BUSINESS REGULATION AND AUSTRALIA'S FUTURE

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edited by

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PREFACE

The contributions to this volume were originally presented at a conference on The Future of Regulatory Enforcement in Australia, convened by the Australian Institute of Criminology and the Australian National University in Sydney during March 1992. The editors wish to express their gratitude to the Institute for supporting the conference, and to the contributors for their cooperation throughout the venture. The conference was part of the Australian Institute of Criminology's long standing commitment to upgrading the quality of policy deliberation on questions of regulatory enforcement in Australia. For the Australian National University, this conference was part of the fundamental rethinking of Australia's future for the project coordinated by the Research School of Social Sciences, 'Reshaping Australian Institutions: Toward and Beyond 2001'.

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Chapter One

Introduction

Peter Grabosky, Clifford Shearing & John Braithwaite

Australia is in the midst of dramatic change in the relationship between government and business. Regardless of which side of politics governs at state or federal levels, it has become quite clear that the major challenge facing our nation as the next century approaches is to ensure Australian competitiveness in the world economy. To this end, gratuitous intervention in the business of business is something to be avoided. At the same time, there must be some safeguards to ensure that the 'public interest' is not threatened. Recent history is littered with examples of 'market failure', where tremendous harm has been done to the public interest as a result of unrestrained economic activity–activity which, one might add, was not necessarily productive.

The entrepreneurial excesses of the 1980s cost Australia dearly. Australian entrepreneurs became the butt of jokes in international financial circles, and Australian capital markets suffered accordingly. We are still picking up the pieces. 'Market failure' is manifest in other areas as well. Because of undisciplined management, soil degradation has brought about the destruction of a significant proportion of Australia's land which had been used for grazing and agriculture. Unrestrained exploitation of south-eastern fisheries has brought about significant retraction of the fishing industry.

Public discourse on regulatory enforcement tends to shed more heat than light. From some quarters, one hears rhetoric denouncing business regulation as strangling the economy; from others, one hears regulation described as the connective tissue of civilisation as we know it.

This volume, based on contributions from leaders in business, government and the academy, seeks to transcend such rhetoric.

A dominant theme in many of the chapters which follow is the principle that the most effective and efficient means of ensuring responsible corporate citizenship lies in prevention, rather than response after the fact. To harness and to structure markets and corporate responsibility in a manner which would inhibit business illegality while

continuing to foster business enterprise, is vastly preferable to rule book enforcement. To encourage and to reward responsible self-regulatory initiatives is often preferable to enlarging the often cumbersome and costly apparatus of command and control regulation. A number of contributors to this volume point to the constructive role which members of the public can play in enhancing the effectiveness of regulatory policy.

The initial chapter sets out the general background for Australian business regulation, and contrasts the Australian style of regulation with those of our major trading partners. It is suggested that Australia is situated between the extreme adversarial style of regulation which characterises the United States, and the more cooperative and consensual style of regulation prevailing in the United Kingdom and Japan.

The chapter by Tony Hartnell, Chairman of the Australian Securities Commission (ASC), describes the regime of regulation established by the recent successor to the former cooperative scheme for companies and securities regulation. The ASC's predecessor was plagued by inadequate resources and by the constraints arising from having to operate within a cumbersome federal framework. Hartnell's paper describes the flexible combination of civil and criminal tools at his Commission's disposal, and demonstrates the useful interrelationship of remedies and sanctions available.

Joseph Longo, a Perth solicitor, notes the formidable powers available to the ASC, and suggests that their existence and use may be regarded as an overreaction to the excesses of the 'Decade of Greed'. His concern for the rights of the accused is manifest in his comments on the demise of derivative use immunity and in his argument that the erosion of legal professional privilege has enhanced access by investigators to certain communications between lawyers and their clients.

Professor Clifford Shearing's essay challenges the myth of deregulation, arguing that corporate activity occurs in what he terms 'regulatory space'. A diminished government presence in this space hardly implies corporate anarchism. Non-government activity in regulatory space will expand to compensate for this diminished presence; markets themselves are significant regulatory instruments. Shearing's constitutive conception of regulation seeks to delineate a new paradigm of regulatory analysis.

John Braithwaite's chapter seeks to transcend the deregulatory debate, and demonstrate how constructive corporate responses to the regulatory environment can contribute to a stronger, more productive economy. He cites examples of astute manufacturers who have exploited opportunities to develop cleaner, safer products, and have thereby become world leaders. Braithwaite's wider vision of regulatory affairs calls for a constructive dialogue between industry, government, and the citizenry, and a mutual recognition of the positive contribution that each can make in ensuring responsible corporate citizenship.

Eric Mayer, a distinguished business leader, provides an economic perspective on the role of regulation in Australia. On the map drawn earlier by Shearing, and to be further developed later in this volume by Gunningham, Mayer identifies a variety of regulatory instruments which exist alongside traditional 'command and control' regulation by government agencies. He provides numerous examples of economic instruments, including taxes and charges, subsidies and tax exemptions, and tradeable permits. These regulatory alternatives have the potential to produce desired outcomes more efficiently and more effectively than traditional methods.

Ray Schoer's chapter on self-regulation at the Australian Stock Exchange argues that the inevitable complexity of black letter law renders it inappropriate as a primary regulatory instrument in his domain. He much prefers the flexibility inherent in his program of self-regulation, based as it is on market surveillance, moral suasion, inquiries, press releases, and the more extreme sanctions of suspension and de-listing.

Robert Baxt, former Chairman of the Trade Practices Commission and currently a solicitor in Melbourne, identifies poorly drafted laws, unrealistic penalties, and inadequate regulatory resources as factors which contributed to the corporate excesses of the 1980s. He observes that federal government policy is marked with inconsistency, both within and between regulatory domains, which reflects the various political pressures to which a democratic government is subject. Baxt also heralds the theme of Roger Wilkins' later chapter by calling attention to the overlap and duplication of regulatory effort which characterise the Australian federal system.

Neil Gunningham's chapter, building upon the framework articulated by Clifford Shearing, reviews a range of regulatory instruments and introduces the concept of regulatory mix. In addition to the economic regulatory instruments noted by Eric Mayer and strategies for public involvement advocated by John Braithwaite, Gunningham discusses such additional devices as liability law, information-based strategies (disclosure and 'right to know' provisions) and self-regulatory activity assisted by third party compliance auditing. Gunningham points toward the identification of an optimal regulatory mix, the ideal complementarity of regulatory instruments which produces economically efficient regulatory outcomes.

John Tamblyn of the Trade Practices Commission (TPC) describes the current regulatory regime of the TPC, with particular emphasis on alternatives to litigation. Tamblyn describes a variety of regulatory instruments including negotiated undertakings and consent orders, targeted publicity, and assistance to industry in developing in-house information and training programs. In particular, he refers to the collaboration between the Trade Practices Commission and the Metal Trades Industry Association (MTIA) in the development of a compliance education

program for MTIA members. The TPC is active in assisting companies and industries to develop codes of conduct, and encourages self-enforcement by those companies which detect breaches of the law on the part of their competitors.

In presenting industry perspectives on regulatory enforcement, John Martin of the Confederation of Australian Industry calls attention to the costs of regulation, and to the abuse of enforcement powers by regulatory agencies. He voices particular concern about the imposition of pecuniary penalties by non-judicial means. Martin adds his voice to the call for more efficient regulation in Australia, and, echoing Gunningham's earlier chapter, advocates a new policy mix of market-based solutions, taxation incentives and effective and accountable self-regulation.

Roger Wilkins' chapter on regulation in the Australian federal system identifies two basic problems—duplication of function by federal and state governments, and inconsistent application of standards across several jurisdictions. He cites the recent achievement in forging the Intergovernmental Agreement on the Environment (February, 1992) as one example of success in overcoming the handicaps of federalism. Pursuant to this agreement, a new national Environment

Protection Agency will set standards, and state agencies will bear the responsibility of implementation. Progress in implementation will be monitored by the national body.

Professor Albert Reiss identifies a looming issue with key implications for regulatory policy in Australia, as elsewhere. The growing internationalisation of commerce and the development of the global economy will make it increasingly difficult for sovereign states to regulate domestic and international business. He cites as illustrative examples the collapse of the Bank of Credit and Commerce International (BCCI), technology transfer facilitating the development of a nuclear weapons industry in Iraq, and the use of overseas bank accounts to facilitate fraud by a travel agency in Sydney, the proceeds of which were allegedly channelled to an insurgent movement in Sri Lanka. Reiss suggests that the years ahead may see the development of supranational regulatory activity.

Bill Coad and Patrick McDonnell describe the new regime for systematic reporting of cash transactions which was established in the late 1980s to combat money laundering and tax evasion. Small businesses with a high-volume cash flow are particularly vulnerable to both of these practices: to mask its origins, illicit income may be co-mingled with legitimate revenue, and/or revenue from whatever source may not be declared to taxation authorities. One assumes that the costs which this regulatory regime imposes on the banking industry will be more than offset by the benefits flowing to law enforcement and to the recovery of taxation revenue.

In his chapter, Trevor Boucher, the Commissioner of Taxation, describes the current investigative strategy of the Australian Tax Office

(ATO). Based upon the principle of risk management, the ATO identifies six broad areas of risk, and within these, further categories of particular interest. Thus are the ATO's investigative resources targeted more efficiently and effectively. Enforcement is not the only means by which the ATO achieves compliance, however. Boucher describes how the fish processing industry was singled out for encouragement in the maintenance of more accurate financial records. A mix of service and enforcement served to improve compliance within the industry.

Michael Rozenes, QC, the recently appointed Commonwealth Director of Public Prosecutions, describes the directions which his office plans to take in the prosecution of regulatory offenders. As a person with years of experience in acting for defendants, Rozenes speaks with some authority when he suggests that 'the only real and effective deterrent for the corporate crook is the certainty of detection followed by the certainty of punishment'. Rozenes recognises that civil proceedings may in some cases accompany criminal prosecution, and is concerned that these two instruments complement rather than conflict with each other in order to balance the goals of deterrence and restitution.

