WHY THE REGULATOR DOESN'T REGULATE

GOODIES, BADDIES AND A CASE FOR FUZZY LAW

By JOHN GREEN

The worst of the corporate damage has been done. Now is the time to reform corporate law to ensure that regulation can work in the future.

Welcome to the new crusade of capitalism. Welcome to the new era of ethics. Welcome to the nightmare task of rebuilding the rules and the way we police them. And let's hope for a bit less rhetoric and a bit more realism in the debate about how the corporate cops are performing.

A cop's job is simple: it's to catch crooks, not to talk about it. But how many crooks have they caught? Not many, but they have talked a lot about how hard it is to enforce the rules. How much of the talk is a smoke-screen for failure, not of the rules but of the regulators?

Before we get the regulators in our sights, let's look at the crooks and at what has happened in Australia.

Buccaneers have boarded the ship Free Enterprise. But they didn't raise the pirate flag. They left up the other one. Then they pretended to sail with the wind, but instead, not only did they sail close to the wind, they did the impossible, the unheard of, they sailed right into it. What was worse, they started to change the direction of the wind itself.

Without being too dramatic about it, what we have had in Australia (and we are not alone—look at the US; look at the UK) is grand larceny. The trouble is that the perpetrators thought "grand" was an English word meaning "excellent" and, boy, did they pursue excellence!

As a result, we are in a crisis of capitalism. *Entrepreneur* is now a buzzword for *shonk*. Risk-taking is regarded as wrong and irresponsible. But we are allowing ourselves to be swayed by a superficial and facile analysis of recent history. We must bring back respectability to entrepreneurial activity. If you think our economy is dead now, just think what it would be like without legitimate entrepreneurial endeavours.

Let's look at some basics for a moment.

Why do we have the corporation with limited liability? So that diverse investors can, with known risk, efficiently join together and put up capital. The principle is one of risking capital on legitimate ventures—not on crooked ones. The shareholders put up the risk capital and the directors' job is to look after it and, with good management, make it grow. The corporate vehicle separates ownership from control.

But what we've seen in recent times is that those who control do not always look after those who own. And, oddly, it often seems to be worse when those who control also own.

What happened? Directors abused their trust. They called it risk-taking. But was it?

The midnight burglar takes risks. Society doesn't condone those risks

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but it does condone the risk-taking of the widget-maker. What we've had is midnight burglars clothed as widget-makers: the well-dressed Arthur Daleys of corporate Australia.

The end sought by both, through various means, has been profit. But in Australian corporate life, it has not always been a case of the end justifying the means; in many cases the end, as well as the means, has been wrong.

The crimes

What did they do? Were they guilty of crimes? Well, whenever someone gets arrested for a corporate crime (and it's not very often), you read that they are charged with 147 different offences, most of which the average person would never hear of or understand.

But there is really no need to analyse 147 breaches. The crimes we are talking about usually involve actions known as:

- "Skimming" or "value-shifting"
  - selling assets to the company at an over-value;
  - buying assets from the company at an under-value;
  - lending to the company at high interest rates;
  - borrowing from the company at low interest rates.
- "Toys for the Boys"
  - doing favours for mates on the basis that they will return the favours;
  - paying yourself very well for doing very little.
- "Dumping"
  - selling to the company assets that are garbage dolled up as gold when no-one else would buy them;
- "Window dressing"
  - representing your company as being in better financial shape than it really is;
  - failing to disclose important information either to the board or to the market;
  - the ubiquitous off-balance-sheet company or transaction.
- "Market Rigging"/Insider Trading
  - ramping the market;
  - warehousing;
  - stealing corporate information for your benefit, not your shareholders'.

Let me give you an example of value-shifting or skimming: suppose a public company leases a painting worth $10 million over five years, with a residual of $5 million. At the end of the lease, the company sells the painting at its book value of $5 million to its major shareholder or a director. The trouble is that the painting is not worth book value; it's worth five times as much. So the buyer pays $5 million for an asset worth $25 million. And later, the company may find unexpectedly that it has a capital gains tax liability for the profit given away.

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That seems an easy one. But how many employees, especially before the introduction of fringe-benefits tax, bought a car from the company at book value at the end of a lease, knowing it to be worth much more? The principle is the same.

All these things come under different and often complex laws. But let's keep it simple. All these things break three fundamental rules:

1. You are not allowed to steal.
2. You are not allowed to lie or cheat.
3. You are not allowed to abuse a position of trust.

These are the very old and very simple concepts which forbid fraud and dishonesty, clearly understood by most people. Do we have laws to ensure that they are observed? Yes. Are those laws clear? For the most part, yes. Our laws are not perfect but, broadly, they're good enough.

The cops

Well, what happened? Let's start with the corporate cops. What were they doing while this crookery was cascading around us? Were they out catching crooks? Some of them were, but too many of them were busy on point duty—or rather, TV duty. Why was this?

I'm not saying they didn't work hard. Unquestionably, they did and they do. But their energies were often misplaced.

