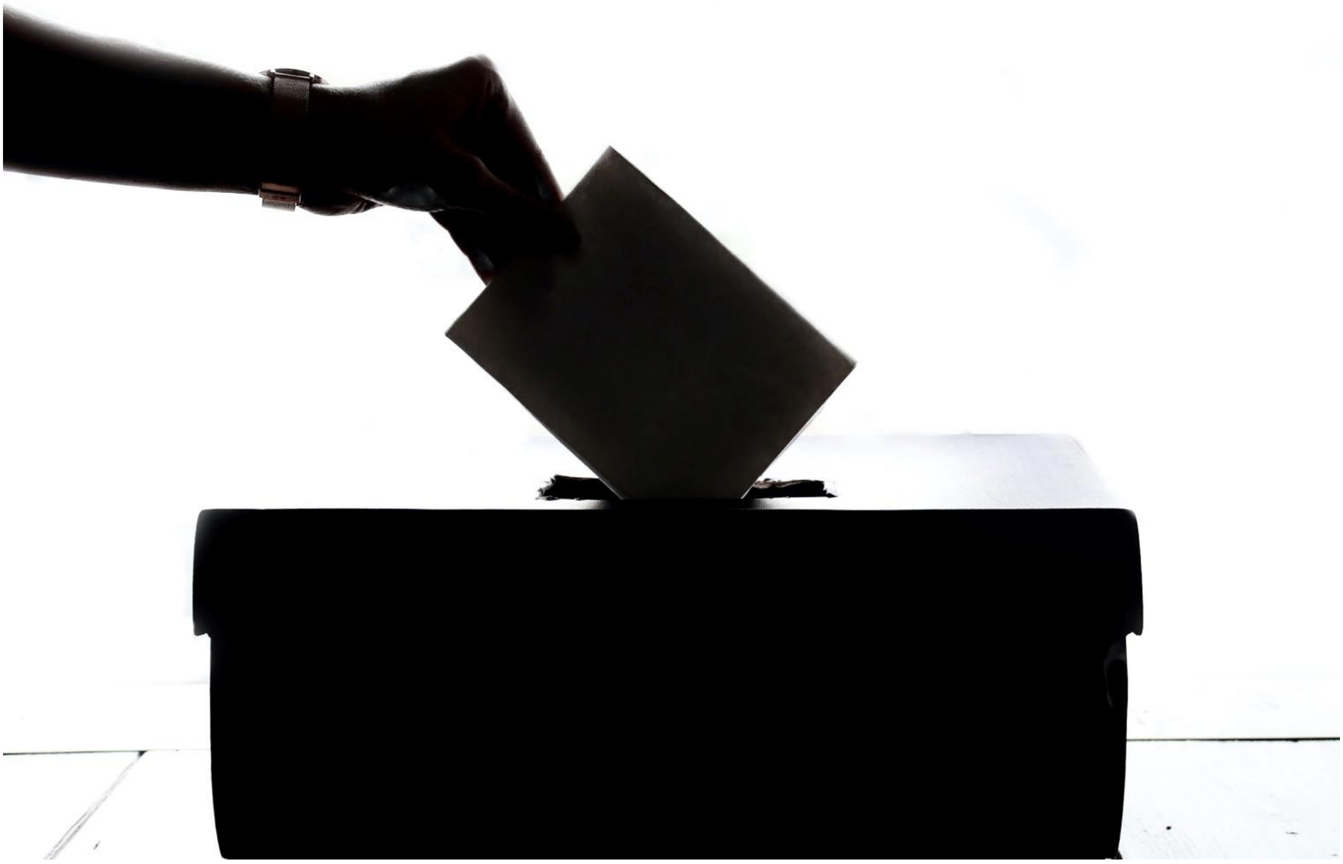
Privatising Regulation To Enrich Democracy



February 2021

The Z/Yen Group

Privatising Regulation To Enrich Democracy

February 2021

Author

Shann Turnbull PhD

Editor

Simon Mills

Introduction

Meta Commerce is a part of the Long Finance research programme managed by Z/Yen Group. The programme aims to identify and structure the critical questions underlying the long-term viability of the financial system.

Inspired by David Hilbert's 23 questions project of 1900, the Meta-Commerce programme brings together financial experts across a range of disciplines with a view to producing a framework of questions in order to prioritise future research and direct action.