Notwithstanding the acknowledgment by both Rozenes and Hartnell that the ideal regulatory regime would entail a complementary mix of criminal, civil and administrative remedies, one sees in their chapters an emerging difference of opinion regarding the appropriate emphasis to be placed on the criminal sanction within the domain of companies and securities regulation. Toward the end of 1992, this difference became the subject of public controversy.

Professor Brent Fisse's chapter addresses the problem of balancing the need for both individual and corporate criminal responsibility. Mindful that preoccupation with corporate liability may lead to an undermining of individual accountability, he develops a model for the allocation of responsibility. Fisse's model embraces the principle that 'all who are responsible should be held responsible', and presents a hierarchy of disciplinary and remedial interventions which provides for individual and corporate sanctions.

In the discussions among the authors of these chapters and commentators upon them at the conference, there emerged a number of points of agreement and disagreement. We see three general agreements that provide the basis for a shared understanding.

First, there is general acceptance of the notion that regulation is and will continue to be necessary. The idea of an unregulated marketplace has not received much, if any, support. This agreement has its foundation in a shared belief that the 'excesses of the 80s' can in large part be attributed to a failure of regulation.

Second, there is substantial agreement that the state cannot, and should not, be the only or indeed the primary regulator. There is widespread acceptance of the notion that regulation can and should

involve a range of players. Most contributors indicate support for the proposition that regulation should be undertaken by a multiplicity of regulators with access to different regulatory resources. Regulation should not be a state monopoly.

Finally, there is considerable support for the proposition that the purpose of regulation should be to shape market outcomes and that these outcomes should be the standards by which regulatory successes and failures should be judged. Within this context rules are identified as tools rather than as goals of regulation. Regulation should ultimately be about meeting output criteria not rules. A fundamental goal of regulation that a number of contributors identify as applicable to a wide variety of levels and forms of regulation is 'public confidence'.

Within this context of shared understandings important disagreements also emerge. The core of these disagreements have to do with differing understandings of the public interest and especially how it is to be identified and realised. These differences are reflected in the proposals put forward with respect to the appropriate division of labour between the various regulatory players.

One may summarise these disagreements by identifying three models of the organisation of regulatory space which appear to be:

Model 1: Private Regulation with State Oversight

The first model, and the one with the widest support, was a model that sought to harness the resources of private regulators and put them at the disposal of the state. The argument advanced there is essentially that the job of regulation is a demanding and difficult one that the state cannot do alone. This requires the coordination of regulatory resources under the direction of the state. In particular it is argued that self-regulation should be encouraged and utilised by the state. The idea put forward is to create a hierarchy of regulatory capacities with the state at the top and private regulators and citizens at the bottom all working towards the same goals. In this hierarchy, regulation would be done by the bottom but controlled from the top—bottom-up performance and top-down control. Each level in this regulatory hierarchy would be policed by regulators at the next level up. To use the capture metaphor, the idea behind this was that the state should seek to capture private regulatory resources.

At the heart of this conception is an identification of state with the public interest. Underlying this is a faith in the democratic process. The critical question within this model is how to structure the hierarchy of regulation in such a way as to promote the highest level of regulatory coordination.

Criticisms of this model arise out of uneasiness about the reliance it placed on the state to 'do the right thing'. Two other models emerged in response to this uneasiness.

Model 2: Keeping the State Honest

This model was developed as a complement to, more than an alternative to, the first. Its proponents argued for greater regulatory accountability to keep the process honest. The principal issue debated is how to make the regulatory process more directly answerable to the public. An idea put forward is the use of public interest groups to watch over the regulatory process on behalf of the public. This model accepts that the regulatory process must be responsible to the government but seeks to keep the voting public better informed about the outcomes regulators are actually promoting.

Model 3: Balancing Interests

The third model is more sceptical of the ability of the normal democratic process to set adequate regulatory objectives. Its proponents seek to acknowledge and exploit the differences between interest groups to establish 'regulatory space' as a terrain of dialogue in which a tension between regulatory entities would be reflected in an active struggle with each other over outcomes. Proponents of this view voice concern about public interest groups being coopted by the state. They argued for the presence of independent regulatory entities who would act to promote their conception of the public interest. The public interest, it is argued, is likely to be better served by dialogue and contest than by a system of coordination and state oversight. A contested view of the public interest rather than one that is authoritatively settled by the state can warrant, for example, Greenpeace-style actions that totally reject and undercut the state's conception of the public interest.

If the 'regulatory culture' that most contributions to this volume tend to foster has any influence over regulatory policy, Australian policy is likely to be dominated by the first model with tendencies to move over time towards an acceptance of the second. While advocates of the third model are likely to be very vocal, and may well set the agenda for policy debate, their proposals are likely to meet with considerable resistance. But then perhaps that impression reflects a predominance in this book of authors from what one might call the regulatory establishment.

Together, the essays comprising this volume identify the major issues and likely directions for Australian business regulation into the next century. The importance of the topic for our future was manifested by the substantial media coverage these papers attracted when they were presented, some of it on the front pages of metropolitan dailies.

The papers by Baxt, Schoer and Hartnell for example, became important contributions to the 'fuzzy law' debate on whether our companies and securities law should be based on broad principles or even more detailed specification standards. Whether the contribution these papers make to the rethinking of our regulatory future will be a positive one, only time will tell.

Chapter Two

Australian Regulatory Enforcement in Comparative Perspective

Peter Grabosky

This essay provides a general description of Australian regulatory enforcement, and contrasts it with regulatory methods employed by some of our major trading partners. A concluding section suggests some factors which appear likely to influence the course of Australian business regulation into the next century.

Of Manners Gentle

In 1984 and 1985, John Braithwaite and the author set out to describe the culture of business regulation in Australia. Together, we visited 96 different regulatory agencies around Australia. The explicit purpose of the research was to identify the enforcement strategies of regulatory agencies —how they went about achieving industry compliance with the regulatory standards which were in place.

Braithwaite the author approached 101 organisations which met our definition of a regulatory agency: a government department, sub-unit of a government department, a statutory authority, or a commission, established independently of the corporate sector, with significant responsibilities for regulating activities of commercial corporations which might run counter to what parliament determines to be broader community interests, and with the capacity to initiate prosecutions. The organisations meeting this definition included each of the state, federal and territory agencies responsible for corporate affairs, consumer affairs, environmental protection, food standards, discrimination based on gender or race, general occupational health and safety, and mine safety. In addition, a disparate array of single agencies concerned with antitrust, aviation safety, maritime safety, motor vehicle safety, labour relations practices, pharmaceuticals regulation, insurance, banking, customs, tax and a variety of others were included.

The conclusions reached were summarised concisely in the title of the book—*Of Manners Gentle: Enforcement Strategies of Australian Business Regulatory Agencies* (Grabosky & Braithwaite 1986). Litigation, or any kind of adversarial confrontation with industry, was undertaken only as a last resort. This did not reflect any inadequacy of powers at the disposal of regulatory authorities. Indeed, the majority of agencies studied were vested with powers of entry, search and seizure, and investigation which would make them the envy of Australian police forces. These powers, however, were rarely used. In fact, some regulatory executives expressed embarrassment at their very existence.

Generally, Australian regulatory executives overwhelmingly rejected a law enforcement ideology. They trusted business as socially responsible and willing to be law abiding. They renounced adversariness in favour of a cooperative posture. In general, they operated on assumptions that business will respond to a reasonable request from them without any need to threaten enforcement action, let alone use it. Prosecution, we were consistently told, was a 'last resort'. As a matter of conscious choice, regulatory executives rejected the option in all but the most exceptional circumstances.

Typology

Our study of the 96 regulatory agencies revealed some distinctive types. One category, which was termed 'conciliators', included agencies which overwhelmingly rejected any kind of law enforcement model, relying instead on achieving regulatory goals by bringing conflicting parties together to resolve disputes. Anti-discrimination agencies, and some consumer affairs agencies comprised this category.

A second category, referred to as 'benign big guns', walks softly while carrying a very big stick. Agencies in this group wielded enormous powers, but rarely if ever used them. Examples included the Reserve Bank, the Australian Broadcasting Tribunal, and the Office of the Supervising Scientist for the Alligator Rivers Region. Means of obtaining compliance were referred to as 'regulation by raised eyebrows' and 'regulation by vice-regal suasion'.

A third category, termed 'diagnostic inspectorates' included agencies whose primary means of obtaining compliance was the provision of technical assistance to companies in breach of regulatory standards. Rather than simply draw the attention of management to specific regulatory violations, inspectors from these agencies recommended remedial measures and encouraged self-regulation. Most of the agencies in this category were mine or radiation safety inspectorates.

The remaining agencies differed from the previous three types in that they were somewhat more likely to undertake occasional prosecutions. They did not place great priority on maintaining cooperative relationships

with industry. From this 'arm's length' position, they tended in general to be more proactive, and more rulebook oriented. Those prosecutions which were successful tended to result in very low penalties.

Our study was descriptive, not evaluative. That is, we did not seek to reach any conclusions as to whether Australians were well served by the systems of regulation then in place. In some domains they were; in others they definitely were not.

A particular area of regulation included in our project were those agencies then participating in what was called the cooperative scheme for companies and securities regulation—the state and territory corporate affairs commissions and the National Companies and Securities Commission.

Based upon our interviews with executives of these agencies, the picture which we painted of corporate affairs regulation at the time of our fieldwork in 1984-85 was not one to inspire confidence. Agencies were hopelessly under-resourced. The backlog of cases awaiting investigation for possible fraud was apparently endless. Responsible ministers resisted requests for additional investigative resources. Political interference was pervasive; ministers were able to quash prosecutions quite readily, and did so. Corporate affairs regulators were told, 'Don't rock the boat.' In the most unusual event that an offender was brought to justice, penalties imposed were tepid, if not derisory. It is no wonder that the sorry state of Australian enterprise which marked the latter years of the 'Decade of Greed' was able to develop.

Fortunately, governments, in their wisdom (if perhaps belatedly) saw fit to replace the inadequate regime of companies and securities regulation which enabled fraud to flourish. It remains to be seen whether the new Australian Securities Commission will fulfil its regulatory potential in the long term.

In the eight years which have passed since our research, we have detected a slight change in the posture of Australian regulatory agencies. Overall, the manners of Australian business regulators are still gentle, but in some cases they have taken on a firmness which was not manifest in 1984.

