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Chapter 6: The Governance Paradox: Regulating Systems That Regulate Themselves

6.1. Introduction

Managing systems that manage themselves is a challenging contradiction of governance. Complex systems—from economies to ecosystems—constant anticipation and adapt to changes in internal regularities, external conditions, and the behaviour of actors. An emergent capacity to regulate may develop, but it is usually attributed to interactions among heterogeneous actors interconnected by diverse channels of exchange. However, political–economic theory warns of the dangers of self-regulation: institutional capture by the regulated and inequality in the power to set and influence regulation outcomes. Horizontal accountability—mechanisms that hold authorities accountable to those subject to their authority—diminishes such risks. Transparency is the foundation of horizontal accountability. Independent external oversight is a second accountability mechanism that can help check the self-interest of regulators.

Arguably, external accountability mechanisms are increasingly required for complex systems of regulation. Regulatory arbitrage occurs, for example, when regulated actors move to jurisdictions with weaker regulation. Technology platforms employ algorithms to govern user behaviour and communication for purposes such as content moderation, information manipulation, and political control, but without legitimate authority. These authority-like functions require legitimate powers and hence the capacity for vertical accountability, which is not conferred on technology-platform owners or users. Without such powers, the platforms are empowered but lack legitimacy. Users and other stakeholders require external relationships with trusted supervisory authorities—legitimate control—and need the information and advocacy support to participate actively and effectively in the regulatory process.

6.1.1. Overview of the Study

Understanding governance as the top-down behaviour of a polity and as the bottom-up behaviour of a social licence leads to two paradoxes. The first paradox of self-regulation arises because the governance of a governance system may fall outside its own boundaries and remain ungoverned. The second paradox of self-regulation arises when the opted-out of the system of governance implicitly grant their acceptance by having rendered themselves accountable to its own constituency. The former paradox is explored in the context of the political economy of regulatory capture, including the regulatory capture of the self-regulatory bodies of the financial market; the latter paradox is explored through the lens of the technology and society literature, focusing on technology platforms that govern themselves through algorithmic governance.
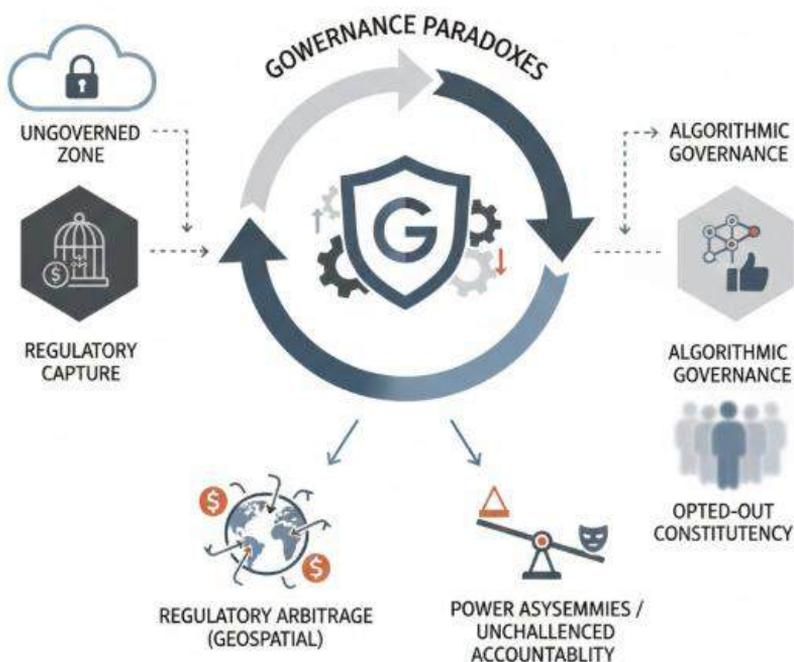
Fig 6.1: The Paradox of Self-Governance: Regulatory Capture, Algorithmic Accountability, and the Legitimacy Gap in Distributed Polities

The consequences of the design of these systems of self-regulation, which are generically built upon a system of reciprocal altruism or reputation in the market, are twofold. First, the actors subject to the regulation may be engaged in regulatory arbitrage, taking advantage of their geographical dispersion to optimise their regulatory exposure. Second, the systems of self-regulation may modulate power asymmetries among their constituents, at least temporarily and at least in appearance, to a degree that renders their accountability unchallenged, even when the layers of intervention that make them self-

regulated do not carry a social legitimacy, nor the power to withdraw the label of governance from the regulation.