By helping to identify a set of core questions that link economics, finance and society., and that need solving in order to have a working financial system., Meta-Commerce maps the road to Long Finance and contributes to its overarching goals - to expand frontiers, change systems, deliver services and build communities.

Three clear issues resonate through our various research areas and questions:

Fairness across different cultures — does fairness as a concept increase as wealth increases and, if not, what other organising principles for financial services could create desirable outcomes?

Trust across different cultures — what creates and destroys trust, where?

Value across cultures and time — what is the dynamic between value and price (which could be an expression of long-term and short-term concerns), and is value always higher than price?

Interlinking all three issues and money is the role of "credit creation in the modern economy". Long Finance seeks funding to develop a clear exposition of the choices society faces, the pros and cons of each choice, and a narrowing down to some probable outcomes – with some of the possible avenues being:

Leverage as usual — striving to return to 'normal';

No leverage — removing the ability of banks to create money, leaving overall levels of credit in government;

Strict leverage — setting some firm level of banking leverage, e.g. 1:1 or 8:1, as well as some overall leverage level in society – what mechanisms might exist to determine such;

'Optimal' leverage — attempting to find some form of equation or indicator that could be used as a measure and target (cognizant of Goodhart's Law);

Abstract

Complexity can only be controlled with matching complexity, which is why current models of regulation for the financial services sector are not fit for purpose. Systemic issues with the governance of regulatory bodies have led to intrusive, expensive, unreliable top-down regulation. The introduction of polycentric self-governance, found in sporting organisations from local to global levels, indicates how businesses could engage with their stakeholders to become more self-regulating and self-governing. If the UK Government were to develop this approach the UK would become a role model for the world.

Background

Should the regulation of financial services be privatized to provide superior protection for citizens and also enrich democracy? This was not a question considered by the UK Government when it invited stakeholders in 2020 for feedback on their "*Future Regulatory Framework Review*"[1].

A key aim of the government is to seek "*appropriate democratic policy input to support a stable, innovative and world-leading FS sector*". To meet this objective requires the wholesale creation of democratically controlled organisations with one vote per stakeholder. This is because currently, the dominant businesses advising and lobbying the government are controlled on the plutocratic basis of one vote per share.

The political objective of government is consistent with system science. This informs us that reliable regulation of any complex activity, and especially financial services, cannot be achieved simply. Complexity can only be controlled with matching complexity[2].

The obvious way to constructively increase complexity is to engage a sufficient variety of stakeholders who require protection, organizing them on a democratic basis, to become bottom-up supplementary co-regulators to facilitate self-regulation. Instead, the UK Government, like other governments around the world, only considers the intrusive, expensive, unreliable ,and ultimately ineffective, top-down regulation of complexity.

Expecting successful regulation using only a top-down approach is like expecting to win a football match by fielding a team with only two players. Facing overwhelming odds, and a

[1] HM Treasury, 2020. Financial Services Future Regulatory Framework Review, Phase II Consultation. October, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/927316/141020_Final_Phase_II_Condoc_For_Publication_for_print.pdf and "The call for evidence - Future of Financial Services" by the UK Parliamentary Treasury Committee at: https://committees.parliament.uk/call-for-evidence/319/future-of-financial-services/

[2] Ostrom, E. 1998. Scales, polycentricity and incentives: Designing complexity to govern complexity. In: L. D. Guruswamy and J.A. McNeely, (eds.). *Protection of global biodiversity: Converging strategies***.** Durham, NC: Duke University Press. https://www.dukeupress.edu/protection-of-global-biodiversity Ostrom is applying the mathematically determined "Law of Requisite Variety" described by Ross Ashby on page 207 of his 1957 book *An Introduction to cybernetics*. Ashby states: "only variety can destroy variety".

battery of expert lawyers and lobbyists, The Financial Conduct Authority and the Prudential Regulatory Authority cannot be expected to win. They require the multiplicity of supplementary, bottom-up co-regulators which are available from the private sector.

Auditors should, and could, contribute as supplementary co-regulators. However, for this to happen requires bottom-up changes which would allow the stakeholders that the government seeks to protect, to obtain the power and resources to control the auditors. Instead, governments around the world have allowed auditors to be controlled by corporate directors who can misuse their power and information to abuse those same stakeholders.

