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Responses to: Discussion Paper 28 November 2013

“Better regulation and governance, enhanced transparency and improved competition in superannuation”
<http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2013/Better-regulation-and-governance>.

Principal recommendations:

- 1) Introduce network governance¹ to remove systemic unethical board conflicts and so the need for so called independent directors with the ever changing associated definitions and compliance protocols for directors requiring detailed monitoring by regulators (p.2).
- 2) Separate the functions of directors acting as fund trustees from any governance role of the trustee company (p.2).
- 3) Make directors of Superannuation Trustee companies and governors of Trustee companies directly accountable and appointed by the beneficiaries of the superannuation fund to facilitate self-regulation and self- governance with less involvement of regulators (p.3).
- 4) Organize industry workshops to design the governance architecture as outlined above (p.4).
- 5) A Parliamentary committee should investigate why:
 - a) ASIC has allowed the ASX to adopt listing rules and recommended so called principles of good governance that ignore, accept or promote unethical conduct and conflicts of interests for both directors and auditors;
 - b) APRA has enforced some ASX principles for financial institutions that the 2011 US *Financial Crisis Inquiry Commission Report* concluded contributed to the “key causes” of the 2008 Global Financial Crisis (p.5).

Response to focus Question 1: *The Government has committed to identifying (in dollar terms) measures that offset the cost imposed to business of any new regulation. What suggestions do you have for how the regulatory compliance burden can be reduced?*

The only effective way to reduce the regulatory burden of reliably controlling complex activities is to empower the stakeholders that need to be protected with the information, incentive power and capability to protect themselves as supplementary co-regulators. That is, to introduce reliable self-governance.

The newly identified “science of governance”² reveals that complex activities like superannuation can

¹ Defined and explained in Turnbull 2013, ‘Educating governance architects with the science and practice of governance: In the public, private and non-profit sectors’ at <https://docs.google.com/document/d/1c9gt9jsSL7i-JovneNfFiGjvxcj2V8Jz98Ku461aHmk/edit>.

² Turnbull, S. 2002, ‘The science of corporate governance’, *Corporate Governance: An International Review*, 10:4, 256–72, October, http://ssrn.com/abstract_id=316939.

only be reliably managed with a “requisite variety”³ of matching complexity. It is only the stakeholders that governments are seeking to protect who can provide sufficient requisite variety of viewpoints to generate the required checks and balances with sufficient distributed intelligence to: identify and have a chance of reliably communicating, and reliably controlling - the known known’s, the known unknown’s and the unknown unknowns.

Top down command and control hierarchies be they public sector regulators or private sector organizations deny the existence of a requisite variety of politically independent cross checking communication and control channels. It is never in the self-interest of a subordinate to fairly report problems for which he or she could be seen as being responsible. The natural laws of governance⁴ identified by Shannon and Ashby require regulators, or senior executives of complex organizations, to introduce network governance with bottom up and outside in communication and control channels to supplement the top down command and control channels of hierarchies.

A fundamental requirement for establishing network governance is to remove the excessive and unethical powers that are inherent in organizations governed by a single board. In this way the conflicts of interests that are systemically present in unitary board governed organizations can be removed with also the power for directors to corrupt themselves or the organization. A division of power also reduces the incentive for others to attempt to make donations to “buy” influence for obtaining personal benefits. The incentive to bias, distort or control election of officer bearers is also minimized.

The establishment of competition for power between different forums within the organization also promotes internal transparency and accountability with the need for external reporting minimized⁵. This reduces the monitoring burden by external regulators and compliance “red tape” for reporting entities. It is of little use to report information publicly if the public or officials lack the incentive, power or capability to act on the information. No laws, regulations or regulators should require reports if no one has the incentive, power or capability to act upon the information. This test could provide a basis for substantial reduction in “red tape” and compliance costs. Both transparency and accountability are necessary but not sufficient conditions for self-regulation.

