all living things. Constitutions represent the DNA of organizations (Turnbull 2000b: 276). So the role of government would be to license organizations to operate provided that they adopted constitutions to protect and further the interests of their stakeholders. This approach is already used to some extent in stock exchange listing rules.

The adoption of a constitution that facilitates self-governance has been a funding condition for creating stakeholder controlled firms around the town of Mondragón in Spain (Campbell, et al. 1977). This suggests that self-regulation could be introduced through the Bank regulator requiring loans to be made on condition that borrowers adopted self-regulating provisions in their constitutions. Likewise, the tax system could be used to promote self-regulating constitutions.

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In 2006 the Australian Securities Exchange (ASX) invited submissions to review proposed changes in its Corporate Governance Principles. The Principles were based on 24 so called “Best Practices” that required 79 pages of explanation (ASX 2006). The author’s submission recommended that the ASX revised Principles be based on outcomes instead of practices (Turnbull 2007). This paper shows how an outcome based approach could also be initiated by Regulatees.

How Regulatees could initiate government de-regulation is illustrated by JTL after it amended its constitution. The changes eliminated or provided processes to mediate the inherent conflicts of interests created in corporations when management powers are not separated from governance powers as identified by Dallas (1977). Specific corrupting powers of a unitary board are identified in Turnbull (2000b: 115). The design changes introduced into the JTL constitution are consistent with “The science of Corporate Governance” (Turnbull 2002d) which is part of “cybernetics” or “system science”.

System science explains the impossibility of directly regulating complexity without “supplementation” (Ashby 1968: 206). Supplementation involves the introduction of sufficient co-regulators to control the variables that need to be regulated. It is through corporate constitutions introducing a “requisite variety” of controllers to act as co-regulators that the ability of companies to manage complexity can be improved. A requisite variety of controllers provides a way to establish “distributed intelligence” to improve decision making as shown by Neumann (1949). This can also reduce information overload to explain why large corporations adopt a multi-divisional structure as explained by Williamson (1985: 280) and the operating advantages of firms who de-compose decision making labor into multiple control centers (Turnbull 2000b: 245).

Stakeholder involvement can be used to introduce a requisite variety of controllers. It also provides a way for stakeholders to obtain the means to protect themselves to replace reliance on government laws, regulations, regulators and governance codes to do this for them. By this means public sector regulation can be replaced by private sector regulation that can be much more sensitive, responsive and flexible while reducing costs for both regulators and regulatees.

The integration of stakeholder interests into the control of organizations also provides a way to improve the integrity of their communication systems. As shown by Shannon and Weaver (1949) the accuracy of communications can be improved as much as desired by increasing the variety of communication channels to cross check for errors, biases and omissions. It is by engaging stakeholders as co-regulators that “requisite variety” of communications channels can be introduced to control complexity. Stakeholder involvement provides the basis for introducing a self-enforcing co-regulatory regime that offers operating advantages for both corporations and regulators. Citizen Utility Boards (CUBs) established the US by Ralph Nader provide an example (Givens (1991).

The two basic outcomes that corporate constitutions need to achieve so as to substitute the need for corporate governance codes, many regulations and some laws are:

1. Processes for agents other than directors to:
  - (a) Control and/or manage conflicts of interest of the directors, and
  - (b) Protect the interest of investors, shareholders, other stakeholders and the community;
2. Processes for directors to monitor, evaluate and direct the performance of management and the business *independently* of management.

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Amendments in the constitution of JTL to achieve both of the above outcomes were designed by the author and adopted by its shareholders who were seeking additional development finance. One innovation inspired by European practice to achieve outcome 1a was the establishment of a watchdog board described as a “Corporate Senate” (Guthrie and Turnbull 1995). The second innovation to achieve outcomes 1b and 2 was inspired by Japanese and some European practices of introducing what are referred to as “Stakeholder Councils”.

The next Section describes the Corporate Senate and the Third Section discusses Stakeholder Councils. The concluding fourth Section puts forward arguments for defining good governance in terms of outcomes not practices. A key outcome desired being a reduction in the scope and cost of government regulation by the introduction of more sensitive, responsive and effective private sector regulation. Background information on JTL is provided in endnote 1 with additional information and details of its constitution available in Turnbull (2000a).