Don't be misled. We don't need massive change to our laws or to our legal system, although some changes clearly would be helpful. Our cops already have most of the guns and bullets they need. But, just once in a while, they should have taken their guns out of their holsters and waved them around.

On the good side, the corporate cops did and still do an excellent job of allowing sensible business to be done where sometimes silly laws get in the way. But a great amount of their time is spent wiping out the unintended consequences of wide-net laws.

However, you can't have it both ways. On the one hand we seem to accept without complaint that many of our corporate laws are so widely written that they can catch innocent, legitimate commercial activity—just as driftnet fishing inadvertently catches dolphins. The argument is (and I accept it) that we need wide nets to catch bad crooks. But, as with the dolphins, we need mechanisms for saving the innocent.

The regulators have done that well. They have discretions which they can exercise to excuse legitimate behaviour and they generally use them sensibly. On one transaction that I was involved with, prompt action by the corporate regulators saved my client $600,000. That's big money.

On the other hand, if the laws are so wide, how is it that they seem to only catch the innocent and not the crooks? Is the problem with the law? No. The problem has been mainly with the cops and their bosses, the politicians.

Tools

Look at the tools that the regulators have had under existing law: the power to investigate; the power to access documents; the power to ask questions; the power to hold hearings; the power to conduct Sec-

tion 541 examinations (note that the corporate cops *do* have this power—they just didn't use it much, although the liquidators do, with great effect); the power to declare conduct unacceptable; the power to prosecute and to sue in civil courts. And much more.

Given all those powerful tools, the regulators favoured the power of publicity. History has proved that to have been a sad mistake. The media may offer instant gratification; only the law offers lasting influence.

Commercial settlements

Sensible commercial settlements are to be applauded: they usually follow a successful catch by the corporate cops. But settlements can be dangerous. They must do more than make the thief put the money back in the till. Otherwise the law becomes a joke: you can commit a crime knowing the worst that can happen to you is that you will have to do what you should have done in the first place.

Goodies and baddies

When I was a kid, I played goodies and baddies. The rules were simple. If you were a goodie, you chased the baddies until you caught them. When you caught them, you won. If you were a baddie, you ran and hid a lot but you knew the rules—eventually you would get caught and be the loser. That game suggested that one of the basic rules of life would be: goodies win, baddies lose.

But I grew up learning that it isn't always a simple two-sided, black-and-white game. Indeed, law school taught me that if there are two sides to anything, it's the two sides of the same story.

Life would be simple if there were only goodies and baddies. You would know the goodies instantly (they are the ones wearing white). But as you become more experienced, you find that sometimes the baddies wear white too, and then you can't be sure who is a goodie.

Enforcement

So how do you keep rogues out of the boardroom? You can't—because you don't know who they are.

Assuming they get into the boardroom, how do you keep their snouts out of the trough?

What we have seen in the corporate world is an explosion of the calculating crooks and, as a direct result, the soft crooks. Then some of the calculating crooks moved up the scale to become hardened crooks

We have laws against murder, with severe penalties, but people still commit murder. Does that mean the law has failed? No, it doesn't. We have laws prohibiting directors from ripping-off their companies. Directors still do it. Does that mean the law has failed? No, it doesn't.

What it means is quite simply explained by Green's Scale of Crooks. In this scale, there are three layers of crooks:

The hardened crooks. Some people will always break the rules, no matter what the penalty is. Either they don't give a damn, they are true anarchists or they believe they have no choice.
The calculating crooks. These are the cold analysts of the risk-reward ratio. They look at it in one of two ways: 1. What are the chances of getting away with it? If the odds are good, I will chance it, especially if the rewards are great. 2. If I get caught, what will the penalty be? Will I really go to jail? Again, does the reward outweigh the penalty (recognising that odium may be part of the penalty)?
The soft crooks. They are honest people. But they look around and see everyone else breaking the rules and say: "It must be OK, everyone's doing it, so I will, too."

What we have seen in the corporate world is an explosion of the calculating crooks and, as a direct result, the soft crooks. Then some of the calculating crooks moved up the scale to become hardened crooks. The success of the calculating crooks infected the rest of the business community so that very many honest people became soft crooks. And then many soft crooks became calculating crooks. The business ethic changed and of course it must change again.

If the cops had enforced the laws so that the risk/reward ratio worked in favour of staying honest, there would have been fewer calculating crooks. And if we had fewer of them, we would have no soft crooks.

Exactly this happened with tax in the 1970s. It took radical change, including visible enforcement, to change the ethic.

The Tax Commissioner also has complex laws to deal with. He has not complained, at least in the past 10 years, about being unable to get the courts to work. He has succeeded in putting people in prison for the really bad offences. It takes only a few jail sentences to change the risk/reward ratio dramatically in favour of the honest.

Of course, not all of the Tax Office's tactics have been acceptable. At times they have been guilty of excessive zeal, treading on the toes of civil rights. However, they have changed the ethic, largely because they tested the law; they sought to enforce it. And where the law was found to be wanting, they were often able to solicit change from the politicians.