By removing the inherent systemic conflicts of interests in unitary boards and providing competitive creditable processes for managing operating conflicts, network governance avoids the counter productive, unconscionable and unethical practices accepted or ignored in the ASX listing rules and corporate governance principles⁶. It also means that the need and role for independent directors is not

Turnbull, S., 2003, ‘Science of Governance’ in David Schultz (ed.), *The Encyclopedia of Public Administration and Public Policy*, 93-94, New York: Facts on File, Inc., <http://www.infobasepublishing.com/Bookdetail.aspx?ISBN=1438110146&Ebooks=1>.

Turnbull, S. 2008, ‘The science of governance: A blind spot of risk managers and corporate governance reform’, Special Issue of the *Journal of Risk Management in Financial Institutions* on The Blind Spots of Risk Management, 1(4): 360–8, July-September, <http://ssrn.com/abstract=1742584>.

³ The need for “Requisite Variety” to assure integrity of communication and control channels was identified respectively by: Claude Shannon, 1948, in “The mathematical theory of communications”, *The Bell System Technical Journal*, 27, 379–423 and 623–656, and by Ross Ashby, 1956, in *An introduction to cybernetics*. Chapman & Hall Limited: London.

⁴ Op cit, n.3.

⁵ Refer to: Pound, J. 1992, 'Beyond takeovers: Politics comes to corporate control', *Harvard Business Review*, March-April, 83–93 and Pound, J. 1993, 'The rise of the political model of corporate governance and corporate control', *New York University Law Review*, 68:5, November, 1003–71

⁶ Detailed critiques of current so called “good” or “best” governance practices are presented in:

1) Turnbull, S. 2010, ‘What’s Wrong with Corporate Governance “Best” Practices? In *Corporate Governance: A synthesis of theory research and practice*, eds H. Kent Baker and Ronald Anderson, John Wiley & Sons, 79-96, <http://ssrn.com/abstract=1506954>.

required for prudential or governance reasons. They may still be able add value through their connections or knowledge.

Response to focus question 2: What is the most appropriate definition of independence for directors in the context of superannuation boards?

The need to define directors as independent is eliminated by adopting network governance.

I strongly recommend that the beneficiaries of superannuation funds elect the individuals responsible for controlling their superannuation funds as occurs in self-managed funds and that the appointees are mainly senior beneficiaries of the fund. This is a basic requirement to reduce the compliance burden of the industry as it introduces governance of the funds by its members for the members. In other words it replaces compliance burdens and bureaucracy with democratic self-governance.

Trustees appointed by unions, employers and executives of for-profit funds are not directly accountable to fund members. This exacerbates the current form of disconnected capitalism that forces a bigger role for governments and their regulators to protect the interest of the alienated fund members. It also denies enriching democracy with self-governance.

The role and size of regulators would reduce as they changed from direct detailed monitoring of many complex operations in many funds to monitoring the efficacy of their self-governing arrangements.

Few, if any independent directors will be found in stakeholder controlled organizations like law firms, accounting practices, and other employee controlled firms like the John Lewis Partnership in the UK and the Mondragon cooperatives in Spain. Yet these firms have a long track record of possessing sustainable competitive advantages over generations of managers.

The concept of independent directors is fundamentally flawed. It is only common sense to note that the more directors are independent the less authority and knowledge they possess to add value. Harvard Professor Michael Porter noted this in his 1992 study of why US firms were not as competitive with those in Japan and Germany. His recommendation to Policy Makers was to: “Encourage board representation by significant customers, suppliers, financial advisors, employees, and community representatives”⁷. He noted on page 11 that: “Both Japanese and German companies practice of form of decentralization involving much greater information flow among multiple units in the company, as well with the customers and suppliers.” This illustrates how network governance, not identified by Porter, introduces greater transparency and accountability.

The various flaws in the concept of an independent director have been raised by a number of governance experts. Clark⁸ has identified how confusion arises from the three different types of independence while Page⁹ reports on the “Unconscious bias and the limits of director independence”.