### **2. Separation of executive and governance powers**

In this Section the opportunity of introducing a division of power with checks and balances into corporate constitutions is explained through the establishment of a type of watchdog board described as a “Corporate Senate”.

Corporate constitutions typically allow all powers not provided to shareholders to be obtained by the directors. As a result, directors obtain absolute power to manage their own conflicts of interest (Turnbull 2000b: 115). If absolute power can lead to absolute corruption then the question must be asked why it is in the best interest of the company to possess a constitution that provide directors such powers and conflicts of interests? Especially when: (a) directors are expected to avoid conflicts and (b) many of the powers that create conflicts for directors are not required for managing the business. This latter point is why a separation of powers becomes both practical and desirable.

Powers that create conflicts for directors, but which do not directly limit their ability to manage the business are concerned with governance. For example, the power to determine:

- (a) Director nomination to the board;
- (b) Director evaluation;
- (c) Director remuneration;
- (d) Director retirement from the board;
- (e) Director related party transactions;
- (f) Director dealing in company securities;
- (g) Director accountability to: (i) shareholders; (ii) one or more dominant shareholders; (iii) other stakeholders;
- (h) Any other Director actual or perceived conflicts of interests.

Financiers commonly require Directors to give up some of these powers as a condition of providing a loan and/or venture capital. So there is nothing new or radical in either separating these powers or making them subject to a veto of a financier. Nor should there be a concern that the separation of powers that create director conflicts need necessarily jeopardize the ability of the directors to efficiently direct, monitor and control the business and its management.

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The contractual arrangements for denying directors powers are commonly found in a loan agreement and/or a shareholder's agreement with a venture capitalist. A separation of powers occurs with Leveraged Buy-Out (LBO) Associations. The Association board composed of financiers, acts as a check on the executive management board. Jensen (1993: 869) expressed the view in his paper on the failure of internal controls that LBO Associations represented "a proven model of governance structure".

When a company makes its Initial Public Offering (IPO), any shareholder's agreement with a venture capitalist is typically terminated. Some Stock Exchanges require that shareholders who are the promoters of an IPO to remain as shareholders for some time to protect the new shareholders. However, without the extra powers of a shareholder agreement, the promoters and/or supporting venture capitalists and other investors lose much of their ability to protect their own interests let alone others.

It is during this initial period as a Publicly Traded Company (PTC) that founders, inventors and management without previous knowledge or experience in running a PTC can go astray to jeopardize the interest of outside investors. It is very much in the interest of supporting venture capitalists and new shareholders that there remain some effective checks and balances. This can be achieved by embedding in the corporate constitution the sort of investor protection provisions that would be found in a shareholder agreement.

The phrase "sort of investor protection" is used because when there are dispersed shareholders the problem of achieving collective action is introduced. This problem is overcome in a number of continental European Countries where a committee of shareholders is established to control the auditor. This practice was embedded in the model constitution attached to the UK Company Act of 1862 (O'Connor 2004:14) and more recently recommended for UK companies by Hatherly (1995) and the National Association of Pension Funds (*AccountancyAge* 2004).

A shareholder committee should not be confused with the continental European practice of appointing a Supervisory Board that then appoints the executive board like in a LBO. A Shareholder committee in the US, UK or Australian context would still mean that the directors were appointed by shareholders and accountable to them. Where Shareholder Committees are appointed in some European countries like France (Analytica 1992: 98, 104, 107), Hungary (Lempert 2003), Italy (Melis 2004) and Spain (Turnbull 2000b: 213) the Supervisory Board is likewise appointed and accountable to shareholders to create three or more centers of power to introduce "Network Governance" (Jones, Hesterly, & Borgatti, 1997; Turnbull 2002a; 2003).

However, a committee of shareholders cannot provide a separation of power if there is a dominant shareholder that can control both bodies appointed by shareholders. This was the situation with the Italian company Parmalat that failed in 2003 (Melis 2005).

The ability of a dominant shareholder to appoint all directors has not always been possible. Up until the mid 19<sup>th</sup> century shareholder voting in the US was *one vote per investor* rather than *one vote per share* (Dunlavy 1998). It was also common to have sliding scale voting to limit the power of dominant shareholders to protect the interest of minorities (Dunlavy 1998). Sliding scale voting was widespread for PTCs in Australia up until the middle of the 20<sup>th</sup> century.