In Victoria, there is an announced policy of using the criminal law, as opposed to regulatory statutes, to prosecute employers whose wilful disregard for employee safety results in death or serious injury.

In New South Wales, Section 8 of the *Environmental Offences and Penalties Act 1989* provides for fines of up to one million dollars in the case of a corporation, or in any other case, $150,000 or seven years imprisonment, or both. Prosecution of individuals and businesses who pollute the environment has become more common than in the past.

Soon after assuming office, the new Chairman of the Australian Securities Commission announced what could be described as a 'hit list'

of cases for possible prosecution. Few, if any of the principals are behind bars yet, but it will be interesting to observe what develops.

The Australian Broadcasting Tribunal successfully challenged the fitness and propriety of the holder of a television license.

In 1991, the federal government announced its intention to increase penalties available under the *Trade Practices Act 1974*—a forty-fold increase from $250,000 to $10,000,000.

It is perhaps not surprising that regulatory reform, as is the case with other types of reform in Australia, tends to occur as the result of scandal. The dramatic sharemarket fluctuations of the late 1960s inspired the Rae Inquiry, which drew attention to incompetence, malpractice and improper conduct on the part of financial journalists, sharebrokers, and directors of public companies. From this ultimately emerged the *National Companies and Securities Commission Act 1979*.

A Royal Commission appointed to inquire into allegations of racketeering on the Melbourne waterfront uncovered tax evasion schemes which cost the treasury hundreds of millions of dollars in revenue. Among the consequences were significant organisational reform within the Australian Taxation Office and the creation of a Commonwealth Director of Public Prosecutions.

More recently, the corporate excesses of the 1980s highlighted by the current Royal Commission in Western Australia helped expedite the development of a truly national scheme of companies and securities regulation.

Despite the increased firmness of Australian regulators, there remains a desire to avoid an adversary relationship with business if at all possible. This no doubt reflects the continued belief that regulatory compliance can be achieved more effectively and more efficiently by friendly persuasion.

Citizen Participation in the Regulatory Process

Another dimension on which Australian regulatory cultures might be compared with overseas counterparts is the role of citizens or other non-governmental actors in the regulatory process.

In Victoria, the institution of elected worker safety representatives complements the government inspectorate. Safety representatives may demand access to inspect any part of the workplace or to inspect company records relating to health and safety. They are empowered to issue provisional improvement notices when they discover a workplace hazard. These notices have the force of law, pending abatement of the hazard in question or authoritative determination by a government inspector. Breach of such a notice renders one liable to prosecution. Safety representatives now number in the thousands in Victoria. Regulatory vigilance in the Victorian workplace is thus enhanced far

beyond the degree which could otherwise be provided by a government inspector.

Other examples of citizen involvement in the Australian regulatory process include the use of volunteers to monitor beach erosion and to submit regular reports to the Queensland Beach Protection Authority; the use of voluntary wardens to watch over historic shipwrecks in South Australia, and the use by the New South Wales Department of Consumer Affairs of a network of volunteers from the consumer movement to discover hazardous products on the market. As we shall soon see, incentives and opportunities for citizen involvement in the regulatory process tend to be significantly fewer in Australia than elsewhere.

Federalism

Another characteristic of Australian regulatory culture is the fragmentation and parochialism which accompanies the Australian federal system. One example is the field of occupational health and safety.

Australia, with a workforce of just over seven million, has nine separate regulatory regimes for occupational health and safety. This framework does not include all workers in the mining, petroleum and maritime industries, which in some jurisdictions are subject to other regulatory regimes. Occupational health and safety standards, and enforcement practices, differ across state and territory jurisdictions.

The consequences of this fragmentation are profound, especially for national industries. They introduce inefficiencies to the mobility of labour and capital which is essential to microeconomic reform and to the improvement of Australia's position in the international economy. The duplication of regulatory effort inevitably occurring in nine separate jurisdictions is wasteful and inefficient, and is an unnecessary burden on Australian taxpayers. Moreover, inconsistencies in standards and in their enforcement can be detrimental to the health and safety of Australian workers, with resulting social and economic costs.

Other domains of business regulation have been plagued by problems arising from the federal system. The evolution of companies and securities regulation from the fragmentation which characterised the first half of the twentieth century, to the 'cooperative' national companies and securities scheme which presided over the corporate disasters of the 1980s, was impeded by parochialism.

The Australian experience of jurisdictional conflicts over regulatory responsibility may be usefully contrasted with the experience of Europe. There, where a dozen different languages are spoken and where, over the past thousand years, warfare has resulted in tens of millions of deaths, impressive progress has been made towards the achievement of regulatory uniformity. Standard rules and enforcement policies will ensure officials that their counterparts in other states are not favouring local enterprises.

The benefits which will flow to the strong and growing economies of Europe should not be lost on Australians, especially in the current economic climate.

There has been recent progress to eliminate duplication and inefficiency across the Australian federal system. Reference has already been made to the Australian Securities Commission. Other examples of progress toward harmonisation or coordination of regulatory policy in Australia include agreement of federal state and territory governments to establish a national food authority, agreement on national nursing home regulatory standards and recent developments in the regulation of agricultural chemicals. In Chapter Thirteen this volume, Roger Wilkins describes the progress made in the environmental protection area generally.

How does this Australian regulatory culture differ from the regulatory styles of our major trading partners?

Regulation in the United States

One basis for comparison with Australian regulatory enforcement is the United States. Because of its size and diversity, it is only with great caution that one should generalise about the United States. In the US federal system, regulatory enforcement responsibilities may be shared by as many as four different levels of government: federal, state, county and municipal.

Economic rationalists and other advocates of deregulation often look to the United States, particularly since the beginning of the Reagan era, as a paragon of deregulatory virtue. The reality is somewhat more complex.

It is nevertheless safe to say that the United States is characterised by a more legalistic and adversarial regulatory style than is Australia. American legal culture is more litigious and rights-based. Its political systems are more open, with centres of power fragmented. Its judicial system is more accessible to public interest groups.

How is this American regulatory culture reflected in operational terms? A few examples include regulatory standards, investigative methods, enforcement styles and penalties imposed on convicted offenders.

Standards

American regulatory standards in general are more restrictive. Pesticides banned in the United States are available for use in Australia. In the domain of securities regulation, at least until very recently, the definition of insider trading was much broader. Conduct which was perfectly legal here in Australia could lead to a prison sentence in the United States.

Investigation

Some formidable investigative strategies exist in the US. A few are mentioned here.

First let us look at covert facilitation. The use of undercover tactics and other elements of deception in the course of regulatory investigation is rare in Australia. By contrast, regulatory authorities abroad have employed some imaginative, and indeed at times outrageous investigative techniques. The following anecdote is instructive:

> A pathology laboratory advertised that it would test one's blood for food allergies. The New York State Attorney General submitted a sample of cow's blood, along with the required $350 fee. Unfortunately, the laboratory failed to detect that the sample was nonhuman. Indeed, the lab reported that the donor was allergic to cottage cheese, yogurt and milk (Marx 1987, p. 47).

To give some indication of the lengths to which investigators in the United States might go, consider the techniques employed in the course of another investigation:

> As one knows, the use of offshore banking facilities to conceal a taxpayer's assets is a problem commonly confronting taxation authorities. Some time ago, a Special Agent of the United States Internal Revenue Service (IRS) engaged the services of a private investigator to learn what he could about a particular Bahamian bank and its depositors. The private investigator arranged for a female confederate to be introduced to a Vice President of the bank in question.
>
> One evening, the banker called upon the confederate at her apartment. After a time, the two left for dinner at a local restaurant. During their absence, the private investigator gained access to his confederate's apartment, removed the banker's briefcase, and, in accordance with previous arrangements, delivered it to the IRS Agent, who photographed its contents. The briefcase and its contents were replaced before the couple returned from the restaurant. The contents of the briefcase were used to convict an individual charged with falsifying a federal income tax return, by denying that he maintained a foreign bank account (*US v. Payner* 447 US 727 (1979).

Enforcement

American enforcement practices tend to be more aggressive. The United States Department of Justice established an Environmental Crimes Unit late in 1982 to target egregious environmental offences. The US Environmental Protection Agency has an office of criminal investigation with 60 staff. Upwards of 100 people each year in the United States are indicted for federal environmental offences.

The District Attorney of Los Angeles County (roughly the equivalent of a Director of Public Prosecutions, although an elected official), established a special environmental and occupational health and safety division in 1985. Since that time, the division has filed 5 felony manslaughter prosecutions, three of which resulted in convictions for manslaughter, and one of which resulted in a plea of guilty to labour code violations. The most recent case was filed in November 1991, and six additional cases were under investigation.

Enforcement activities are often accompanied by maximum publicity. Former US Attorney for the Southern District of New York, Rudolph Giuliani, invited film crews and press photographers to record his arrests of white-collar offenders in their Wall Street offices. Recently, the Consumer Affairs Commissioner for the City of New York personally padlocked the pumps at a petrol station which had repeatedly misrepresented octane levels to its customers.

It might be said that discussions of regulatory enforcement dwell too much on issues of deterrence and punishment, and too little on positive incentives for exemplary corporate conduct. The criminal law is, after all, a relatively blunt instrument, and principles of regulatory efficiency, about which we will have more to say later on, require us to explore alternatives to the heavy hand.

A couple of examples of positive incentives as they are applied in the United States are mentioned here. Voluntary disclosure of corporate wrongdoing would strike some in the United States as foolish. It is after all common for most white-collar miscreants there to deny any culpability. In the face of this natural inclination, the federal government offers leniency to those companies which had made a good faith attempt to implement compliance programs prior to the offence, which voluntarily disclose their transgressions, and which cooperate fully with subsequent investigations. Some regulatory authorities in the United States have programs which excuse from regular inspection those companies which have exemplary compliance programs in place.

Another fundamental difference between regulatory systems in Australia and the United States arises from variation in constraints on freedom of expression. In Australia, laws of libel inhibit open and robust discussion of corporate illegality and its control. Laws relating to contempt inhibit discussion of matters before the courts. Despite recent

innovations in relation to the law of standing in Australia, it would appear that individual citizens and interest groups in the United States enjoy a much greater capacity to participate in regulatory enforcement than do their Australian counterparts.