This poisonous, unethical and toxic relationship has actually been promoted by UK governance codes. The "*terrible mistakes*" made by the first code in 1992 are described in my article "*The Need For Radical Reform Of Corporate Governance* – *A Narration*" [3]. Highly respected and good people created the code in order to illustrate how good people can do bad things[4].

Their views were so influential, that they created a powerful global "*group think*", even among regulators[5] and ethicists. The result is a business culture where some executives can no longer tell the difference between what is right or wrong. A point made by Australian Royal Commissioners reporting on a financial failure in 2003 and misconduct in 2019.

Stakeholder Empowerment

The empowerment of shareholders and other stakeholders to have the ability to democratically select, appoint and control qualified stakeholder advocates (independently of corporate directors), becomes essential to reliably protect citizens against abuse. Using this approach, a multiplicity of advocates become responsible for the integrity of self-regulation on a bottom-up and firm-specific basis.

Unlike regulators embedded in corporations, stakeholder advocates can become management mentors, helping to improve competitiveness as well as stakeholder benefits. Stakeholder governance both enriches and spreads democracy by systemically providing the citizen with both a voice and influence in the social institutions that affect their wellbeing.

Numerous examples of stakeholder, bottom-up, self-governing organizations exist around the world particularly in sporting and civic organizations. Your author was involved in the incorporation of the Australian controlling body for skiing in 1974. The body which federated the self-governing State controlling bodies, that in turn had been formed by federating their self-governing ski clubs. The self-governing national body of skiing represented the Australian States who competed against each other in competitions but cooperated to represent the country internationally.

[3] Turnbull, S. 2020, The case for radical reform of corporate governance: A Narration. *Corporate Governance Insight*, 2(2): 4-30, https://www.grfcg.in/images/2021/CGI2020_31Dec.pdf

[4] Turnbull, S. 2019, 'How shareholders, corporations and directors can become ethical', *The European Financial Review*, August 26, pp. 28-32, https://www.europeanfinancialreview.com/how-shareholders-corporations-and-directors-can-become-ethical/

[5] Turnbull, S. 2018, Royal Commission into misconduct in the Banking, Superannuation and Financial Service Industry, "Regulators poisoning corporate culture and performance", 28 May. Reference number PWF.0001.0001.7989.

I describe this as ecological governance because as it creates the same type of distributed decision-making as found in our brains[6]. Elinor Ostrom, a political scientist, used the term "*polycentric governance*" to describe distributed decision-making in her 2009 Nobel Prize speech[7].

Our brains operate similarly, with different parts of our brains making different types of decisions competing for dominance according to our internal needs and external risks and opportunities with the different parts also cooperating.

A take-home message is that risk and opportunity management needs to be continually subjected to challenge. Contesting decision-making in centralized command and control hierarchies is commonly denied, resisted, and even punished. This denies reliable risk governance in hierarchies, a fact neglected by risk managers, regulators, and governance codes. Simple hierarchies expose organizations to existential risks and failure without warnings as is frequently reported. Twenty sources of failure are noted in Table 1 with how they are can be avoided by introducing ecological governance as shown in Figure 1 (page7).

Table 1. Systemic Problems Of Hierarchies (See also Figure 1)

	Toxic problems of hierarchies	Mitigation by mimicking nature
1	Society assumes top-down control is natural	Nature uses bottom/up control & top/down guiding
2	So no education about ecological governance with distributed control to simplify complexity	Complexity simplified with almost self-governing sub-systems dependent upon contrary guiding
3	Unitary boards obtain absolute power to identify and manage their own conflicts of interest to allow absolute corruption of directors, the business and society	Shareholders appoint one board to manage the business and another board to become integrity guardians to govern the corporation and represent all stakeholders & community views for investors
4	Group think arises from directors captured by CEO to hide risks, misconduct & malfeasance	Guardians of stakeholder voices obtain contested "*requisite variety*" of data for checks and balances
5	Corporations can lie and/or mislead themselves about director independence	Directors independence becomes irrelevant except for their relationship with Guardians
6	Directors capture auditors who judge their A/c	Guardians control auditors who judge directors A/c
7	Auditors lie that they are independent	Auditors kept independent by Guardians
8	Accounting doctrines hide how investors get overpaid beyond their investment time horizons with surplus profits creating hidden sources of inequality and stakeholder exploitation	Ownership of surplus profits distributed by corporations issuing shares to citizen stakeholders that democratizes wealth and power. Reduces the need for corporate taxes and welfare programs
9	Directors control advisors to shareholders	Shareholder advisors controlled by Guardians
10	Directors nominating themselves for election	Director nomination by shareholders & Guardians
11	Directors control their own pay after setting and marking their own "exam papers" aka KPIs	Guardians determine director pay from Stakeholder Key Performance Indicators (KPIs)
12	Directors control reports about corporate impact on the environment, stakeholders and community welfare and their own governance	Stakeholders provide guardians with reports for shareholders on Guardians pay, corporate impacts on stakeholders, the environment and society.