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For a shareholder committee to achieve the outcome of protecting minority investors it needs to be elected on a democratic basis of one *vote per investor* as is typically found in cooperatives. The property rights of investors would still be protected by all other shareholder voting being on a plutocratic basis of one *vote per share*. However, to avoid one or more dominant shareholders imposing its views uniformly on all board members, cumulative voting, a form of preferential voting, was introduced for the election of JTL directors.

Cumulative voting was mandated in a number of US States early in the 20<sup>th</sup> century (Gordon 1993) and is used in the Philippines where family controlled PTCs are common (World Bank 2001: 6). Cumulative voting still involves one vote per share but shareholders can accumulate all their votes for just one or more of the directors to be elected to the board (Bhagat & Brickley 1984). In this way minority shareholders can elect nominees to the board of a subsidiary company and so provide them with the will to act independently of a dominant shareholder. Cumulative voting provides directors elected by minorities with the will to *privately* expose related party transactions of a dominant shareholder to a shareholder committee appointed by minority shareholders. The shareholder committee in the case of JTL had the power to veto any transaction in which any director had a conflict of interest.

As described in Turnbull (2000a: 148–51), JTL in 1986 had three dominant Australian investors and a board of five with three being Australians. Each of the Australian directors, including the author, was providing services to the company and so possessed a conflict of interest. Indeed, it was the opportunity to develop new business opportunities that provided the incentive for the directors to invest in JTL.

A number of US citizens owned 47% of the company shares and had no related party interests. The US citizens had invested money in a US progenitor venture<sup>1</sup> that had failed. They then contributed funds a second time to hire the author in 1984 to re-organise the failed company incorporated in Vermont. It was to attract a third round of funds from the US investors that the constitution of JTL was changed with the unanimous agreement of all shareholders in 1988.

One of the changes was to establish a shareholder committee<sup>2</sup> described as a “Corporate Senate”. Extracts of the relevant sections of the corporate constitution establishing the Senate are reproduced in Turnbull (2000a: 152–5). No changes in corporate law were required and it is likely that this could be the situation in other jurisdictions.

Any shareholder could nominate themselves, or a representative, for election to the Senate. It was constituted with three people elected each year. No Senator could also be a director or have any related party interest with the operations of the company. As significant investors, Senators required no remuneration. Each Senator had power to obtain information about the company that was available to the directors. The Senate only had power to veto matters where any director had a conflict of interest. Two of the three Senators were US citizens. The three members of the Senate did not need to meet to carry out their business. This was carried out by phone and faxing a “flying minute” to approve the three to six conflicts that might arise in a year.

The Senate engaged and remunerated the external auditor and controlled the process for counting votes for the election of directors. A member of the Senate chaired shareholder meetings to avoid directors being exposed to the conflict of controlling the process by which they became accountable

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to shareholders. The Senate was required to publish an annual report on its activities and decisions. This was appended to the report of the External Auditor and sent to all shareholders with the Annual Accounts of the Directors.

Directors had the right to convene a meeting of shareholders to overturn a Senate Veto with shareholders voting on the usual one share one vote basis. This right was never exercised. If it did for a PTC then the arguments for and against overturning the veto would become a public matter. If a dominant shareholder overturned a veto then it would be the market price of the shares that would identify the value of the decision.

Although the Corporate Senate had no explicit power to be a nominating or remuneration committee its veto powers over conflicts of director's interests in these matters could be influential. A proposal for a shareholder committee to become a combined nominating, remuneration and audit committee was unsuccessfully put forward in the Australian Parliament for inclusion in the Company Reform Bill of 1997. This more robust and less nuanced form of a Corporate Senate was more appropriately described as a "Corporate Governance Board" (CGB) by Senator Murray who sponsored the proposal. His minority report (Murray 1998) noted that the CGB was based on the Corporate Senate. Senator Murray was a member of a minority party that had the balance of power in the Senate. He latter proposed that the inclusion of a CGB be a condition for the partial privatisation of the government owned national Telecom. This proposal to protect new minority investors against the controlling government ownership was not accepted by the government.