In the United States, regulations under the Surface Mining Control and Regulation Act 1977 allow citizens to request an inspection by federal regulatory authorities. The citizen must submit a signed written statement which would give regulatory authorities reason to believe that a violation exists. The citizen may accompany the inspector in the course of the inspection, and is entitled to receive a copy of the inspector's report. In the event that no inspection is conducted, the citizen is entitled to a written explanation for the decision in question (Shover, Clelland & Lynxmiler 1986). Most federal environmental legislation in the United States contain provisions permitting private parties to sue others for non-compliance, regardless of whether or not they have suffered injury (Greve 1989).

Private citizens who discover fraud against the federal government may sue for damages on behalf of the United States. This course of action originated in fourteenth century England as a means of private redress to supplement what were at the time modest efforts at public enforcement. The term employed for this type of litigation was qui tam (Latin for 'who as well'; that is, who sues for the state as well as for him or herself). The False Claims Act guarantees that the private citizen who initiates the suit receives a proportion of the damage award—between 15 per cent and 30 per cent at the discretion of the presiding judge. The remainder of the damages are paid to the US Treasury.

Cultural inhibitions against informing or 'dobbing-in' one's fellow citizen, once strong in Australia, may be eroding. Whilst Australian regulatory agencies will cheerfully receive information, they do not offer rewards or bounties to the citizen-informer. Contrast this with the United States, where section 7623 of the Internal Revenue Code and subordinate regulations permit the Internal Revenue Service (IRS) to pay a reward to citizens providing information leading to the detection and punishment of anyone violating the internal revenue laws. Special provisions are made to ensure the security and to preserve the confidentiality of informers' communications. Other provisions prevent the payment of rewards to informers who themselves participated in tax evasion schemes or who prepared returns for taxpayers with the knowledge that they were evading taxes. Reward payments are regarded by the IRS as taxable income.

Recently, pursuant to the Insider Trading and Securities Fraud Enforcement Act of 1988, the United States Securities and Exchange Commission (SEC) has explicitly authorised the payment of bounties to persons providing information leading to the recovery of a civil penalty from an insider trader, from a person who 'tipped' information to an insider trader, or from a person who directly or indirectly controlled an insider trader. Civil penalties may be up to three times the illegal gains (or

losses avoided); the bounty payable may be up to ten per cent of the civil penalty assessed.

Sentences and Other Sanctions

In contrast to the sanctions available under Australian law, sanctions available in the United States are more varied. The modest monetary fines which are imposed on Australian corporate offenders who are unfortunate enough to be successfully prosecuted are little more than a slap on the wrist. They are a cost of business which can easily be absorbed or passed on to the consumer, with little deterrent or rehabilitative impact on the corporate miscreant. They fail to communicate to the general public that serious corporate crime is simply intolerable. In Professor Fisse's (1990, p. 200) words, 'they create the impression that corporate crime is permissible provided the offender merely pays the going price'. Any citizens victimised by the corporate misconduct in question must resort to the civil process to recover compensation.

Penalties imposed on regulatory offenders in the United States are much more draconian. Although his prison term was ultimately reduced, Michael Milken, the Junk Bond King, was sentenced to ten years in federal prison for securities fraud and insider trading (not to mention his having to pay hundreds of millions of dollars in civil and criminal penalties). To date, the only person convicted of insider trading in Australia was a former employee of the National Companies and Securities Commission!

Fines levied on corporate offenders in the United States can amount to many millions of dollars. The Exxon Valdez oil spill resulted in a criminal fine of $125 million, on top of hundreds of millions of dollars in civil penalties and clean-up costs.

Other post-conviction remedies can be extremely painful to the wayward corporation. Convictions under the Clean Air and Clean Water Acts trigger automatic prohibitions from further contracting with the US Government.

The above penalties are extreme, and may well produce unwanted side effects, such as job losses. To overcome these disadvantages, a variety of alternative sanctions have been introduced in some United States jurisdictions. These include probation and punitive injunctions, adverse publicity, and community service for corporate offenders.

Corporate probation, authorised under the Sentencing Reform Act of 1984 (a United States federal statute) has been used increasingly to achieve the ends of corporate rehabilitation. To this end, they tend to require the introduction of corporate disciplinary action or other kinds of organisational reform, such as special audit procedures, compliance monitoring, and communications procedures to facilitate identification and disclosure of future regulatory breaches.

Some of the more imaginative prosecuting and sentencing authorities in the United States have designed programs of community service as conditions of probation or pursuant to an agreement not to prosecute (Fisse 1981). In the case of the *United States v. Allied Chemical Corporation*, the polluter was required to make a charitable contribution to the Virginia Environmental Endowment. A construction company convicted of fraudulent bidding on highway contracts was required to endow a chair in Ethics at the University of Nebraska. Six bakeries convicted of price fixing were excused from paying a substantial portion of their fines in return for the provision of a year's supply of baked goods to charitable organisations in the New York metropolitan area.

Ideally, however, community service orders would involve something more than merely writing a cheque. The requirement that a polluter develop and publicise a new emission control technology, or that a corporate offender design and sponsor an industry-wide compliance training course are illustrative of the type of community service orders which directly address the problem giving rise to the offence, and thereby help to rehabilitate the corporate offender.

Court-ordered adverse publicity has also been used as a sentencing option against corporate offenders (Fisse & Braithwaite 1983). To cite an Australian precedent: Earlier this century, publicans in Queensland who were caught watering down their beer were required to post a placard outside their premises advising prospective customers of these transgressions. Such penalties have fallen into disuse in Australia, and there appears no great pressure to revive them with new applications in the era of mass communication.

By contrast, in the United States publicity sanctions are not uncommon. One corporation convicted of dumping toxic waste was ordered to advertise its offence in The Wall Street Journal.

Publicity sanctions can also be used to educate the public about the harm occasioned by corporate misconduct. Another company convicted of unlawful toxic waste disposal was required to place an advertisement in the *Los Angeles Times* which read in part 'WARNING..... Pollution of our environment has become a crisis. International clandestine acts of illegal disposal of hazardous waste, or 'midnight dumping', are violent crimes against the community'.

The world, of course, is a very big place. There is more to regulatory enforcement than is manifest in Australia and the United States. In stark contrast to the combative and adversarial American regulatory culture are those of two other of our major trading partners, Japan and Great Britain. Let us look briefly at Japan.

Japan

One need hardly be reminded that Japanese society is profoundly different from our own. There, order and harmony are of utmost importance. The politeness of the Japanese is legendary. The maintenance of positive relationships and the avoidance of confrontation are important values, as is deference to and respect for authority. Japanese regulatory authorities are vested with wide discretion. The essential regulatory style of Japanese regulators is perhaps best characterised by the term 'administrative guidance'.

Administrative guidance is primarily informal, without a statutory basis, and without any framework of legal rights and obligations. Negotiations between agency and industry provide the forum within which such guidance is proffered.

Such forums are closed to the public, and few other opportunities exist for public consultation about matters of regulatory policy. The legal system, and the traditional passivity of the Japanese judiciary, inhibit the citizen's use of the law in regulatory matters. Opportunities for public participation in the regulatory process are severely constrained. Whilst it is risky to try to draw parallels between Japanese and Australian regulatory styles, one could suggest that 'administrative guidance', as practised in Japan, most closely approximates the 'regulation by vice regal suasion' practised by the Reserve Bank of Australia before the deregulation of the banking industry in the early 1980s.

In the event that administrative guidance fails to prevent wrongdoing by a Japanese company, the most likely outcome is profound public apology on the part of corporate executives. Confession, repentance, and absolution tend to characterise the Japanese response to corporate mishap. Japanese company presidents have been known to make condolence calls on bereaved relatives of persons who have died in accidents involving company activity. Their counterparts in the west, particularly in the United States, would be more likely to deny responsibility and avoid further comment, much less contact with the victims.

Great Britain

Although the general culture of Great Britain differs dramatically from that of Japan, their regulatory cultures share some broad similarities. Traditionally, government-business relations in Great Britain have also been characterised by consensus, cooperation and deference to authority (Hawkins 1984). The aggressive, win at all costs ethos which characterises much of American enterprise is less apparent in Britain, where relationships between government and business have traditionally been characterised as clubbish.

Changes occurring in the British economy, in particular those accompanying the emergence of more aggressive commercial practices, have begun producing a more adversarial regulatory culture. During the Thatcher decade, the emergence of 'corporate cowboys' necessitated the introduction of a more formal regime of company regulation. For the time being, however, at least in most other areas, going to law remains a last resort for British regulatory officials.

Conclusion

It would appear that as Australia approaches its centenary as a nation in its own right, regulatory policy will be driven primarily by one consideration–the agenda for microeconomic reform. Despite the profound market failures of the 1980s, both in Australia and abroad, there is growing enthusiasm for private enterprise as the key to economic growth and to the preservation of living standards. At the same time, it is widely conceded that the size of the public sector must be contained. These two themes will shape the future of regulation in Australia.

Regardless of the political persuasion of those governments which will lead Australia into the 21st century, the years ahead will see considerable pressure on most if not all regulatory agencies. For some this will mean extinction; for others contraction. The desirability of regulatory harmonisation across the Australian federal system was noted above.

Australia's goal will be to achieve regulatory outcomes which are economically efficient. The ideal is an optimal level of regulation, one which imposes no gratuitous burdens on Australian enterprise, yet one which protects Australian society from the worst excesses of market failure. The attainment of this goal will involve some old ideas and some very new ones.

It might be useful to speculate on a few themes which may well take on prominence in the years ahead. As the international economy becomes truly global, one may expect a degree of convergence in national regulatory styles. International agreements, such as those achieved for the purpose of protecting the biosphere, might be regarded as illustrative of pressures toward harmonisation at one level. In addition, widespread recognition of the discipline and efficiency produced by market forces will see the increasing use of market-based incentives to implement public policy.

One might expect to see a greater involvement by non-government actors in the regulatory process. This will entail more activity by individual citizens and interest groups who will challenge perceived lapses of corporate citizenship and lapses of regulatory administration, through the legal system, as well as through the political process. The extent of this involvement will of course be determined by developments in the law of liability and standing, as well as by situational political circumstances.