[6] Kelso, J. A. S. Dumas, G. & Tognoli, E. 2013. Outline of a general theory of behavior and brain coordination. *Neural News*, 37, 120-131.
[7] Ostrom, E 2009. *Beyond Markets and States: Polycentric governance of complex economic systems***,** Prize lecture, December 8th, https://www.nobelprize.org/prizes/economic-sciences/2009/ostrom/lecture/

Table 1 (Continued)

	Toxic problems of hierarchies	Mitigation by mimicking nature
13	Directors control how they are held accountable to shareholders at AGMs and control the voting processes on own election and remuneration.	Stakeholder nominee controls conduct of AGMs. Guardians determine AGM agenda, location, acceptance of proxy votes, vote counting, etc.
14	Directors ignorant of shareholder identities, etc.	All ultimate owners and/or controller made public
15	Share trading relationships and price manipulation hidden from directors and public	No shares traded without prior disclosure of any related derivatives and identity of counter parties
16	Shares traded covertly by third party exchanges	Corporations directly execute all share transfers
17	Directors not held to account by various stakeholder groups who may have conflicting interest but on who directors rely upon to improve the quality, reliability, and efficacy of continuous operational improvements	Each common interest stakeholder group obtains rights to form their own non-profit associations to appoint advocates/supplementary regulators/ management mentors that avoid directors and shareholders being kept in a cocoon of ignorance
18	Directors of simple command and control hierarchies lack systemic process to cross check management actions and misreporting	Directors obtain stakeholder communication and control channels independent of managers to cross check integrity of operations and outcome reports.
19	Impossibility of controlling complexity directly	Complexity controlled indirectly by stakeholders
20	Self-regulation/governance is impossible	Self-governance shrinks costs & size of government

Also presented in Turnbull, S. 2020. ***Do we need "A new model of corporate governance?"***
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3735205

The idea of any organization being able to survive and thrive in complex environments without a central controller is incomprehensible to many people, including social scientists and policy advisers. However, neurologists understand how our brains operate without any "*Chief Executive Officer*" neuron[8].

Sporting bodies provides an example of how self-governance can be achieved globally without markets or state. The Australian national controlling body of skiing was in turn a self-governing unit of the International self-governing global body for skiing. This was in turn was a unit of the self-governing Olympic organization, to illustrate how democracy can be spread and enriched from the bottom up.

In 1978 your author revised the constitution of *The Company Directors Association of Australia*, to introduce self-governing state chapters. The Association merged with another organization in 1990 to become *The Australian Institute of Company Directors*. The election of State Committees was maintained to facilitate self-governance to locally engage with members. While Australia has only a fraction of the population of either the US or the UK, the membership of AICD is now about twice that of either the centrally controlled *National Association of Corporate Directors* in the US or *the Institute of Directors* in the UK.

Empowering local citizens with the information, power, resources, and incentive to act enriches democracy at a systemic bottom-up basis. While this introduces complexity it need not involve governments as discussed above. Ostrom provided evidence that these structures have existed since pre-modern times, well before before states or markets existed. She described how groups competing for shared, life-sustaining resources could become self-regulating. This avoided what is described as the "*Tragedy Of The Commons*"