6.2. Conceptual Foundations

The Governance Paradox: Regulating Systems That Regulate Themselves—present an objective, evidence-based scholarly analysis with formal structure, clarifying aims, scope, and findings.

Definitions of Governance and Regulation

Starting matters require definition of terms. First, governance terminology is often used interchangeably with management and administration, yet is better understood in a broader and more participatory sense. Governance can thus be simply defined as the decision-making processes by which societies—at any level—adapt to change. Governance establishes the rules of the game, the institutions that make these rules, the processes to amend or change the rules, and the power balance between these institutions and processes as well as different actors. Governance can therefore be understood as a process of public choice in which the mode of decision-making, the politics of decision-making, and the content of decisions, shape the outcome of interest in social choice. Regulation is a sub-set of governance that concerns the authority by which one specific actor sets the rules and conditions according to which another actor can engage in an activity. Regulatory powers are frequently exercised in the political economy perspective. However, governance—including in a political economy considered perspective—cannot engage in processes in which self-governing systems exercise their own decision-making procedures in their own better interest.

Self-regulation as a governance modality

Regulation is generally understood as government by another name and, consequently, as a function necessarily exercised within the State. In fact regulation is sometimes also termed co-regulation, distinguishing spokespersons of different governance modalities and functions. However, the acknowledgment of self-regulatory organizations signifies that a self-regulatory function exists and that systems might regulate themselves without formal external support. Therefore, because regulation is defined by the nature of functions and not by the kinds of actors, regulation can be performed by non-State actors or by several actors together, thus becoming self-regulation or co-regulation.

6.2.1. Definitions of Governance and Regulation

Governance, in this study, is understood with respect to complex systems. Governance relates to "the arrangements…the how of the social order's operations, stability, and change." Within complex systems, established meanings of governance remain widely applicable but additional aspects of governance are made more salient. Such systems experience continual change while simultaneously supporting continuity. Self-governance, that is, active self-regulation, is an inherently crucial aspect of governance in such systems. External rules and regulation are inconceivable in the absence of self-regulation. Therefore, governance modes support these different aspects.

Regulation is a governance modality aimed "specifically at constraining the actions of those agents whose social choices generate, or threaten to generate, large negative external diseconomies." The need for regulation thus arises when an entity's decisions or actions can no longer be assumed to be consistent with the proper needs of, or the avoidance of large losses by, others. Processes of self-regulation have been defined as "the rules, procedures, and institutional structures designed to promote the efficient and ethical functioning of…[markets or other systems] from within," or as "mechanisms through which an industry articulates its concerns, resolves its conflicts, and establishes policies." Both of these past meanings suggest that a focus on internal mechanisms for regulating a system's sphere of activity is vital.

6.2.2. Self-regulation as a governance modality

Self-regulation, defined broadly, constitutes a governance modality that differs from the exercise of political authority. Under self-regulation, organizational actors establish, monitor, and enforce standards and rules of behavior to promote the common good within a specified domain; compliance costs are borne primarily by the governable actors. Self-regulation can therefore be conceptualized as "governing by organizations for organizations," where the governing and governed actors share an institution that generates norms. It is thus distinct from situations where organizations are primarily governed by investment capital, political authority, or market forces, and accounts for many institutions found in the international arena, as well as in industries such as air transport, aviation, the chemical economy, construction, finance, health, and telecommunications.

Governance within organizations can also be characterized as self-regulatory when the rules and codes governing the behavior of organizational members are formally established and enforced by these members. Joint-stock corporations with a board of directors, stockholders' meetings, and independent auditors self-govern in this sense, and so do trade unions, public-sector unions, private universities, and governments in

countries with a parliamentary structure and independent state audits. Just as joint-stock companies are accountable for their governance to their stockholders, people can be held accountable for the governance of trade unions to the union members.