Perhaps even more significant will be devolution of much traditional regulatory activity to the private sector. This will entail both a greater investment in self-regulatory activity, as well as the emergence of commercial entities to provide services to assist companies to achieve regulatory compliance.

One need not look far for a precedent. The requirement that the accounts of a public company be subject to independent professional audit has long been a keystone of Australian companies regulation. Required certification by a non-governmental entity is by no means a guarantor of good corporate citizenship, as a number of audit failures, here and overseas, would vividly illustrate. The occasional occurrence of audit failure has not been invoked to justify doing away with the requirement, but rather to make accountants more accountable.

The analogue of the financial audit appears likely to play an increased role in other domains of business regulation. Increasingly, we may expect to see the transfer of responsibility for ensuring honest and competent corporate behaviour from government bodies to private interests with economic incentives to safeguard good corporate citizenship.

We are about to see a burgeoning industry in commercial inspection, certification and testing services, as well as in consultancies specialising in risk management. In some instances these very services may be linked with, or prerequisites to, obtaining insurance or finance for particular enterprises, projects or processes.

By way of illustration, consider the following examples.

- An insurance company which sells workers' compensation insurance, also offers risk management services to help clients identify opportunities for safety improvements.

- Businesses whose operations entail the risk of pollution may be required to undergo an environmental audit in order to qualify for a loan from a financial institution.

- Prospective corporate mergers and acquisitions will be conditional upon a determination of minimal financial liability arising from the previous questionable conduct of the target company.

- Pursuant to clear signals that have been given by both the Federal Court and the Trade Practices Commission, large corporations that do not have credible trade practices compliance programs will find that they face heavier penalties in courts before which they will appear more regularly.

- Independent, objective certification of environmental acceptability will become an important consideration in retail marketing.

It takes little imagination to see that such market-based alternatives are, in many instances, potentially more efficient regulatory instruments than are costly and often cumbersome bureaucracies.

We find ourselves on the threshold of a new era in the control of business activity. More efficient, and more effective alternatives to the traditional command and control enforcement of regulatory standards are now emerging. The challenge is to determine those circumstances in which private actors are best situated to further the public interest, to identify appropriate incentives to self-regulation, and to provide incentives to private parties to ensure responsible corporate conduct. There must also exist a framework of openness and a mechanism of accountability, to determine whether the promise of self-regulation is eventually honoured.

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Chapter Three

Regulatory Enforcement by the Australian Securities Commission: An Inter-Relationship of Strategies

Tony Hartnell

The history of entity regulation, broadly understood, is not a modern phenomenon. Though Gower (1979, p. 28) suggests the consequences of the 'South Sea Bubble' Act are identifiable with the first attempt at the regulation of 'corporate' bodies, that is unfair to its early Roman predecessors (for example, the governance by Justinian over the societas) and generous to its proclaimers. However that may be, 6 Geo.1, c18 essentially adopted sanctions and remedies not dissimilar in form to some of those still in place 272 years on. Brokers were then liable to penalties (s. 21) for dealing in securities of illegal companies, undertakings 'tending to the common Grievance, Prejudice and Inconvenience of His Majesty's subjects' were illegal and void. Prohibition and restraining orders not dissimilar to those in use today were available but were not to affect any home or foreign trade in partnership in such manner as had until then been lawful.

Three centuries on, the enforcement of corporate regulation has developed into a database for the effective governance, in this country, of greater than 800,000 corporate entities and a plethora of foreign corporate interests.

In terms of legal prose, corporate regulatory provisions extend over thousands of provisions in contrast to the less than 40 section reach of the Bubble Act. The nature and role of the sanctioning and remedial process attendant on the morass of legislation has increasingly come under scrutiny.

Civil and Criminal Sanctions—A Developing Jurisprudence

The distinctions between the civil and criminal procedures and sanctions that would appear obvious to the historian are less recognisable to the modern commercial lawyer. Ball and Friedman suggest that:

> the history of criminal law is in fact a history of the reasons why techniques of criminal law enforcement have been brought to bear in particular areas to advance social goals (Ball & Friedman 1965, p. 211).

The authors suggest that a distinction could be drawn between enforcement of law by individuals and enforcement by the state, the latter attracting criminal consequences, the former attracting civil consequences. A brief review of the available remedies and powers of the Australian Securities Commission (ASC) under the Corporations Law and the ASC Law invalidates the justification for that distinction, as indeed does the subject of this conference, 'regulatory enforcement', which in 1965 (and even later) may have been viewed as an oxymoron.

The distinction between civil and criminal in this country, in relation to companies and securities laws, is no longer absolute. Recent amendments to the insider trading laws are an example of more onerous sanctions and remedies being introduced by the legislature. The Corporations Legislation (Amendment) Bill (No. 1) expanded the ambit of illegal insider trading and increased the penalties tenfold to $200,000 or five years imprisonment for a natural person or $1 million for a corporation. In addition, a range of civil remedies were introduced which envisage potentially triple liability. For example, pursuant to s. 1005 and 1013 the insider can be liable to the other party to the transaction or the agreement, to the company whose securities were dealt in and also (if the person engaging in insider trading was an officer or employee of a company) then he/she could be liable to their employer company for any damages or lost profits (s. 232(7)).

The Corporate Law Reform Bill (1992), released in draft form in February of that year, provides further examples in the context of directors' duties, of the increasing interplay between civil and criminal remedies and sanctions. Contravention of a civil penalty provision under the draft amendments (s. 1317(AJ)) would attract civil liability for a pecuniary penalty of up to $200,000. If the contravention involves dishonesty, deceit or fraud, a person may be found guilty of a criminal offence. Notably, the 'civil' pecuniary penalty is not limited to compensation or damages. Unlike traditional civil 'remedies' only the Commission, a Commission delegate or a person authorised by the Minister may apply for a civil penalty order. Such pecuniary penalty as the Court may order is payable to the Commonwealth. Such an approach builds upon the foundations of the enforcement of Part IV of the *Trade Practices Act 1974*.

Considering the inter-relationship of civil and criminal remedies is not merely an exercise in contrast and comparison but an appreciation of the changing social focus on contraventions of corporate law and its consequences. The focus has changed, markedly, in Australia in the past five years–from regulation to enforcement and compliance.

In 1987, Arie Freiberg remarked that:

> Corporate Affairs officers do not see themselves as being in the business of prosecuting criminals . . . A major reason for the lack of rigourous enforcement may well be that the ideology of 'regulation' which prevails in agencies such as the CAC [Corporate Affairs Commission] is not consonant with an aggressive prosecution/deterrent orientation (Freiberg 1987, p. 73).

The enforcement strategy of the ASC reveals the inaptitude of that remark to the present Corporations Law enforcer. The success of the Commission in enforcing the Corporations Law cannot be gauged by the yardstick of prosecutions alone. It is, rather, the inter-relationship of deterrence programs, prosecutions and preservative and recovery actions that the ASC believes will achieve effective enforcement, of and compliance with, the Corporations Law.

As John Thomas identified:

> many regulatory problems are compliance oriented, requiring a flexible enforcement model whereby the threat of sanctions can be instrumental in remedying the problem created by an offender (Thomas 1982, p. 115).

The Corporations Law, and the enforcement philosophy of the ASC which reflects and reinforces it, provide a mechanism for a results-oriented approach to regulation and enforcement which recognises that sanctions must respond to the complexities of the behaviour they seek to control. Just as an analysis of current corporate behaviour and its regulation cannot be 'straightjacketed' by traditional notions of civil and criminal sanctions, so must the success of the ASC be judged not only according to its prosecution or even litigation record, but consistently with an understanding–reflected in its enforcement policy–of the complexities of the legal, political and commercial milieu in which it operates.

This paper explores the enforcement policy of the ASC in the context of this developing jurisprudence. It raises some practical problems attendant upon the transition from a traditional civil/criminal dichotomy to the more flexible regime embodied in the Corporations Law, and concludes by reference to the ASC's public accountability in its role as regulatory enforcer.

The Enforcement Policy of the ASC

In our first year as national regulator of the Corporations Law, the ASC has developed and institutionalised its enforcement policy. The Corporations Law and the ASC Law provide an array of enforcement alternatives, around which the ASC has designed a national strategy of enforcement. The statutory scheme of enforcement, as the ASC sees it, is as follows:

- prosecutions by the ASC;
- civil actions by the ASC;
- intervention in third party civil actions;
- provision of information to third parties; and
- final reports of investigations.

Our strategy focuses attention on the use of preservation, recovery and prosecution remedies. Further, and not least significantly, the ASC is committed to the development and implementation of a deterrent net against contraventions of the Corporations Law.

It is relevant to note briefly the policy of the Commission regarding each of these pivotal limbs in our enforcement focus considered together with other relevant collateral matters.

Preservative actions

Effective preservative action is central to the philosophy of the Commission's enforcement strategy. Often, preservative action is the necessary precursor to future effective remedial action. Alternatively, such preservative actions as the appointment of a provisional liquidator may obviate the need for later civil proceedings. Both the common law and the Corporations Law provide actions which assist in limiting the consequences of contravention.

The preservative powers of the Commission include:

- the use of common law injunctions and statutory mandatory or restraining injunctions to direct the affairs of a particular corporation (s. 1324);

- the power to apply to the court for appointment of a receiver/manager(s. 1323) and seek asset freezing orders;

- the power to seek a winding up or a provisional liquidator (ss. 464, 472);

- restraining orders against dealers' and brokers' bank accounts (s. 874-878, s. 1224-1227); and

- restraining orders against the disposition or dealing in securities (s. 1114, 1268).

Recovery actions

The preservative actions available to the Commission, by their nature, do not limit the opportunity for future civil or criminal investigations and proceedings to be instigated. The Corporations Law facilitates civil recovery of damages and compensation from those who contravene its provisions.

Recovery actions are available for contraventions of such provisions as, for example:

- duties imposed upon directors (s. 232);
- loans to directors (s. 234);
- upon a company incurring debts while insolvent (s. 592); and
- pursuant to the liquidator's powers upon the identification of preferences (s. 565).

In addition, of particular importance, are the orders available under s. 598(4)—to pay money or transfer property to a corporation in cases of fraud, negligence, default, breach of trust or breach of duty in relation to a corporation.