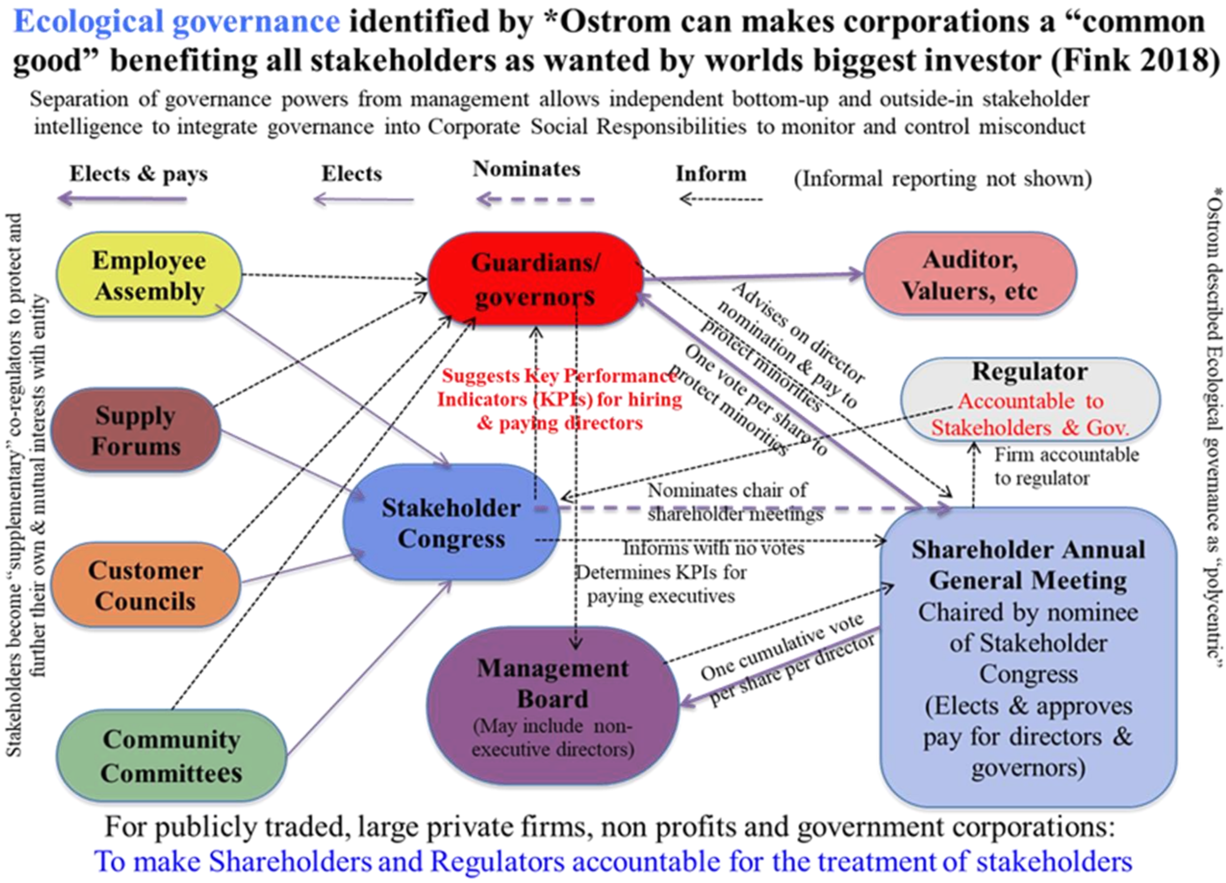
[8] Kurzweil, R.1999. *The age of spiritual machines: When computers exceed human intelligence*. p. 84, Viking: New York.

when competing self-interests results in excess exploitation to deny the resource for everyone. The same situation exists with shareholders competing with other stakeholders for the resources of a corporation.

Polycentric Governance

A generic, simplistic illustration of how existing public corporations could transition to an ecological, "*polycentric*" self-governing organizational structure that provides benefits for all stakeholders is provided in Figure 1. One vote per share for directors maintains shareholder primacy while one vote per stakeholder introduces democracy. In this way, creative tensions are established to negotiate win-win solutions.

Figure 1 How Mimicking Nature Can Mitigate Systemic Problems Of Hierarchies



Crucially, the separation of the power to manage the business from the power to govern the corporation guarantees stakeholder voices are heard to protect and further their interests. Each self-governing stakeholder constituency can both contest and/or support any one or more other constituencies, including shareholders accountable to society for benefiting citizen stakeholders. In this way, regulation becomes integrated into democracy rather than hollowing it out with poorly accountable State officials.

Enriching democracy and regulation becomes dependent on establishing "*a community of stakeholders*" as noted by Mainelli & Gunten[9]. This allows the private sector to continuously define acceptable standards for both firms and stakeholders while facilitating innovations to increase economy, efficiency, and effectiveness. The professionally qualified and paid stakeholder advocates/management mentors would replace the need for either government or corporate ombudspersons.