6.3. Theoretical Perspectives

Divergent theoretical perspectives shed light on the governance paradox. Early contributions in political economy demonstrate how associations of private economic interests acquire an inordinate influence on the formation and implementation of government regulation (Stigler, 1971). More recent work on complex systems provides an alternative understanding of self-regulation as emergent capacity. This literature identifies the need for novel forms of regulation that can deal with the increasingly technical nature of contemporary governance problems (Daskalaki et al., 2021; Weyer et al., 2019).

In line with the political economy perspective, the regimes of self-regulation considered here exist largely to defend the embedded interests of their members at the expense of the wider public and have no regulatory legitimacy of their own. In contrast, the complex-systems approach reveals that self-regulation should not be limited to the specific capabilities of Governments Theory of Self-regulation but instead can be understood as a general property of complex adaptive systems. From this vantage point, regulatory functions are fulfilled by all sorts of directed and undirected processes that emerge in response to the self-organizing dynamics of the system, even in the absence of any centralized or formal structure. Burgeoning algorithmic governance is a case in point. Algorithmic infrastructures regulate users' behaviour by shaping their interactions with others, optimising their experiences on digital platforms, and determining their access to a wide range of opportunities. By guiding and constraining behaviour, these infrastructures respond to the expectations of stakeholders even though the designers and operators of the systems do not consider governance explicitly when developing and deploying the technology.

### 6.3.1. Political economy and regulatory capture

Insights from contemporary political economy call attention to self-regulation's potential shortcomings. This literature explores the capture of regulatory agencies by established industries with political clout that they are supposed to regulate. Similar processes may be at work also when self-regulatory structures, positioned at the intersection of business and politics, are designed to provide a modicum of governance for emergent economic spaces beyond state control, such as financial markets or the internet. It is thus possible that self -regulatory organizations (SROs) typically do not

serve all the actors in the sectors they regulate but rather represent vested interests. The case of the Organization of American States gives cause for concern specifically when it acts as a SRO for issues pertaining to drug trafficking in Latin America.

The potential for failure of SROs in fulfilling their assigned mandates has been famously framed by the motto: "Regulation by the industry, for the industry." In significant areas of self-regulation, actual costs and risks have been largely borne by the public, while most benefits have flowed into the coffers of the financial industry. The mostly industrial players have been prominent actors in the development and support of knowledge--sharing forums, engaged in policy research, and strategic lobbying. Nevertheless, the multiple attempts to close the regulatory gap by designing appropriate SROs have failed to provide real answers to the growing gaps in domestic and international regulatory frameworks governing cyberspace, the global economy, the environment, and international security.

6.3.2. Complex systems and emergent regulation

The financial consideration of who constitutes the regulator is often secondary to how a specific system governs itself or is governed. Systems usually produce credible and reliable results, as Alfred Chandler (1962) once observed of the American economy, only if they have a degree of collective self-regulation. However, the verification or validation of that regulatory capacity by an external or independent module is essential if it is to be considered a legitimate form of governance.
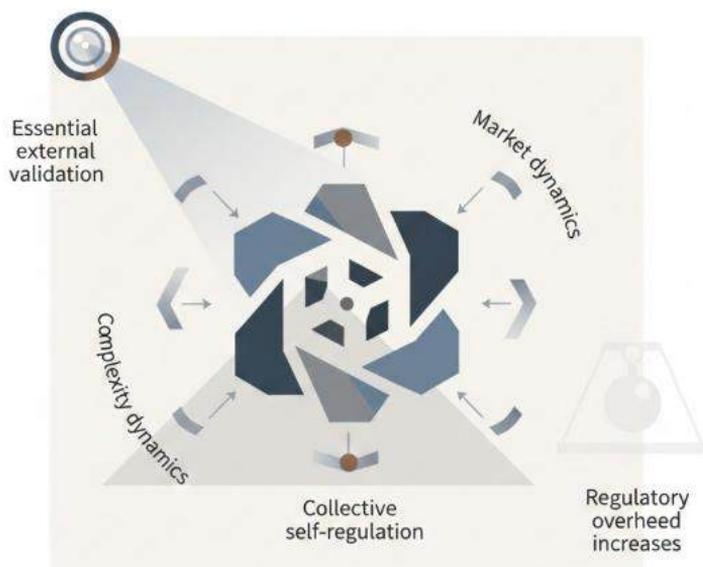
Fig 6.2: The Paradox of Institutional Autonomy: Structural Dynamics and the Legitimacy of External Validation in Complex Regulatory Systems

The institutional regulatory capacity of a market is reflected in its dynamics and expressed in its structure. However, the very self-regulation or governance of complex systems legal theorists and purveyors of regulatory policy must be careful not to adopt a missionary zeal for regulation or rendered as the infallible solution to all problems. The governance of such systems in a living, growing, complex economy is, in reality, a paradox, for it may take more human effort to achieve the goal of regulation than to let it go.