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- 2) Turnbull, S.2010, ‘Why “Best” Corporate Governance Practices are Unethical and Less Competitive?’ In Laura Hartman and Joseph Des Jardins (eds.), *Business Ethics for Personal Integrity and Social Responsibility*, 2nd ed. Burr Ridge, pp 576–583, IL: McGraw-Hill, <http://ssrn.com/abstract=1260047>.
 - 3) Turnbull, S. 2012, ‘The limitations in corporate governance best practices’, in *The Sage Handbook of Corporate Governance*, Thomas Clarke and Douglas Branson (eds.) Chapter 19, 428–449, Sage: London & Thousand Oaks, CA, <http://ssrn.com/abstract=1806383>.

⁷ Porter, M. 1992, *Capital Choices: Changing the Way American Invests in Industry*, A Research Report Presented to The Council on Competitiveness and Co-sponsored by the Harvard Business School, p. 16.

⁸ Clarke, D. C. 2007, ‘Three concepts of the independent director’, *Delaware Journal of Corporate Law* 32 (1): 73–111.

⁹ Page, A. 2009, ‘Unconscious bias and the limits of director independence’. *University of Illinois Law Review* 2009 (1): 237–294.

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Rodrigues¹⁰ describes the “fetishization of independence” while Romano¹¹ describes how it has resulted in “quack corporate governance”.

A basic requirement in introducing network governance without independent directors is to adopt a constitution for the Trustee company that separates the power of acting as a Trustee of the fund from the power to govern the trustee company. Governance powers are those involved in nominating Trustees, remunerating Trustees, controlling the auditors of the accounts presented by the Trustees of the fund and the trustee company, and controlling the process of making Trustee directors accountable to members as Annual Meeting of the fund members and of the Trustee Company. A Stakeholder’s Council of service providers to the fund could also be established as part of the network governance architecture to provide expert opinions to fund members and their governors. This could include advise on Key Performance Indicators (KPIs) for evaluating directors.

The board size of a network-governed organization need not be in excess of nine persons and not less than three. There are many arrangements to consider. These would best be discussed in a workshop of those directly involved in the industry.

The election of trustees should be on a different basis from the election of governors. Cumulative voting for trustees would remove the possibility of a dictatorship of the majority by facilitating minority interest to be elected and so be able to provide opposing minority reports to the board of governors. With contentious matters the governors could then refer the matter to a general meeting of members.

The governance board may only have three members with one member elected each year. To inhibit board stacking in industry funds by unions or employers harvesting votes, the right to vote for governors could be restricted to senior beneficiaries. Seniority could be defined in terms of length of membership and/or size of their entitlement.

There are many other voting options to consider such as: Should eligibility to vote on electing Trustees or Governors be based on democratic principles or on the size of the member’s entitlement? Should voting rights of members be reserved for those who have been members for a year or so? Should the gender of appointments follow the gender mix of the members? Whether or not gender equality is specified should voting for one gender be dependent upon being a member of the opposite gender? Should large funds have some form of Electoral College for nominating directors or governors? As the roles and responsibilities are shared between at least two boards so would the remuneration of officer bearers.

Response to focus question 3: *What is an appropriate proportion of independent directors for superannuation boards?*

This question also has little relevance for network governance that I am recommending. Network governance removes the inherent unethical conflicts that are systemic in unitary boards¹².

Response to focus question 4: *Both the ASX Principles for listed companies and APRA’s requirements*

¹⁰ Rodrigues, U. 2008, ‘The fetishization of independence’, *Journal of Corporation Law*, 33: 447-496

¹¹ Romano, R. 2004, The Sarbanes-Oxley Act and the making of quack corporate governance, Yale ICF Working paper 04-37.

¹² Refer to Table 3.6 “Corrupting powers of a unitary board” in Turnbull, S. 2000, *The Governance of Firms Controlled by More Than One Board: Theory development and examples*, PhD dissertation, Macquarie University Sydney, <http://ssrn.com/abstract=858244>.

for banking and insurance entities either suggest or require an independent chair. Should superannuation trustee boards have independent chairs?

The ASX principles and APRA requirements should on no account be accepted or used as a role model. Like their sister institutions in the US and the UK they ignore, accept or enforce systemic unethical unconscionable conflicts of interest for directors and auditors. It is their principles and requirements that led the 2008 Global Financial Crisis (GFC). This is a very inconvenient truth that Parliamentary committee should investigate.