In 1991 JTL decided to reduce its annual maintenance costs by changing its international auditor to a local auditor. Australian and UK auditors are appointed for a different purpose to US Auditors and are appointed by shareholders and report only to shareholders, not also to the directors as in the US (Turnbull 2005b). However, the Australian regulator accepted the authors request to exempt JTL from the cost of convening a meeting of shareholders to approve a change of the Auditor on the basis that this decision was approved by its Corporate Senate.

By 1997 JTL had licensed three organizations to manufacture and sell its technology. However, no revenues were produced and the company was voluntarily wound up. As a result, provisions in its constitution designed to empower non-executive directors and provide management and the business with operating and competitive advantages were not established. These provisions involved the introduction of by-laws to establish "Stakeholder Associations" (Turnbull 2000a: 155). These are discussed in the following Section.

### **3. Contractual communications systems independent of management**

This Section describes how corporate constitutions can introduce contractual variety in communications within a firm to increase both the integrity of information and its scope for: management; directors, shareholders and stakeholders. The arrangements represent another element in developing "Network Governance" as articulated by Turnbull (2002a, 2003).

As a start up business, it was uncertain what business model JTL would adopt so a flexible approach was incorporated in its constitution to obtain feedback communications to and from its operating stakeholders such as employees, suppliers, distributors, customers and others. The JTL constitution made provision for the Directors to establish by-laws for the formation of "Stakeholder

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Associations” and to delegate such powers as they think fit to “Stakeholder Councils” elected by the Associations (Turnbull 2000a: 155). Members of Stakeholder Associations had the right to attend and speak at meetings of shareholders. In mature operating companies it would be desirable for the Corporate Senate rather than the Board to specify the enabling provisions in the corporate by-laws for stakeholders to form associations.

This is because it is very much in the interest of shareholders that they obtain information independently of the directors to evaluate the directors and the business. Likewise, shareholders have an interest to establish processes for their directors to obtain information about the Strengths, Weakness, Opportunities and Threats (SWOT) of the business independently of management. In addition, advice from stakeholders allows non-executive directors to obtain information on the performance of their executive director colleagues, as well as their management team and the business independently of them.

A fundamental reason for shareholders to delegate power to directors is for the directors to direct and monitor management. Directors cannot creditably achieve this purpose for being appointed if they rely only on the information provided by management. The purpose of having independent witnesses in a law court is to validate the integrity of information put before the court. But directors of US, UK and many other countries have no systemic process to obtain reports independently of management on the SWOT of management or of the business. This makes directors less responsible and diligent than media reporters who seek independent sources to verify their stories or managers who commonly obtain reference checks on prospective employees.

The economic consequence of directors being misled can be far greater than a jury judging an accused in a court of law or from a false media report. Indeed, it seems inconsistent for courts to accept that directors have exercised due care and diligence in carrying out their fiduciary duties without them having a systemic process for monitoring management and the business independently of management.

A fundamental flaw of the US/UK system of corporate governance is that directors lack a systemic process for discovering when their trust in management might be misplaced. It is simply not good enough, and indeed irresponsible for directors to rely on their interpersonal evaluations of executives. Executives commonly obtain their position, amongst other reasons, because they are persuasive and effective communicators.

Even with the best will in the world, the communication of a message from one person to another is likely to introduce biases, errors and gaps as commonly observed with the game of “Chinese Whispers”. In this game a message is sequentially and privately passed along a chain of three or more individuals. The message reported by the final member of the chain often becomes quite different from the initial message. However, in a business context, those reporting to their superiors will be judged by the results that they report. This provides a compelling incentive for individuals to “spin” or eliminate bad news. In this way senior managers can be kept in ignorance for what they are being held responsible as is often revealed after a corporate collapse. The problem is exacerbated by the need for reports to be condensed when communicating up a hierarchy and the need for commands down the hierarchy to be interpreted and put into practice.

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On conservative assumptions, Downs (1967: 167–8) has indicated how over 96% of the information available to low level workers is lost or wrong when reported through four levels of a hierarchy to a CEO. Board members are at an even greater disadvantage. This means that it is irresponsible for Regulators to rely only on directors to adequately control large organizations to obey the law. The solution has been identified by pioneers of system science (Shannon and Weaver 1949). They showed how to increase the accuracy of communications as much as desired by increasing the number of communication channels to cross check each other and reduce “noise”.