6.4. Case Studies

Financial markets depend on regulated entities, external market rules, and strong deterrence against risk-taking. Yet, their precautionary designs induce evasion, such that systemic failure has become a recurring feature. To mitigate this hazard, self-regulatory organizations (SROs) directly govern industry practices through integrative mechanisms. These compensate for deficient deterrence—as with corrective justice, SROderived rules can extend beyond their domestic jurisdictions—yet the capture risks remain acute. Digital platforms, in contrast, entail an unregulated structure of decentralized risk and informal rules generated from private interactions. SROs emerge in response, digitally sifting harmful content and alerting authorities to irregular data exploitation. They thereby govern actors unable to emerge from self-governance or industry design. Nevertheless, their informal character and incomplete vertical vertical networks limit their defensive capability.

Technology platforms have established a legally unregulated structure of decentralized risk in the digital realm. This is governed by informal platform-generated rules. The asymmetrical and often predatory nature of these informal rules has, indeed, incited users' protests over intolerance and overreach. Algorithmic rule generation has become a crucial mechanism for maintaining situational order among actors who are either unable or unwilling to comply with prevailing legal rules or platforms' formal regulations. Algorithmic governance empowers technology platforms to internally sift harmful content, exposing actors engaged in illegal or abusive data exploitation. In this manner, platforms act as self-regulatory organizations, performing the role of cautional governing agents lacking independent external authorities. These algorithms, however, are neither altruistically designed nor cast in stone. Their manipulative leveraging and frequent reprogramming testify to the subsequent development of another informal governance layer above platform administration, connecting the aggregative roles of external detection and reparation and exacerbating the trend of embedding informal government in formal platform structures.

6.4.1. Financial markets and self-regulatory organizations

In the early twenty-first century, operators in financial markets adopted a sophisticated repertoire for self-regulation. They established rules for their behaviour and for the functioning of the markets, sought to ensure compliance through supervision (including conducting their own investigations) and imposed discipline through their means of enforcement. Self-regulatory organisations (SROs) were charged with fulfilling these tasks, sponsored by their members but entrusted with public supervision and oversight. The critical dilemma was the threat of regulatory capture: the risk that the regulators would defend the interests of the industry rather than society.

Regulators for SROs were charged with monitoring the risks of regulatory capture and ensuring an equitable balance of power between industry and society. In continental Europe, it was recognised that market power was not merely a motive for unethical behaviour but a determinant of it. The integrity of the relevant markets demanded the dismantling of positions of market power within them. When financial markets suffered a crisis, self-regulation was discredited; a more centralised public regulatory response was proposed, although it had its own failings. A balance of power between SROs, primary regulators and other agencies at arms' length was the most effective means of achieving the fine-tuning needed for an equitable market outcome.

6.4.2. Technology platforms and algorithmic governance

The self-regulatory approach has also been adopted in the regulation of technology platforms. In this context, the function of self-regulatory organisations (SROs) is fulfilled through the establishment of internal guidelines, procedures and rules for content moderation and appeal, which also apply to decisions affecting entire user communities. In addition, platforms report on the application of the rules, while third parties (for instance, external researchers or civil society organisations) can scrutinise the process, access moderation data and hold periodic transparent meetings with platforms' representatives. Such measures have been considered as increasing the accountability of platforms and their processes, which are often opaque. Various overlapping SROs have been set up to address issues of inauthentic activity and misinformation. Besides, complex systems theory suggests the emergence of algorithmic governance systems stabilising distributed technology systems.