As reported by Adams¹³ global financial institutions more closely follow what is thought to be good governance practices because this is what their regulators require. However, the 2011 US *Financial Crisis Inquiry Commission Report* stated: “dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis.” In other words what is globally considered good practice is the source of the problem, not the solution. The solution is network governance as argued in a number of my articles including those with my co-author that have been internationally peer reviewed¹⁴.

UK and US governance principles got muddled because the US Securities and Exchange Commission modeled their annual audits on the UK 1928 prospectus audit provisions where directors appoint the auditor not the shareholders¹⁵. Australian annual audits are based on the UK statutory audits for

¹³ Adams, R. B. 2012, Governance and the Financial Crisis, *International Review of Finance*. 12(1): 7-28.

¹⁴ Pirson, M. & Turnbull, S. 2011, ‘Corporate Governance, Risk Management, and the Financial Crisis- An Information Processing View’, *Corporate Governance: An International Review*, 19(5): 459–470 September <http://onlinelibrary.wiley.com/doi/10.1111/j.1467-8683.2011.00860.x/abstract>.

Pirson, M. & Turnbull, S. 2012, ‘A New Approach to Fix Broken Governance’, *ISEI Insight* 13: 28-35, Second Quarter, Business School, University of Navarra, <http://www.ieseinsight.com/doc.aspx?id=1366&ar=3>.

Turnbull, S. & Pirson, M. 2012, ‘Could the 2008 US Financial Crisis been avoided with Network Governance?’ *International Journal of Disclosure and Governance*, Special issue on Financial Crises and Regulatory Responses, 9(1): 1–27, (Working paper at: <http://ssrn.com/abstract=1855982>).

Turnbull, S. 2009, ‘Mitigating the exposure of corporate boards to risk and unethical conflicts’ in *Risk Management and Corporate Governance*, Robert Kolbe, ed. Wiley-Blackwell Publishing, Loyola University Monograph Series, Chapter 7, pp. 143–74, 2009, http://papers.ssrn.com/abstract_id=1106792.

Turnbull, S. 2010, ‘Naïveté of directors and regulators revealed by GFC’, *Keeping good companies*, Institute of Chartered Secretaries, pp. 539–541, Sydney, October, (Re-published in London by: *Corporate Governance*, 199:8–9).

‘Turnbull, S. 2012, Rethinking directors duties, governance and regulation’, presented to 3rd Conference on Financial Markets and Corporate Governance, Melbourne, Australia, La Trobe University April 12-13th, <http://ssrn.com/abstract=1972877>.

Turnbull, S. 2012, ‘Discovering the “natural laws” of Governance’, *The Corporate Board*, March/April, (ed.) Ralph Ward, Vanguard Publications Inc.: Okemos, MI, <http://ssrn.com/abstract=2062579>.

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Turnbull, S. 2013, ‘A sustainable future for corporate governance theory and practice’ in S. Boubaker, Bang D. Nguyen and Duc K. Nguyen (Eds.) *Corporate Governance: Recent Developments and New Trends*, pp. 347–368, Springer-Verlag, Heidelberg, working paper: <http://ssrn.com/abstract=1987305>.

Turnbull, S. 2013, ‘Network Governance Theory Development and Examples, summary of PhD dissertation, Macquarie University, Sydney, Australia, <http://ssrn.com/abstract=2343456>.

Turnbull, S. 2014 ‘A proposal for self-governing corporations’, in Philip Blond (ed.), *The Virtue of Enterprise: Responsible Business for a New Economy*, 52-54, January, ResPublica: London, posted at: http://www.respublica.org.uk/documents/jae_The%20Virtue%20of%20Enterprise.pdf

Turnbull, S. 2014 (forthcoming) ‘How Might Network Governance Found in Nature Protect Nature?’ *Journal of European Law*.

¹⁵ Turnbull, S. 2005, ‘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, <http://ssrn.com/abstract=608241>.