Stakeholder Associations and their representative Councils provide a way to introduce as many separate communication channels as desired to cross check the information being received by senior executives and their directors from line management. Information from distributors, agents and customers on product and/or service quality may well be biased against management. Information obtained from suppliers and low level workers may also be biased against management. Management in turn has an incentive to blame others for inadequate performance. If these points are accepted then one can argue that directors have a duty to establish processes for obtaining “the other side of the story” to that provided by management.

In a similar way, Stakeholders can provide another side of the story being provided by the directors to shareholders. This is why the JTL constitution provided stakeholders the right to attend and speak at meetings to provide a balanced view to investors.

It is very much in the interest of shareholders that their directors have a systemic process to obtain information independent of management to undertake a SWOT analysis of management and the business. This provides another reason for shareholders support a change in the corporate constitution to allow various classes of stakeholders to establish their own representative associations independently of management. Because no business can exist without employees, suppliers, contractors, customers, distributors and agents it is also in the interest of shareholders, their directors and management, to bond these strategic stakeholders to the business.

Research by Hippel (1986) has shown that “lead users” can contribute more to product innovation and development than the Research and Development department of a firm. The establishment of users/customer associations provides a formal way of engaging with them to obtain competitive advantages in the development and delivery of products and/or services. Feedback from lead users could provide guidance to directors on how they should direct the business. The market and competitive intelligence available from lead users and customers provides a way of reducing the scope and cost of market research.

Likewise, supplier associations provide a way to formally integrate “Just-In-Time” delivery of goods and services and integrate “Total Quality Control” into the supply-customer relationship. In these ways Stakeholder Associations provide a basis to reduce the cost of quality control processes on both the procurement and sales side of a business.

In summary, Stakeholder Association provide a basis to provide information on strategic direction of the business, the development of its products and services, add operational value and competitive advantages while reducing the need and cost for market research, R&D and other service providers.

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The experience of Raph Nader in establishing Citizen Utility Boards (CUBs) in the US provides evidence that there could be little or no cost in corporations establishing Stakeholder Councils. Nader invited retail customers of public utilities in the US to donate money when paying their monthly bills to set up a watchdog board to counter the arguments presented by management to utility regulators for increased prices rather than increased efficiency (Givens 1991). While less than 5% of customers contributed funds, this was still sufficient to hire professional advocates to inhibit regulators from being captured by management. There are a number of other examples of user associations being formed. Often stakeholders may invest considerable time and money to protect themselves from corporate actions and/or inactions. The incentive for stakeholders to volunteer their resources to protect their interests is also illustrated by the Trade Union movement and associations of shareholder activists.

Evidence of how the integration of stakeholders into the governance architecture of firms can provide competitive advantages have been provided by Porter (1992). He was commissioned to investigate why Japanese and European firms were proving to be more competitive than US firms in the 1980's. He concluded that it was because of the feed forward and feedback communications they obtained through their suppliers, employees, customers and host community.

As a result, Porter (1992: 16–17) recommended: “Encourage board representation by significant customers, suppliers, financial advisers, employees, and community representatives”. However, this was ignored as it would have introduced intolerable board conflicts of interest. What Porter neglected to consider was that in Japan and Germany, stakeholders had formal communications channels with the directors from *outside* the boardroom through various stakeholder forums like a Keiretsu Council, Supervisory Board, and Works Council and so on.

Stakeholder Associations and their representative councils provide a way to implement the strategy described by Porter and Kramer (2006) for promoting social responsibility while obtaining competitive advantages. Stakeholder Councils provide a way to obtain commercial intelligence and operational knowledge without introducing conflicts of interest by appointing stakeholder representatives to the executive board. In addition, stakeholder councils provide a way to use the inherent conflicts of interest between different stakeholder constituencies to create competition between them in providing information and gaining influence with directors and their shareholders (Turnbull 1997; 2002a).

The form of the various stakeholder constituencies and their representatives councils need to be designed to carry out the functions described above. There are other functions that they can perform such as reducing the scope and detail of information that directors need to report (Turnbull 2005a). Disclosure requirements of corporate law, regulations, listing rules and governance codes have become excessive because much of the information is made on a contingency basis that the information might be required in some situations, for some companies at some times and that there is at the same time individuals who have the motive, ability and power to act upon it.