Despite satisfying the need for regulation, major platforms are still confronted with the lack of legitimacy of self-regulatory mechanisms. The governance triangle relies on multi-stakeholder oversight by including different stakeholders, yet the board function of governance SROs is often filled with representatives of the main affected parties, leaving other stakeholders under-represented. In this regard, the European Commission

has proposed and the European Parliament is negotiating the creation of a new independent authority, the European Digital Services Board. Yet, for now, platforms appear to prefer self-regulatory options closer to their own decision-making activities and aimed at mitigating sanctions from regulators.

6.5. Mechanisms of Accountability

Self-regulation and its implementation need to be supported by mechanisms of accountability that can deliver legitimacy and trust. Two groups of generally applicable mechanisms are examined: (1) mechanisms of transparency and reporting made accessible to all, and (2) mechanisms of external scrutiny, which provide independent assessment of various dimensions of activities and performance.

Transparency and reporting. A fundamental mechanism for enabling accountability is transparency: the possibility for outside stakeholders—those stakeholder groups that do not have a direct role in the self-regulation process or its governance—to have a clear, comprehensive, and intelligible understanding of what is going on. Transparency implies both the publication of relevant information and its accessibility to the external audience. "Exposure to scrutiny" is an essential condition for ensuring that self-regulated actors are, in a way, accountable to third parties, actually monitoring the process through their involvement in, or influence on, the debate around the self-regulation effort.

Selection of the data to be disclosed, the specific manner of representation of such data, and the communication strategies adopted are factors of vital importance. A mechanism closely related to transparency is reporting on key dimensions of the self-regulation initiative. The need for reporting is especially salient for self-regulatory organizations (SROs), which need to reconcile the many objectives linked to their activities—notably, the various, sometimes conflicting, expectations of their different categories of members and other key stakeholders—within a managerial framework that also enables them to demonstrate their effectiveness convincingly.

6.5.1. Transparency and reporting

The challenges of regulating systems capable of self-regulation have not gone unnoticed. Properly designed and implemented accountability mechanisms are seen as potential means to mitigate the risk of governance failure. Transparency and reporting therefore play a prominent role in the political economy of self-regulatory governance. Through their contribution to the comparability, quality and quantity of information available to relevant audiences, transparency and reporting mechanisms can enhance decision-

making, enable informed choices and strengthen processes of collective and independent scrutiny.

Efforts to improve transparency and reporting in the context of self-regulatory governance can take at least three distinct forms. The first involves making available the rules, policies and practices of self-regulatory organizations and systemically important firms. Publication of rules and/or standardized metrics has become common practice for many self-regulatory organizations in financial markets. By making their guidelines publicly available, SROs enable market participants and enforcement authorities to assess compliance and/or the extent of deviation from best practice standards. Similarly, the systemic importance of major technology platforms has led experts and civil society groups to call for the publication of standardized metrics related to the behaviour and operations of these firms. By facilitating horizontal evaluation of the behaviour of major platforms, the introduction of standardized parameters lowers monitoring costs and enables greater scrutiny by civil society and the media.

6.5.2. External scrutiny and independent oversight

Self-regulation, in its narrow and broad forms, inherently lacks accountability. This challenge can be offset through scrutiny and oversight by external stakeholders who are independent with respect to the self-regulated system. Such scrutiny can aim at specific acts, processes, and outputs of the self-regulating body, or at the adherence by the whole system to a set of principles, rules, or norms, such as legality, proportionality, necessity, or effectiveness. The extent of external scrutiny may also vary, with external stakeholders acting either in an ad hoc manner or performing continuous monitoring. Independent external scrutiny and oversight not only enhance accountability, but can also increase performance and effectiveness. The quality of system performance and the legitimacy of empowerment thus are interdependent.

The need for independent external scrutiny has been widely acknowledged for self-regulatory organisations (SROs) in financial markets. Following the last crisis in financial regulations, self-regulatory structures of SROs have been significantly redefined in several jurisdictions (including the Dodd-Frank Act in the US, MiFID II in the EU, and Israeli regulation), particularly for SROs that were seen as having legislative powers and expertise in the regulatory process. Emerging technology frameworks for SROs are also converging towards the introduction of external independent oversight as a necessary transformation and accountability mechanism. Such frameworks draw on the principles of accountability used in traditional governmental regulatory structures and other self-regulating systems in which external supervision is deemed necessary to ensure that the utility of the SRO is attained and risks are minimised.