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members with members or shareholders appointing the auditor. The confusion was compounded by the Cadbury Committee using US audit practices to recommend audit committees be formed by directors instead of shareholders. Shareholder audit committees remove conflicts for both directors and auditors and are required in some European jurisdictions. The UK 1864 Companies Act had included this approach in its model Articles of Association.

This is another reason why directors of superannuation Trustee companies should not nominate, appoint, remunerate or control the auditor of either the Trustee Company or its fund. The role of the external auditor is to judge the accounts and no judge in a court of law can be appointed, remunerated, controlled, or influenced by the persons being judged. Network governance solves the problem by having the board of Governors take-over the role of a directors audit committee for either the internal or external auditor.

Response to focus question 5: *Given the way that directors are currently appointed varies across funds, does it matter how independent directors are appointed?*

Independent directors are not required with network governance.

Response to focus question 6: *Should the process adopted for appointing independent directors be aligned for all board appointments?*

Independent directors are not required with network governance.

Response to focus question 7: *Are there any other measures that would strengthen the conflict of interest regime?*

Yes - removing the power of directors to identify and manage their own systemic conflicts of interest by trustee companies possessing at least two boards to separate the role of being a trustee from the role of governing the trustee company. This is a first step for introducing network governance to introduce a requisite number of cross checking communication and control channels to facilitate self-governance and minimize the need and role of regulators and compliance burdens.

Response to focus question 8: *In relation to board renewal, should there be maximum appointment terms for directors? If so, what length of term is appropriate?*

Network governance provides a different context for this question. However, limits on tenure are desirable to prevent incumbency establishing power coalitions and abuses of power. Instead of fixed limits it can be desirable to require re-elections to be contested for an incumbent to be re-elected. In this way voters always obtain a choice. The number of people voting can also be used to establish re-election criteria with the number increasing with each re-election of an incumbent to eventually force change.

However, if incumbency provides material source of income, power, status and influence that can provide incentives for buying votes in one way or another, then this incentive can be largely removed with a two stage election process. Members first elect a panel of delegates with the appointed of a delegate to a board position determined by lot. In this way board nominee cannot guarantee financial and other supporters that they can pay them back with favors if they are elected as a delegate.

Response to focus question 9: *Should directors on boards be subject to regular appraisals of their performance?*

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Without network governance the answer is that board appraisal can be very self-serving and so should not be required. As founding co-author and presenter of the first educational qualification in the world for company directors in 1975 I am very skeptical of board appraisals. Especially when conducted by consultants conflicted by being appointed by one or more board members who represent a self-appointed power coalition to maintain their incumbency.

Network governance creates a different context for director appraisals especially if contested elections are built into the system. It makes little sense to consider appraisal of members elected to Parliament when they are subjected to contested elections.

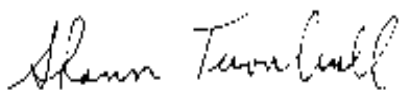
With network governance, the Board of Governors carries out director appraisal on a continuous basis. This is because the Board of Governors replaces the need for directors establishing nominating, remuneration and audit committees by taking over these functions. In addition the Governors establish the Key Performance Indicators (KPIs) for evaluating the board. The Governors would take advice from the Stakeholder's Council of service providers in establishing the KPIs.

Response to focus question 10: *Would legislation, an APRA prudential standard, industry self-regulation or a combination be most suitable for implementing changes to governance? What would the regulatory cost and compliance impacts of each option be?*

The principal change agent would be APRA that has adopted an unethical, counter productive governance regime. Network governance can be introduced for companies without any changes in the law in most countries of the world as is demonstrated by their existence around the world noted earlier. However, there may need to be some minor changes in the dedicated superannuation legislation if the current unethical counter productive practices have been enshrined in law as has occurred in the US with Sarbanes Oxley Legislation¹⁶.

Response to other focus questions: No specific responses except as already made above in regards to provided to "Transparency", "Benchmarks" and "Efficiency" that are inherent feature of network governance.

Yours faithfully



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¹⁶ Refer to Romano, 2004, Op cit, n.10.