Stakeholder Councils could become responsible, instead of the directors for reporting on issues of corporate social responsibility on a need to know basis for shareholders and the general public (Turnbull 2005a). This would remove the need and cost of engaging auditors to check such reports when they are prepared by director who are held both responsible and accountable for unacceptable outcomes.

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The intelligence reported by Stakeholder Councils to a Shareholder Committees would provide much more intimate knowledge of business operations, director performance, related party transactions and other conflicts to take corrective action and/or advise shareholders according. In this way, the existence of Corporate Senates and Stakeholder Council could allow a substantial reduction in the information that is currently required to be made public on a contingency basis in the hope that someone has the will and power to act. The degree to which public disclosure was required could then be left to the shareholder committee. In this way the information made public could change from a contingency scatter gun approach to rifle shot need to know basis. This could make a substantial reduction in the scope and detail of disclosure.

The disclosure of information is of little use unless it is received by people without the will, ability and power to act upon it. Dispersed shareholders and stakeholders are generally not in a position to meet these three tests to use the information that the law may require to be disclosed. So why require the information to be reported?

The number, nature and functions of stakeholder association could change as the business model of a company changed. For this reason, the use of by-laws is suggested to change the number, nature and functions of stakeholder associations and their representative stakeholder councils. In more mature companies the power to initiate changes in the by-laws could be vested in the senate to ensure that stakeholder involvement was designed in the best interest of the shareholders rather than just the directors.

There are many nuanced ways to introduce efficient and effective checks and balances in corporate constitutions and by-laws between the various stakeholder constituencies to generate win-win situations. What is required is competition between firms to identify the most efficient and effective arrangements. At present, the opportunity for identifying superior ways to protect and further the interest of corporate stakeholders and society while increasing the operating advantages of firms is denied by a plethora of practices enshrined in laws, regulations, listing rules and governance codes.

Identifying outcomes instead of practices creates a strategy for introducing bottom up stakeholder co-regulation on an incremental trial and error basis. The insights of system science indicate that the current top down regulation cannot possibly regulate the complexity of corporate activities because it does not have requisite variety of information (Shannon and Weaver 1949), decision making (Neumann 1949) and control (Ashby 1968). This statement is relevant to either a National regulator or a single board of directors controlling a large firm.

The concluding Section considers how an outcome co-regulatory approach could subsume the current corporate governance regimes based on practices rather than outcomes.

### **4. Defining good governance in terms of outcomes not practices**

This concluding Section argues that good corporate governance should be defined in terms of outcomes for shareholders, investors, stakeholders and society.

One purpose of corporate laws, regulations and listing rules is to facilitate commercial activities in a way to protect the interests of those that may be negatively affected. While laws are required to facilitate the existence of corporations the outcome of protecting those affected can be built into the

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instrument of incorporation as indicated above. This approach would make a fundamental change in the role of government as envisaged by the former US Vice President (Gore 1996).

Gore proposed that governments should not attempt to directly intervene in regulating society but act indirectly by “imprinting the DNA” of self-regulation into the institutions of society. This strategy of nature to create and manage complexity is based on the insights of Ashby (1968: 206). Ashby identified the law of requisite variety to control complexity and its corollary that it is impossible to directly regulate complexity. The amplification of regulation is only possible through indirect means of “supplementation” that in a social context means co-regulation.

The approach suggested by Gore indicates that “Good Governance” should be defined in terms of the outcome of improving the ability of companies to become self-governing so as to minimize the intervention of governments and their regulators. In this way the costs to both the company and the government can be minimized.

Governance is about power. The inconvenient truth is that corporate constitutions provide what Monks and Sykes (2002) describe as “inappropriate powers” for the directors. These powers are tabulated in Turnbull (2000b: 115; 2000c). Monks and Sykes went on to say that the removal of these inappropriate powers “is thus the litmus test for any worthwhile reform of shareholder capitalism”. The introduction of shareholder and stakeholder watchdogs in the form of Corporate Senates and Stakeholder Councils provides a way to meet this test.