Ideally, each stakeholder constituency would be established by corporate constitutions. Alternatively, each stakeholder constituency for each firm could be incorporated separately as a non-profit civic organization as mandated by the regulator. The regulator would grant corporations discretionary self-governing powers in exchange for them funding stakeholder constituencies to independently and competitively selecting and controlling their advocates. The advocates would also become co-regulators with their qualifications and pay determined by the regulator.

The Key Performance Indicators used by governments to evaluate and remunerate their regulators would be determined by an association of stakeholder elected advocates. As a result, the "*governance structure is accountable to its stakeholders*" as proposed by Mills and McDowall[10]. This is another way of enriching democracy.

These suggestions are also encouraged by the various US initiatives introduced by Ralph Nader half a century ago. One initiative was the formation of Citizen Utility Boards (CUBs)[11]. These empowered and informed stakeholders to act as watchdogs, whistleblowers, and counter corporate directors capturing government regulators. Your author acted in this way for 13 years as an unpaid director of the non-profit Australian Shareholders Association.

Ostrom identified design rules for introducing self-regulation of natural resources. Your author has reformatted these rules[12] to apply to corporations and their stakeholders. They create *"A new model for corporate governance*". This is wanted by Larry Fink[13], the CEO of the biggest asset manager in the world to "*provide benefits for all stakeholders*." An objective supported in 2019 by 180 of Fink's CEO colleagues from the US Business Round Table who also had Fink as a shareholder.

The "new way to govern[14]" would not require any changes in the Law, only perhaps changes in corporate constitutions and/or how regulators regulate. The changes would introduce stakeholder self-regulation. The enduring competitive advantages and resiliency of bottom-

[9] Mainelli, M. & von Gunten, C. 2013. Backing Market Forces: Voluntary standards markets and the regulation of financial services. November, p. 23, London: British Standards Institute, Chartered Institute for Securities and Investment and Long Finance, https://www.zyen.com/media/documents/BSICISILF_Backing_Market_Forces_November2013.pdf

[10] Mills, S. & McDowall, R. 2017. Responsibility without power? Distributed ledgers (aka) Blockchains, p. 42, July London: Z/Yen Group, Long Finance & Cardona Foundation, https://www.zyen.com/publications/public-reports/responsibility-without-power-the-governance-of-mutual-distributed-ledgers-aka-blockchains/

[11] Givens, B. 1991. *Citizen Utility Boards: Because utilities bear watching*, Centre for Public Interest Law, University of San Diego, School of Law, California, http://www.cpil.org/download/CUB_Report.pdf

[12] Turnbull, S. 2020, 'Do we need "A new model for corporate governance"? *Working paper*, https://papers.ssrn.com/abstract_id=3735205

[13] Fink, L. 2018. *Larry Fink's letter to CEOs*, https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter

[14] Turnbull, S. 2002. *A new way to govern: Organisations and society after Enron*. London: The New Economics Foundation, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=319867

up governance being introduced with top-down controls are illustrated in many stakeholder-governed businesses around the world. Examples that have existed for half a century or more are *VISA International* in the US, *The John Lewis Partnership* in the UK, and the *Mondragon Cooperatives* in Europe.

Self-financing tax incentives could be used to obtain shareholder agreement to change corporate constitutions to introduce elements of bottom-up self-regulation and self-governance. The tax incentives would introduce bigger profits quicker with less risk to provide institutional investors with a fiduciary duty to agree to change corporate constitutions. The cost-benefit metrics of this proposal are provided in my academic articles[15] and the Appendix of my 1975 book *Democratising the wealth of nations*[16].

The tax incentives become self-financing because the tax base moves from corporations that are typically taxed at a lower rate to individual stakeholders who become beneficiaries of corporate benefits. The stakeholder benefits also generate a universal well-being income to privatize welfare as well as regulation. The cost, size, and intrusiveness of government are reduced to further enrich democracy.

Conclusion

The Ministerial Foreword of the UK 2020 consultation paper noted: "*The importance of the UK as a financial centre and the role it plays in the global financial system, mean that the success or failure of our regulatory approach can have important consequences far beyond our shores*." In the past, these consequences have poisoned the business cultures in its former colonies[17].