One set of corporate cops, the Australian Stock Exchange, has already got its act largely together. It has made a distinct shift to the visible and sensibly aggressive. It is questioning more. It is demanding better answers. It is upgrading its listing rules. It is putting substantial resources into surveillance.

Not long ago the ASX was regarded as a regulatory wimp. No longer. The change is relatively recent and may take time to be fully effective. But in its new style, the ASX should be willing to go further than questioning and suspending. It should tackle non-complying companies with court action.

Too often in the past the ASX would shy away from court action for fear of showing its listing rules to be flawed. It is better to find out and fix them. Indeed, one rule the ASX should introduce is that if it is forced to race to court, and it wins, the listed company should pay all the ASX's costs, on a full indemnity basis.

The politicians

Why has the Tax Office been able to take on the corporate world, midgets and giants alike, where the corporate cops cannot?

The corporate cops, unlike the Tax Office, have been scandalously under-funded and under-equipped. We all accept that. But the real problem was that petty jealousies between state and federal regulators and the hoary old bogey of centralism got in the way of enforcement of our laws and our national interest.

The politicians told the National Companies and Securities Commission that it had to delegate prosecutions to the state Corporate Affairs Commissions but gave the NCSC no authority to see the cases through.

No-one took charge of corporate Australia—neither the politicians nor the regulators. We divided up Australia with a different sheriff in each zone, each answerable to a different mayor. It was a prescription for disaster—and we got it.

This should never have happened. The politicians should have seen it coming. The business community and the professions did; for the most part, they have been calling for nationally co-ordinated regulation for years.

At last, with the Australian Securities Commission, we will have it. The head of the ASC, Tony Hartnell, should be able to train up an elite group of managers, preferably not only career bureaucrats. Highly skilled specialists should be seconded to the ASC from the private sector for short but sensible periods.

The ASC should then contract outside experts to do the bulk of the work: accountants, bankers, lawyers and other professionals. His crack force would manage the investigations, cracking the whip on the outside hired help.

At the end of the day it would cost the community far less than it does now. It would operate with lower overheads, the best available people and fewer delays. It would also help create a better ethic on both sides.

But the outside help must be *everybody*, or no-one will do it for fear of offending their other clients.

The law

If enforcement is to be part of the solution, what of the laws to be enforced?

Generally, we do have the laws—too many of them. Our legislators have been lazy. All our reform has been piecemeal. We need to reform our laws, not merely by rewriting them in plain English—although that would help—but by reducing the quantity of law so as to improve the quality.

In doing this, many activities should be "decriminalised", with prison penalties reserved for real crime. It should continue to be a crime for a director to act dishonestly. But it should not be a crime for a director to act unreasonably. Civil remedies, yes. Criminal, no.

Is the need to reduce the law urgent? Yes, but the urgency should be balanced against the need to get the changes right. Most of the cowboys are dead or dying. Most of the damage has been done. The excesses of the immediate past are unlikely to be repeated in the near future.

So if our legislators are enthusiastic, even zealous, about "doing something", let them do it properly, starting with the fundamentals and working up from there.

Fuzzy law

What I am going to suggest about reform of the law will be considered by many of my legal colleagues as heresy: move away from black-letter law, give power to the courts (rather than to bureaucrats) and hope they do not need to use it too often.

I have invented the term "Fuzzy Law" for this, after the "fuzzy logic" used in developing new computer technologies. It involves probabilities and imprecision.

The concept of fuzzy law is similar: our laws would be imprecise, but binding.

This would give our courts room to move and an ability to reflect the changing values of our society, something black-letter law makes very difficult. It would encourage the courts to move away from technicalities and towards substance. It would discourage loopholing because, without black-letter law, it would be harder. It would focus attention on what was right and wrong.

Some rules should remain black letter, where technical rules remain important. But many laws could go fuzzy. The legal provision dealing with directors' duties is a good example of fuzzy law. It talks of directors acting honestly and reasonably.

But the definition of "subsidiary" is an example of black-letter law which allows the exploitation of loopholes. Hence the excesses of the off-balance-sheet company. But consider changing the definition away from "control" to "effective control" or "effective dominance". Fuzzy, yes, but everyone understands what those terms really mean.

Fuzzy law should be encouraged, not just its poor cousin, plain English drafting. Fuzzy law is conceptual, abstract. Plain-English drafting is mechanical.

Defensive mechanisms

Recent discussion about corporate practices and governance has been refreshing. It proposes that the corporation, as an important vehicle of capitalism, needs restructuring to fit the nineties. It also tells us that we cannot rely only on the law but must use other safeguards. Defences such as audit committees and independent directors are sound responses to many of our past problems.

Perhaps the ASX, as the governor of Australia's leading companies, should set out a voluntary code, in addition to its listing rules. Companies electing to comply with these new guidelines could be given a special ASX Code, a type of corporate governance rating.

This in turn may affect the "real" ratings of the companies and assist them to use the capital markets more efficiently. If that does happen, others will follow the example. □

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