Many current reforms in corporate laws, regulations, listing rules and governance codes do not reduce or mitigate the inappropriate powers of directors so problems continue to arise. If reform of the law, regulations and listing rules meets the test proposed by Monks and Sykes there would be little or no need for any corporate governance codes. Their existence can be taken as evidence that the current top down strategy of regulation is inadequate and not acceptable.

To obtain sufficient variety of control to regulate the complexity of corporate activities stakeholders need to be introduced as co-regulators. By constructively sharing power with stakeholders to allow them to initiate action to protect their interests a self-enforcing regulatory regime can be introduced. It is the stakeholders that first become aware of problems and so are in the best position to initiate action to protect their interests and/or that of the business. It is by this means that network governance can introduce much more sensitive, responsive, effective, and efficient way for corporations to control their operations and achieve the outcomes required by Regulators and/or society.

Corporate Senates and Stakeholder Councils in addition, legitimize, protect and facilitate the role of non-executive directors whether or not they meet the various test of being described as “independent”. Research by Bhagat and Black (2002) reported the “non-correlation between board independence and long term firm performance”. This is consistent with the view that independence reduces the ability of a director to add value as they have less knowledge and authority about the firm. The information provided by Stakeholder Councils to directors overcomes this criticism to legitimize the role of non-executive directors.

It is envisaged that peak Stakeholder Councils would meet with directors on a regular basis of say every three to four months. The operations of a Corporate Senate would occur whenever one or

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more directors were involved in a conflict of interest. A CGB that took over the role of a board: Audit Committee, Remuneration Committee and Nominating Committee would need to meet more frequently. However, an offsetting cost saving would be that the appointment of non-executive directors would not be required, whether or not they were considered to be “independent”. This in turn would greatly simplify corporate governance codes and eliminate listing rules, regulations and laws that specify the need for board committees and the ever changing complex tests of what makes a director independent. This indicates the potential for an outcome based approach to simplify laws, regulations, listing rules and dispense with Corporate Governance codes.

According to Rodrigues (2007) “conventional wisdom” has created "The Fetishization of Independence" a view supported by Clarke (2006) who points out that “important elements of the concept of and rationale for independent directors remain curiously obscure and unexamined”. Both writers raise the point that the outcome of having independent directors is often not stated and that different outcomes require different types of independence. Clarke considers the difference between an independent director, an outside director and a non-interested director. Also the different definitions used to define independence in various codes, listing rules, regulations and laws around the world that arise from the different outcomes that are not explicitly identified.

For example, is independence required from management to control their remuneration, and/or is it from a major shareholder to control the terms of related party transactions, and/or is it from the company to protect it from acting illegally and/or in a way that can damage its reputation, and/or is it to provide an independent point of view on the strategic direction and operations of the business and/or is it independence of a director from business dealings with the company? Any and/or all of these outcomes can be achieved without the need for defining the nature of an independent director with corporate constitutions that introduce a Corporate Senate or CGB and Stakeholder Associations with their representative councils.

The problem of individuals obtaining “independence of mind” was identified by Milgram (2004) who conducted experiments in 1958 on how good people can do bad things like occurred in Nazi Germany. His findings were verified by the more specific research into “Why Good Accountants Do Bad Audits” (Bazerman, Loewenstein, & Moore, 2002) and “The impossibility of auditor independence” (Bazerman, Morgan & Loewenstein 1997). The lessons of this literature are that the necessary but not necessarily sufficient conditions for a director to be independent are to have: (i) the information to act, (ii) the will to act and (iii) the power or ability to act constructively.

All these three conditions can be provided by non-standard corporate constitutions that introduce: (i) Stakeholder Councils to provide directors with the information to act independently of management; (ii) cumulative voting to provide directors with the will to act to get re-appointed by minority shareholders and (iii) Corporate Senates to provide directors with the ability to act privately without jeopardizing their reputation by being seen to be a “whistle blower” or jeopardizing the reputation of the company by needing to report matters to the regulator and/or calling a meeting shareholders.

While the introduction of a Corporate Senate and Stakeholder Associations and their Councils may be seen as a complication to the governance architecture of corporations they result in the simplification of the knowledge, duties, roles and compliance obligations of company directors. In this way they can reduce the exposure of Directors to litigation and the cost of obtaining professional indemnity insurance.