Fig 6.3: Beyond Self-Governance: Independent External Oversight as a Catalyst for Accountability and Systemic Legitimacy in Financial Regulation

6.6. Risks and Limitations

Economic and political theory cautions that self-regulation is prone to regulatory capture. Indeed, the adverse effects of concentration and monopoly power often motivate demands for regulation in the first instance. The regulatory arbitragist can be found on both sides of the regulatory ledger. Regulation introduces compliance costs, which affect the prices and profit margins of regulated firms and thereby influence decisions about where to locate and invest. Such influence does not only determine whether firms choose to support regulatory compliance. It may also influence their decision-making on where they choose to operate and invest—whether in a jurisdiction that is regulated or not.

Regulatory capture can be thought of as the cybernetic system's sticking point. The more self-regulatory capacities a system has, the more sophisticated its decision-making and the more advanced its know-how, the more its own development will be its Achilles' heel. A more advanced region, institution or authority that falls prey to capture will find it harder to develop and may even fragment. There are core reasons, then, for the view that systems should not be empowered to regulate themselves when there is no reason to believe that their development is sufficiently well advanced for them to be able to engage in self-regulation with the requisite level of legitimacy.

6.6.1. Regulatory arbitrage and jurisdictional gaps

The governance paradox suggests that regulation is required precisely for regulatory systems that regulate themselves. Such systems are embedded in their environments and must continually adapt to changes in values, technology, and environment. Their rules are usually co-created by the community of regulated entities and may even favour them, yet they can weaken a system's overall coherence and resilience, encouraging the emergence of malicious conduct. Hence, independent review and oversight remain key conditions for effective self-regulation. Similar contradictions arise in relation to external pressures. Self-regulated systems can also be vulnerable to regulatory arbitrage, where a regulated entity bypasses stricter requirements in favour of a weaker regime, or to the perception that an entity operating in a non-regulated space is not bound by the same legal or moral expectations.

Two examples reflect this logic: financial markets and their self-regulatory organizations, and technology platforms, which increasingly conduct governance without legal mandates but through the algorithmic design of their services and the consistent monitoring of user conduct. In these cases, networked semi-public institutions and algorithmic decision-making at scale are expected to play a key role in an era defined as one of componentised governance.

6.6.2. Empowerment without legitimacy

Self-regulatory mechanisms respond to demands for governance resulting from the emergence of new phenomena. However, such mechanisms often lack legitimacy, necessary to elicit compliance and cooperation from third parties and external stakeholders. The risk of armchair regulator becomes heightened when regulatory agencies outsource or externalize the design and execution of regulations. For example, doubts persist about the motivations, means and manner behind the governance activities of social media companies, which are the driving force in creating a distinct era of governance marked as the delete era or the moderation age. Twitter's Trust & Safety Council, Facebook's Oversight Board and YouTube's Partner Program constitute a trinitarian pact between those companies, their advertisers and the state. In this context, the power exercised by the platforms through moderation and censorship could be described as government without the state. Although technology firms remain a critical point of contact for the governance of platforms, the main logics shaping the devices used for moderation remain the logics of capitalism—profit maximization.

Their authority derives from a power that is in fact private. Their decisions can be opaque, arbitrary and inconsistent. The advisory councils and the vaguely identified community are not the relevant constituencies—a full social contract cannot be founded