However, corporations providing benefits for all stakeholders become a common good. Global corporations then became agents for promoting common benefits globally like countering pollution, loss of biodiversity, and many other sources of risks and harms to the environment and humanity. In this way, the UK could become a positive role model for the world. A possibility facilitated by the Treasury Minister possessing responsibility for both taxation and regulation.

[15] Turnbull, S. 2000. Stakeholder governance: A cybernetic and property rights analysis. In R. I. Tricker, (ed.), *The history of management thought: Corporate Governance*, pp. 401–413, London, Ashgate Publishing, http://papers.ssrn.com/sol3/paper.taf?ABSTRACT_ID=11355

[16] Turnbull, S. 1975, *Democratising the wealth of nations*, The Company Directors Association of Australia, Sydney, https://papers.ssrn.com/abstract_id=1146062

[17] Turnbull, S. 2020. Webinar on: The case for radical reform of corporate governance for the Global Research Foundation for Corporate Governance, https://www.youtube.com/watch?v=xWve9MJyRXA#action=share

Earlier Shann Turnbull Articles Published By Long Finance

2020 "Curing infected economies with self-financing money", 15 April, ***Long Finance***, https://www.longfinance.net/news/pamphleteers/curing-infected-economies-self-financing-money/

2019 'Holacracy – How Extinction Rebellion's success in organising protests is based on management science', ***Long Finance***, Friday November 1, https://www.longfinance.net/news/pamphleteers/holocracy-how-extinction-rebellions-success-organising-protests-based-management-science/

2018 'Why no standard unit of value', ***Long Finance,*** published: Thursday, 08 March, 15:42 http://archive.longfinance.net/news/long-finance-blogs/1170-defining-value-to-simplify-money.html

2017 'Should money have a stable predicable value?' ***Long Finance***, Thursday, 24 August 12:49 https://www.longfinance.net/news/pamphleteers/should-money-have-a-stable-predicable-value/

2015, 'Why should the UK adopt a digital currency?' *The Pamphleteers*, ***Long Finance***, 9th, April, 9:12, London, at: https://www.longfinance.net/news/pamphleteers/why-should-the-uk-adopt-a-digital-currency/

2013, 'Can Democratic Money with Environmental Values Reduce Market Failures? February 26, ***Long Finance***, at: https://www.longfinance.net/news/pamphleteers/can-democratic-money-environmental-values-reduce-market-failures/

Author

Dr Shann Turnbull is the Principal of the International Institute for Self-governance and co-founder of the New Garden Cities Alliance and Sustainable Money working Group

He qualified as an Electrical Engineer in Tasmania, and has a BSc from Melbourne University, and a MBA from Harvard. His PhD from Macquarie University in Sydney established the science of governance in any specie. He has worked as a business entrepreneur founding a number of enterprises including two public mutual funds and three firms that became publicly traded.

In 1975 he co-authored the world's first educational qualification for company directors and wrote "*Democratising The Wealth Of Nations*" which was published by The Company Directors Association of Australia and launched by Dr Jim Cairns MP, Deputy Prime Minister of Australia. In 1977 he was commissioned by the Australian Minister for Aboriginal Affairs to undertake the first economic analysis of Aboriginals for the Australian government, and in 1991 he advised on employee privatisation in the Czech Republic, Slovakia and China.

He is prolific author on reforming the theories and practices of capitalism by adopting the practices of nature to achieve sustainability. A list of his publications can be found at https://independent.academia.edu/TurnbullShann .

"*When would we know our financial system is working?*" is the question underlying Long Finance's goal to improve society's understanding and use of finance over the long term. Long Finance aims to:

- expand frontiers - developing methodologies to solve financial system problems;
- change systems - provide evidence-based examples of how financing methods work and don't work;
- deliver services - including conferences and training using collaborative tools;
- build communities - through meetings, networking and events.

www.longfinance.net

Z/Yen is the City of London's leading commercial think-tank, founded to promote societal advance through better finance and technology. Z/Yen 'asks, solves, and acts' on strategy, finance, systems, marketing and intelligence projects in a wide variety of fields. Z/Yen manages the Long Finance initiative.

Z/Yen Group Limited
41 Lothbury, London EC2R 7HG, United Kingdom
+44 (20) 7562-9562 (telephone)
hub@zyen.com (email)
www.zyen.com