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Network governance is ubiquitous in nature because it minimizes the materials and energy required in the communication and control architecture of living things (Turnbull 2000b: 134). Its complexity simplifies the role of its component parts. It is by this means that it simplifies the role and duties of company directors by distributing responsibilities through the network. In this way it reduces information overload and allows the decomposition of decision making labor by introducing “distributed intelligence”. Network governance allows simple creatures to survive and reproduce in complex and dynamic environments. As society and business increases in complexity network governance becomes more ubiquitous as reported ten years ago by Jones, Hesterly, and Borgatti (1997).

The operating and competitive advantages of network governance in less complex business activities were reported by a World Bank study of the nested network firms located around the town of Mondragon in Spain. Thomas and Logan (1982: 126–7) reported that:

Various indicators have been used to explore the economic efficiency of the Mondragón group of cooperatives. During more than two decades a considerable number of cooperative factories have functioned at a level equal to or superior in efficiency to that of capitalist enterprises. The compatibility question in this case has been solved without doubt. Efficiency in terms of the use made of scarce resources has been higher in cooperatives; their growth record of sales, exports and employment, under both favourable and adverse economic conditions, has been superior to that of capitalist enterprises.

Another relevant feature of the Mondragón stakeholder controlled network firms is their ability to be self-governing: a feature consistent with the political ambitions of the Basque country in which they are located. Network governance provides a strategy for maximizing self-governance and so “good governance” as defined above. Mondragón provides evidence of the potential of replacing external regulation with internal self-enforcing regulation. Mondragón also demonstrates the operating and competitive advantages of network governance. In shareholder owned firms this provides a basis for reducing the cost of finance as indicated by JTL and the author’s earlier experience in raising venture capital described in the second end note.

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### END NOTES

<sup>1</sup> The name of the progenitor company was The Quadractor Corporation Inc (TQC). It raised equity from investors in Vermont during the early 1970's to build an innovative light weight and very economical tractor to pull timber out of wood lots. The tractor had a drive wheel at the bottom of each of its four vertical "legs" that allowed it to straddle loads to transfer their weight to itself to obtain traction. The patents and manufacturing equipment were sold to the Peoples Republic of China (PRC) who was not successful in getting into production to sell vehicles to the US. The inventor of the Quadractor and CEO of TQC received a large sum from the PRC for the patents. However, TQC was placed in Chapter 11 in 1982. A number of security holders in TQC contributed funds to contract with the author to set up a successor entity in 1984 that was incorporated in Vermont as Jefferson Approtrac Company Inc (Jac). A former employee of TQC redesigned the Quadractor to replace its twisting frame with a patented swiveling frame. Jac Inc only had sufficient funding to build an Evaluation Vehicle (EV1) and apply for patents. Operations were suspended while the author returned to Australia and explored the possibility of obtaining funds in Australia. In 1986 the author organized some private operating companies with related interests, augmented by a government grant and a publicly traded venture capital company to contribute funds to incorporate in Australia JAC Tractor Pty. Ltd. (JAC). JAC acquired the intellectual property of Jac Inc and EV1 by issuing its shares to the US stockholders and option holders of Jac. The Australian investors included three shareholders who provided services to JAC. JAC was established with three Australian directors and two US directors. US citizens together held 47% of the shares. While building EV2 the company saw the need to replace the belt drives with vertical drive shafts. This required additional funding to build EV3. It was to obtain funds from the US investors who had originally invested in the project over ten years earlier that the company changed its constitution at an Extraordinary General Meeting of Shareholders in February 1988. Additional details are provided in Turnbull (2000a: 148-51).

<sup>2</sup> The author had previously established in 1980 an elected "Audit Committee" to control the Auditor of a large irrigation farming venture. The author and a partner owned all the land and investors they introduced obtained 15 year leases with a guaranteed minimum return and profit share (Turnbull 2002c). The formation of the Audit Committee was part of the contractual leaseholder arrangements with the investors with the owners appointing only two of the five committee positions. The independent chairman of the committee held a registered caveat over the land to stop the owners dealing in the land without permission of the leaseholder investors. The committee also had power to manage conflicts of interests. When a flood washed away a major water storage area and additional funds were required, the Leaseholder Audit Committee was used to negotiate conversion of all leasehold interests into shares that became listed on the Australian Stock Exchange in 1983 (Turnbull 2002b).