Further, the ASC Law allows the Commission to bring a recovery action in the name of an aggrieved party (s. 50) and the Corporations Law allows the Commission to intervene in existing proceedings (s. 1330).

Section 50 of the ASC Law vests power in the Commission to initiate representative public interest civil actions in the name of a company, or if not a company, with the person's written consent, for the recovery of damages or property. Section 50 is potentially an important power to protect minorities without financial resources to challenge the actions of the company or its directors. This is the basis of current litigation pending, based on s. 50, concerning the affairs of the Adelaide Steamship Co Ltd and David Jones Pty Ltd.

It is relevant to contrast recovery actions with the *Proceeds of Crime Act 1987* (Cwlth). The proceeds of crime legislation, an effective deterrent tool in other areas of criminal law enforcement, provides little direct tangible benefit to the corporation, its members or creditors. The Commission's focus on civil preservative and recovery actions is not specifically enhanced by legislation that requires a conviction to be secured prior to a forfeiture order against the relevant property. Proceeds of crime recovered under the Act are not utilised for the compensation of the immediate victims. The objectives of that legislation sit awkwardly with a proactive preservative or recovery approach to corporate regulation.

Support for third party civil litigants

This is a significant part of the ASC's enforcement strategy. It can involve direct intervention for a variety of responses, or less direct support.

Pursuant to s. 1330 of the Corporations Law the Commission is entitled to intervene in any proceeding relating to a matter arising under the Corporations Law. The ASC does not regard intervention as a method by which it may subsidise litigation brought by a private party. However, matters of national significance, issues concerning the construction of the Corporations Law and circumstances where information acquired through investigations would assist the court, will potentially attract ASC attention and intervention (*see Policy Statement* page 9/1).

An example of successful intervention occurred in the Commission's intervention in the oppression action against *Enterprise Mining NL*. In another case, *Duke*, the ASC had formally intervened in the civil proceedings (now settled) between the Duke Group (In Liq) and Arthur Young in the Supreme Court of South Australia. The ASC had intended to make submissions on the law in relation to the duties of independent experts. The proceedings related to the preparation of an experts' report under s. 12(g) CASA and Rule 3J3 of the Australian Stock Exchange Listing Rules. By contrast, the ASC intervened in recent notorious civil proceedings in Victoria concerning Regal and Occidental Insurance Co (now settled). This action by the ASC was designed to assist the court with relevant evidence obtained in the ongoing investigation into breaches of company law–which is to determine whether the ASC should prepare any criminal briefs.

Short of direct intervention in civil litigation, the ASC may, nonetheless actively support it. This comes from the use of s. 25 of the ASC Law.

Subsection 25(1) of the Law gives the Commission a discretion to give a copy of a written record of an examination, together with a copy of any 'related book' to a person's lawyer, if the lawyer satisfies the Commission that the person is 'carrying on, or is contemplating in good faith, a proceeding in respect of a matter to which the examination related'. Further, s. 25(3) of the Law gives the Commission discretion to give such information to a person, subject to such conditions (if any) as it imposes. Subsection 109ZB(3) of the Corporations Law indicates that the word 'may' in s. 25(1) and 25(3) confers on the Commission a discretion to release a copy of a written record of an examination.

The last paragraph is drawn from a forthcoming ASC policy statement on s. 25–which should be essential reading for all lawyers contemplating civil litigation and hopeful of support of evidence in the hands of the ASC. That policy statement is long and detailed, let me capture just the highlights.

We see this power as a major part of the enforcement weaponry available to the ASC. It clearly underpins a government philosophy to

encourage enforcement of the Corporations Law through private actions and not just rely on action by the ASC. However, the ASC will use the power carefully. What this really means is that the ASC will only exercise the power, in practice, where its own investigations are sufficiently advanced for it to form a view on the substance of matters in contention (so that it can form an adequate view on its own options). Further, the ASC will always seek to preserve any confidentiality–to the extent that the information is not placed directly in evidence.

Prosecution

The ASC has the power to commence and conduct criminal proceedings pursuant to s. 49 of the ASC Law and s. 1315 of the Corporations Law.

The ASC has been active in initiating criminal proceedings as well as continuing criminal actions inherited from the former cooperative scheme. Where serious breaches are involved, the conduct of the prosecution is referred to the Director of Public Prosections (DPP) pursuant to written guidelines developed and agreed between the DPP and the ASC. The Commission recognises the DPP as the professional prosecutor.

It states in the guidelines for referral of matters from the ASC to the DPP that:

> Ideally, in the first instance, civil recovery actions to preserve property will be taken and disposed of as quickly as possible for the benefit of the members and creditors of a particular company. Thereafter, the wider public interest should be satisfied and appropriate criminal prosecutions brought.

In the period 1 January 1991 to 31 January 1992, over 144 matters were referred to the DPP. Sixty-one matters resulted in charges being laid, 19 matters were discontinued, 20 matters are being considered by counsel and 30 matters are still under investigation. No matter referred to the DPP in that period resulted in an acquittal.

The completion by the ASC of inherited Corporate Affairs Commission/National Companies and Securities Commission (NCSC) investigations will facilitate the shift in emphasis towards civil sanctions by allowing a reallocation of ASC resources. In resource terms, these inherited matters have proven particularly burdensome. However, the successful and speedy conclusion of the inherited NCSC matters is essential to the complete transition to the national scheme.

The ASC has taken a huge step in substantially completing the investigations of the 'National 16'. On 11 September 1990, in a speech to the Australian Institute of Company Directors the author stated:

> We perceive the major national priorities for investigation, and potentially (depending on the results of the investigation) litigation to be in relation to the following corporate groups:
>
> Rothwells

Spedley
Bond
Independent Resources
Estate Mortgage Trust
Unity-APA
Girvan
Qintex
Duke
Metrogrowth Property Trust
Budget Corporation
Hookers
Interwest
Linter Group
Underwater Systems of Australia/Falcona/Golden Bounty Resources
Equiticorp

The ASC has substantially achieved that. Of these sixteen national priority investigations, seven have resulted in significant criminal charges before the Courts (Interwest, Estate Mortgage, Spedley, Rothwells, Entity, Qintex, IRL). In two (Hookers and Falcona/USAL), investigations have been completed and the ASC has determined that no criminal charges are appropriate. In four of the matters (Duke, IRL, Bond/JN Taylor, Golden Bounty), the ASC has intervened before the Courts or has commenced civil proceedings. By 30 June 1992 the ASC will have totally finished the job. Do not underestimate the significance of that effort—the resources to achieve it were enormous. About 70 of our most experienced investigators, representing approximately a third of our total investigative resources, were devoted to these matters. In addition to absorbing ASC staff resources, these investigations have been very costly in terms of expenditure on external costs such as counsel and expert witnesses.

What is more, all of the above happened in an atmosphere of (in the first part of 1991) traumatic employment changes for investigative staff which continued from the old cooperative system and the recruitment of substantial numbers of new staff. All had to be trained in the new (sometimes significantly adverse) conditions of the Corporations Law and Commonwealth legal environment in general. Many had to be trained in the basics of investigative techniques. All had to be trained as to the requirements and procedures of the Commonwealth DPP (in respect of serious criminal actions).

The public thirst for blood sees this process as too slow and not resulting in quick convictions. It is a mystery why criminal actions take so long to progress through the Australian court system. The time taken between the 'first' finalisation of an investigation by the ASC and the consideration of the results by the DPP and, particularly, legal counsel at the bar is a slow and frustrating process which has been taking as long as the initial investigation—sometimes longer. Perhaps one way to speed up that process is to integrate the officers of the DPP more closely with the

officers of the ASC from the start of a serious (that is perceived as significantly criminal) investigation. That process of integration is now happening. It would have saved a lot of public anxiety if it had happened Australia-wide during the later part of the 1980s.

The ASC itself prosecutes all minor statutory offences such as failure to lodge documents. For example, in 1991 the ASC issued 122,400 warning notices to companies for failure to lodge annual returns for the 1990 year, followed by 75,000 penalty notices. We are now in the process of issuing notices preliminary to commencement of summary prosecutions to the directors of the (mostly proprietary) companies which have not complied with the penalty notices. Following recent upgrades to the corporate database and related information services a system is now in place which provides for the automatic issuing of penalty notices to secretaries of those companies which miss the required date for lodgement of annual returns. Further action, including legal proceedings or the cancellation of company registration, will then be taken against companies which remain in default.

Referrals and joint task forces

As a corollary to its responsibility for administering and enforcing the Corporations Law, the ASC is committed to the development of mutually beneficial relationships with relevant government, law enforcement, and regulatory agencies, both domestically and internationally.

To this end, the ASC has finalised, or is in the process of finalising, memoranda of understanding (MOUs) with several such agencies directed at facilitating the provision of assistance, and cooperation and coordination between the signatory agencies. Briefly, and obviously, each agency assists the other, including but not limited to the provision of information within the mandate of each.

To date, the ASC has concluded MOUs covering one or more of these matters with the Cash Transaction Reports Agency, the Australian Taxation Office and the National Crime Authority (in relation to one particular investigation), and is negotiating MOUs with the Australian Stock Exchange, the Australian Federal Police, Customs, State Police and the Australian Bureau of Criminal Intelligence as well as several foreign regulatory agencies.

Although the existence of an MOU is obviously the best basis of interagency cooperation, during 1991 the ASC has operated on the basis that the existence of an MOU was not a sine qua non to such cooperation. We have had close cooperative arrangements with a number of agencies without an MOU, in particular, the Australian Stock Exchange, the UK Serious Fraud Office, the UK Department of Trade and Industry, the NZ Serious Fraud Office, the US Securities and Exchange Commission and the Securities Commissions of Hong Kong, the Philippines and the Canadian provinces.