in these imaginary communities. Although the motivations of individuals on these committees are sincere and genuine, they can still end up producing bad decisions. The original zero confidence in social media is compounded by zero accountability. When discussing the capacity of self-regulatory efforts to fill a gap created by the legitimation crisis of institutions of public authority, one should keep in mind that empowerment does not automatically produce legitimacy. If legitimacy is missing, it can also be claimed that genuine self-regulation capable of producing real results cannot be set up by the same actors that participated in the exploitation or abuse of a system at an earlier stage.
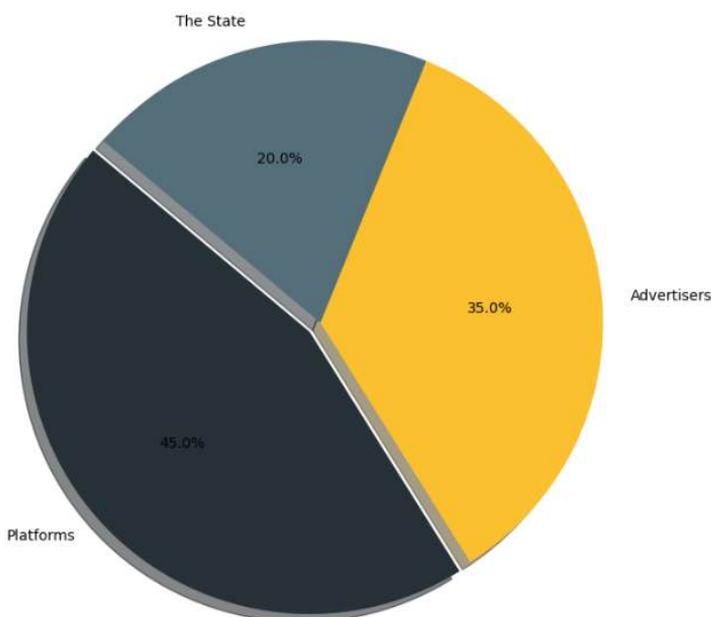
The Trinitarian Pact of the Moderation Age

Fig 6.4: The Trinitarian Pact of the Moderation Age

6.7. Conclusion

Success or failure of a system's self-control remains to be seen; it has passed through several evolutionary phases, culminating in two complex synthesis: the human brain, the planet's most advanced regulator, distributing mechanisms concentrating mechanisms in unique ways, too sophisticated to be viewed merely as "homeostatic," and for it's tech1nologieS the omnicontroller—the social system, a collective replacement of the more primitive addition of homeostatic mechanisms, regulating the biosphere and the autonomous sub-games with samples of its social brain. Self-control of or within controlling systems remains nonetheless a singular problem because of certain structural characteristics.

The systems that regulate themselves—whether the self-control of the self-governing free-market capitalist economy's society or that of the self-governing, closed operating-system technology—are regulated systems but do not possess a higher coordination entity, capable of controlling all the mechanisms of this self-regulation. Self-controlling systems are also typically structures without an explicit commander: all the controlling mechanisms can lead towards an analogous goal without being exactly instructed towards it. A social brain, for example, can make independently direct contributions, liberating itself from unilateral candidacies and opportunistic attempts to colonize short-term potential by transparent contributions in semantic and agenda-setting flows, which induce the collaboration of subgroups with different (party-affiliated) dominant mechanisms.

The problem of the external visible and transparent contributions to self-control is always the problem of self-control of controlling systems—or of an additional weaker but non-translatable control of controlling systems. When self-finding, autonomous regulating subsystems substitute for the natural self-regulatory mechanisms or for numberless natural self-controlling mechanisms, the risk of opportunistic attempts to conquer the new power via replacing non-rival algorithms, without causing high costs to the whole regulating system, grows. Empowering constitutions, governments, and laws with clear (but easily attributable) limits of self-control appears the only known protective passage against this risk.

6.7.1. Final Reflections and Future Directions

The contemporary tradition of economic liberalism has treated self-regulation as the 'second worst' form of regulation. The more ruled conditions in which decision-makers operate, the better. Whether in relation to the World Trade Organization (WTO) or trade agreements negotiated by regional blocks, the conclusion remains the same: greater integration reduces the risks of self-regulatory failure and the perverse consequences of jurisdictions competing for lax standards in the hope of attracting commerce. The self-regulation of financial markets, meanwhile, has been subjected to acute criticism, culminating in an increasing focus on regulating the regulators. The effects of the governance paradox become even clearer if the focus is not on risk but rather on legitimacy.

A recent study identifies the two basic pillars of legitimacy in the governance of states—democratic representativeness and constitutional supremacy—and argues that these two dimensions are now increasingly absent from the algorithmic governance of social media platforms. The main criterion when assessing whether self-regulation should be used in a particular area of governance, and the degree to which it is justified, should therefore be the extent to which self-regulatory arrangements are capable of producing good

governance. The risk of regulatory arbitrage emerges clearly once this basic criterion is adopted. The absence of adequacy requirements in the regulation of self-regulation engenders a race to the bottom, and the absence of trust facilitates the emergence of self-regulatory arrangements lacking any democratic or constitutional foundation.

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