The deterrent net

In terms of a cohesive and flexible enforcement regime, the interrelationship of the Commission's litigation strategy cannot be viewed in isolation from the deterrent net. A principal objective of the ASC's compliance-orientation is to develop and encourage a deterrent net against contraventions of the Corporations Law. The collapse of Estate Mortgage provides a vivid example of the need for greater monitoring and surveillance of, for example, unit trust managers. The surveillance programs now introduced by the ASC encourage both the supply of information and accountability which, the Commission considers, will assist in promoting an environment of compliance. The ASC's surveillance programs include:

- the ASX Referrals Response Program—designed to set up specific liaison and cooperation between the ASC and the ASX to investigate serious market irregularities detected by the ASX. Since 1 July 1991 there have been 23 referrals to the ASC; each has been examined promptly and appropriate action taken. In the case of the referral about purchases of shares in Sloane Square Ltd, the ASC reached an agreement requiring the parties to sell on-market the shares held;

- the Securities Industry Compliance and Surveillance Program—involves surveillance of the conduct of licensed dealers and investment advisers, the Program also monitors the activities of unlicensed persons;

- an Accounts Examination Program—involves the scrutiny of financial information issued by companies;

- a Post Registration Vetting Program—examines prospectuses and takeovers and share buy-back documents after lodgment or registration to assess whether they comply with the Corporations Law and disclose sufficient information to enable investors to make sound investment decisions;

- a Liquidators' Review and Inspection Program—monitors the performance of official liquidators, liquidators and managers and official managers to maximise returns to shareholders and creditors;

- a Property Trust Surveillance Program—monitors the performance of managers and trustees of property trusts to promote a high standard of conduct from these parties and the restoration of investor confidence; and

- active use of s. 51 hearings to stay current with corporate techniques and, generally, matters 'in the news.

Most often these deterrent net activities go no further than agreements on procedures for future compliance. Sometimes (perhaps often) licensees have decided voluntarily to leave the business on the basis that it was only profitable when they ignored the law. Finally, at least for auditors and liquidators, matters can and are being referred to the Companies Auditors and Liquidators Disciplinary Board. The ASC has either referred, or is planning to refer in the foreseeable future, over 20 such matters Australia-wide. This Board is currently badly structured in its legal base and inadequately resourced, is not and never will be able to cope with life under a pro-active enforcement structure.

Civil Sanctions and Deterrence

The preference for pursuing civil litigation over criminal prosecutions is in many circumstances a response to temporal demands. The speed and flexibility of the civil/administrative action, particularly in obtaining preservative interim relief, has obvious attractions. The burden of proof, and the evidential advantages in gathering and using evidence in the face of claims for the privilege against self-incrimination are also strong indicators of the practical advantages in favour of civil enforcement strategies. Combined with the deterrent net cast by the surveillance programs is the deterrent effect achieved by the prospect of the personal and often immediate liability of defendants for compensation and damages.

In a recent volume of the *Companies and Securities Law Journal* it was remarked that:

> While the accessibility, speed and flexibility of the discretionary sanctions offer advantages over the limitations of the traditional criminal sanctions, they also raise questions as to their adequacy as deterrents (Duns 1991, p. 365).

The issue raised is whether the advantages of pursuing civil remedies outweigh their inadequacies, once identified, as effective deterrents. The issue is not unique to the Australian experience of regulatory enforcement. In the United States the issue has been debated for decades.

However, as in the United States, the focus of the debate should not be on the elusive element of existence of a discretion in the available sanctions but on the decision to enforce at all.

While the availability of civil remedies encourages both a greater spread of enforcement and a more immediate spread, the existence of a choice between available remedies does not, of itself, alter their deterrent value. It need only be mentioned that the Commission's enforcement

strategy draws a clear distinction, not adequately drawn in Duns' remark quoted above, between the discretion to enforce at all and the decision to take civil/administrative action, criminal action or a combination of both. That discretion resides in the senior officers of the ASC. The discretion is exercised not in an ad hoc manner but in accordance with national guidelines which take into account such factors as:

- the need to respond to the perceived illegal activity and thereby maintain public confidence in the integrity of corporations and capital markets;
- the likely deterrent impact of enforcement action;
- the level of risk, or potential for further loss to investors' or creditors' funds;
- the availability of company assets, property or funds for recovery or damages;
- the possible impact of enforcement action on the market, company operations, shareholders and so on;
- the availability of resources to complete civil or criminal enforcement action; and
- the impact on other investigations or regulatory action.

The Inter-relationship of Civil and Criminal Remedies: some Problems

Civil and Criminal Actions and the Privilege Against Self-Incrimination

Until recently, section 68(3) ASC Law and s. 597(12) Corporations Law provided for a derivative use immunity which caused serious difficulties to the ASC in conducting efficient and cost-effective investigations. Not only was a person's answer to a question inadmissible against him/her in later criminal proceedings (or proceedings for the imposition of a penalty), neither was any evidence or information subsequently obtained as a direct or indirect consequence of the person having given the information. In practice, the derivative use immunity meant that the decision to pursue civil or criminal actions be made 'up front', before evidence-gathering commences. If the ASC used coercive interrogation powers then it was required to proceed with a civil case. If criminal charges were contemplated in the first instance, the case proceeded much more slowly

(if at all), without the benefit of coercive powers, since the potential for tainting all evidence gathered subsequently was simply too great.

In at least five significant investigations where the ASC was considering possible criminality, the ASC reluctantly chose to forego formally examining key witnesses under s. 19 of the ASC Act because of the real possibility of jeopardy to potential prosecutions. The five investigations are Bond, Qintex, Independent Resources Ltd, Interwest and Regal and Occidental. These examples vividly illustrate the hindrance which the derivative use immunity created for the ASC in the conduct of its investigatory and regulatory powers.

In late 1991, the Parliamentary Joint Committee on Corporations and Securities conducted an inquiry into the effect of the derivative use immunity and recommended that it be removed from s. 68(3) and 597(12). The government supported these recommendations and proposed amendments to the legislation, contained in the Corporations Legislation (Evidence) Amendment Bill 1992. The amendments removed the derivative use immunity whilst retaining the privilege against self-incrimination in subsequent proceedings.

These amendments allow the Commission to use its investigative and evidence-gathering powers to obtain information for the purpose of preservation or recovery action without compromising potential criminal proceedings. As noted in the Explanatory Memorandum to the Bill:

> The proposed amendments are required to ensure that effective investigation and prosecution of corporate offences is not hindered by inappropriate evidentiary requirements in the particular circumstances of corporate crime where frequently the perpetrator is the only person having knowledge of the details of the complex transactions by which an offence has been committed or concealed, and may consciously use the present immunities, provided by operation of statute, to make a full confession of crimes for which he or she may then not be prosecuted.

Recently, the privilege against self-incrimination has been extended to the corporation. The American case law, which expressly denies to corporations the privilege, was distinguished in *Caltex Refining Co Pty Ltd v. State Pollution Control Commission*, a decision of the New South Wales Court of Criminal Appeal in December of 1991. The Court of Criminal Appeal held that it was consistent with the organic theory of company law that the corporation be able to avail itself of the privilege. Central to the decision was the policy concern that the privilege, according to Gleeson CJ, assists to 'hold a proper balance between the powers of the State and the rights and interests of the citizen. In that term I include what are commonly described as 'corporate citizens".

The Commission does anticipate commencing criminal proceedings against the corporation where appropriate. The Parliamentary Joint Committee took that view that 'since the corporation is a legal entity and

not a real person no question of civil rights is raised by its prosecution', and recommended the abrogation of the immunity in the case of corporations. This recommendation is implemented in the proposed amendments which deny to corporations the benefit of any use or derivative use immunities.

Parallel investigations and civil and criminal proceedings

Legal principles developed for individuals are often inexactly applied in the corporate context (Hart 1954, p. 37). This is no less true in the application of traditional criminal sanctions against corporations.

The inter-relationship of the available remedies and sanctions, though a necessary tool in regulatory enforcement, sometimes has results which do not sit easily with established legal structures. However difficult, academically, it is to define a sanction as criminal or civil, there are substantive procedural distinctions which attach to the two methods of enforcement.

The conduct of investigations by the Commission in circumstances where civil proceedings have commenced involving the subject of the investigation requires careful consideration. The essential issue raised is whether the conduct of the investigation amounts to a contempt of court (*Pioneer Concrete Pty Ltd v. TPC* (1982) 43 ALR 449). Where the Commission is a party to the civil litigation, either as instigator or by intervention, there is no blanket restriction on continuing the investigation. Of course the investigators must be cautious not to supplement their civil case, or the civil case of another party, via the investigation. The rules of civil procedure must be complied with. This has a practical effect which might strategically limit the legitimate use of the Commission's powers. Recently, in the investigations into Duke, the Liquidator requested that the investigation by the ASC be temporarily stayed while civil proceedings, which the ASC had intervened in, were conducted. The ASC complied with that request at the expense of its ongoing investigations into possible serious breaches of the Corporations Law.

In the context of criminal prosecutions commenced during the currency of an investigation, the High Court has authoritatively stated that the pendency of the criminal proceedings will not protect the accused from continued or future investigations. However, the investigation, if it continues, must be most cautious not to constitute a contempt of court (*Huggall v. McCusker* (No 2) (1990) 2 ACSR 247).

The ASC, in the exercise of its investigatory and evidence-gathering powers is particularly sensitive to ensuring that the due processes of the judicial arm of enforcement are satisfied. Various issues arise. For example, s. 51 of the ASC Law provides the ASC with a general inquiries power and allows the ASC to hold hearings for the purposes of the performance or exercise of any of its functions or powers other than a function or power conferred in relation to investigations which occur when

a contravention of the Law is suspected. Thus, if in the course of a s. 51 hearing a suspicion arises that there may have been a contravention, the hearing must be terminated.

Parallel civil and criminal proceedings

The complicated matrix of facts in many corporate matters may unfold to reveal, prior to or during the currency of civil proceedings, serious criminal conduct, requiring criminal proceedings. The inter-relationship on the one hand of civil action taken and on the other of the potential for prosecution is placed in sharp relief in circumstances where a civil defendant applies for a stay of proceedings or where a defendant or witness refuses to comply with the discovery procedures or to answer questions on the grounds of self-incrimination.

The common judicial response to the dilemma confronting the ASC is to permit the conduct of all relevant interlocutory steps in the civil proceedings and then to stay the civil proceedings until the determination of the criminal actions. The Courts have formulated guidelines for the exercise of discretion in striking the balance between:

- the uncontested right of any plaintiff to the determination of his civil proceedings in the ordinary course of the court's business; and

- the prejudice which may be occasioned to the defendant in the pending criminal proceedings by the continuation of the civil proceedings to hearing.

The considerations set out in the judgment of Wootten J in *McMahon v. Gould* (1982) 7 ACLR at 206 will be reflected in the conduct of the Commission's proceedings. (*See Halabi v. Westpac Banking Corporation* (1989) 17 NSWLR 26). In *Chariah Resources v. Tricontinental Corp* [1991] ACL Rep 325 Vic 12, for example, the applicant, Mr Johns, sought orders that the civil proceedings be stayed until the conclusion of the criminal charges against him and/or that the civil proceedings be stayed pending the publication of the findings of the Royal Commission into the Tricontinental Group of Companies. Johns was then awaiting trial in the County Court on charges including corruptly receiving a secret commission and conspiring to be paid a secret commission. The civil proceedings involved a damages claim by Chariah Resources against Johns and Tricontinental alleging it bought millions of shares in companies on Johns' recommendations using money borrowed from Tricontinental, during which purchase Johns did not disclose a beneficial interest in the companies. Chariah also alleged Tricontinental breached its duty to take reasonable care in recommending and encouraging Chariah to make the share purchase.

The application for a stay of civil proceedings was refused because the Court was not convinced there was any real danger (rather than notional danger) of injustice occurring in the pending criminal proceedings if the civil case continued. The Court also held that the Royal Commissioner would be sensitive to Johns' rights and would take evidence giving due consideration to the ongoing civil and pending criminal proceedings so as to minimise any injustice to him. Johns' criminal trial was deferred pending the Royal Commission.

Accountability and the Inter-relationship of Deterrence and Civil and Criminal Sanctions

The ASC of course accepts that it is properly subject to public examination and public accountability. The focus of media attention on the ASC's prosecution record as definitive of its performance, however, perpetuates a traditional law enforcement emphasis on 'head counting'—statistical summaries of arrest, prosecution and conviction—which is clearly inappropriate to the enforcement framework embodied in the Corporations Law and implemented by the ASC. The ASC can, of course, and does point to its litigation record and the volume of briefs referred to the DPP as indicative of a high level of investigative and enforcement activity. Numerical assessment, however, overlooks qualitative factors such as the complexity of matters undertaken and their resource-consuming nature. Further, and more importantly, the successful development and implementation of deterrent net programs has no precedent in the traditional language and ideology of law enforcement accountability. The absence of misconduct, which is the ultimate objective of a deterrence philosophy, cannot, by definition, be quantified.

The solution is not immediately apparent, and the dilemma is one shared by law enforcement and regulatory agencies as they become increasingly sophisticated. For present purposes, I merely draw attention to the fact that while prosecution is an essential ingredient in the enforcement methodology of the Commission, it is not an adequate yardstick of its success. The belief, in some quarters, that the ASC exists to exact retribution upon high profile individuals for past criminal activities is a far from accurate reflection of the reality of corporate regulatory enforcement in the 1990s and beyond.

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Chapter Four

The Powers of Investigation of the Australian Securities Commission: Balancing the Interests of Persons and Companies under Investigation with the Interests of the State

Joseph P. Longo

The purpose of this paper is to evaluate the power of the Australian Securities Commission (ASC) to obtain evidence for use in criminal prosecutions. Do the ASC's powers reflect a proper balance between the interests of the state and individual liberties? This paper will attempt to show that there has been a steady expansion of the powers at the expense of the individual. This has occurred as an over-reaction to instances of serious commercial misconduct. There is no evidence that more successful prosecutions have been achieved as a result. In the meantime, the growth in the power has proceeded upon an unjustified willingness to depart from fundamental protections. This has lead to the critical balance between the interests of the state and individual liberties being unduly distorted in favour of the state.

After setting out the background to the present position, this paper addresses in broad outline the competing philosophical considerations underlying the powers in question. That discussion will form the basis for an analysis of the two issues that will form the focus of the paper. The first concerns the derivative use immunity provided for in section 68 of the *Australian Securities Commission Act 1989* ('the ASC Law') and recently repealed by section 4 of the *Corporations Legislation (Evidence) Amendment Act 1992* which came into effect on 14 May 1992. The immunity precluded information being used if obtained as an indirect consequence of giving other self-incriminating–information. As a result of the 1992 amendment only direct evidence (a statement made or the fact of signing a record) is not admissible in evidence in the circumstances set out in section 68 (*see* below). While the amendment makes redundant the plea for the immunity's retention, the issues and principles involved, as this

paper makes clear, remain complex. The repeal of the immunity strengthens this paper's central argument that the balance between the rights of the individual and the rights of the state have become distorted. The second issue is, whether legal professional privilege, which protects the confidentiality of certain communications between lawyers and their clients from compulsory disclosure, ought to be restored.

Some attention will also be given to responding to notices requiring production of documents or submission to formal examination; the right to legal representation; the application of the rules of natural justice (or procedural fairness) in an ASC investigation; problems arising out of the contemporaneous pursuit of civil and criminal remedies and, finally, some observations on the question of overlap of different regulators' jurisdictions. The conclusion offers some suggestions for reform.

The Current Climate

Since January 1991, the Australian Securities Commission (ASC) has become the pre-eminent regulator of Australian corporate and commercial activity. An enormous amount has been achieved by the Commission in that time. In particular, it has managed, for the first time, to build systematically a unified, national scheme of regulation for Australia. There can be little doubt of the need for such a scheme, nor of the fact that its existence has, as a general proposition, restored some credibility to law enforcement generally in the corporate area.

The excesses of the 1980s have led to persistent calls for decisive and effective law enforcement in the 90s. The Commission, in stark contrast to the 1980s, says it has the will, but as the recent debate over self incrimination shows, the concern now appears to be whether the ASC is in fact and in law equipped to do the job.

Regulation of any activity should lead to a consideration of whether a proper balance between the interests of the state and individual rights has been achieved. This is always an important question. The issue is particularly pertinent at a time when the pressure on the ASC to prosecute is very great (e.g. 'ASC battles to live up to its promises', *The Australian Financial Review*, 13 February 1992, p. 18). The ASC has an extraordinary array of investigative powers unmatched by other regulators of commercial activity in Australia. Indeed, in most material respects at least, unmatched also by regulators in the United Kingdom and the United States.

Overview of the Issues and some Observations on the Role of the ASC

The fundamental issue is what the proper purposes or objectives of the ASC's powers ought to be. One approach may be that the powers are required to enable the ASC to perform its various functions under the ASC Law and the Corporations Law. The ASC's powers enable it to bring actions to protect the interests of shareholders and creditors in appropriate cases and, of course, to institute criminal prosecutions for breaches of the Corporations Law and related legislation for which the ASC is responsible.

The powers are designed to enable the ASC to perform what are, in substance, administrative or regulatory functions, more effectively or to gather material to bring civil proceedings. However, those designs are quite different from a *criminal law enforcement objective*.

As a frequent contributor to the literature has succinctly observed, 'this is not an area of consensus' (Kluver 1992). Moreover, reading the various submissions made to the Joint Committee on Corporations and Securities on the question of whether the derivative use immunity should be repealed, one obtains a real sense of how polarised views have become, though often expressed upon shared assumptions about the values which should govern the competing interests of the state and the individual. Many of the matters raised in this paper ultimately fall to be considered against, essentially, the philosophical position one adopts in response to the question: 'What is to be done about those white-collar criminals?'

A comprehensive answer to that question is beyond the scope of this paper. However, some preliminary observations can be made which at least serve to highlight some material considerations.

The criminalisation of a wide range of unacceptable commercial activity suggests that great care must be taken to achieve the proper balance between the public interest and individual interests. The criminalisation of breaches of common law and fiduciary duties by directors (Section 232 of the Corporations Law, Section 229 of the Companies Code) is perhaps the most powerful example of this. Interestingly, there is strong support for what has been described as the 'decriminalisation of company law'. The ASC supports this view and has said that there ought to be a much greater emphasis placed on the use of administrative action and civil litigation to prevent harm to investors and to recover assets.

The basic problem with criminalisation is that it is wrong and misconceived to put the regulator (effectively the prosecutor) in a position to extract under compulsion information from the very persons against whom it is sought to bring criminal prosecutions, for the purpose of using such information to bring those prosecutions. The justification is that

critical information may not be obtainable by other means. That this is the real objective of the ASC can be seen from its statement to the Lavarch Committee (in the context of the derivative use immunity question—*see* below) that maintenance of this immunity 'will often make it necessary to conduct investigations along traditional lines by assembling as much evidence as possible before using compulsory powers against potential defendants' (Australia 1991, p. 214).

This insidious approach has not attracted great dissent in our community.

In that regard, the Lavarch Committee concluded (Recommendation 30) that as many provisions of the Corporations Law as possible should be decriminalised 'with the remaining criminal provisions to be recast so that elements of dishonesty, deceit, deliberate or reckless disregard of obligations, or similar conduct amounting to moral turpitude, would need to be shown before a criminal offence is proven' (*see also Corporate Law Reform Bill 1992* supra).

It should be steadily borne in mind that as a general proposition the powers of investigation conferred upon the ASC are not available to state and federal police officers responsible for the enforcement of the criminal law generally. Rather, the ASC's powers represent a specially constructed capacity to investigate corporate and commercial activity that is not available, say, to law enforcement officers investigating offences such as rape, murder or armed robbery.

It is salutary to recall the recommendations of the Australian Law Reform Commission (ALRC) in its well received and influential report on Criminal Investigation in 1975 and ask why should the position be any different in the commercial area.

Just four of the ALRC's recommendations illustrate the point:

> As a general rule, a police officer should not be entitled to question a person against his will or to exercise any other compulsive investigative power in respect of that person unless he can satisfy the criteria that would justify an arrest of that person (Paras 8, 64).
>
> There should be statutory recognition of the suspect's right to silence, a statutory requirement that he be afforded the opportunity to obtain such professional assistance as is necessary to enable him to exercise that right (Paras 142, 146ff).
>
> General search warrants in all forms should be abolished (Para 196).

The procedures governing the issue of search warrants should be tightened by requiring an affidavit from the informant stating the reasons why the warrant is thought necessary, and requiring the judicial officer to (a) satisfy himself that the stated reasons or some others justify the issue of warrant and (b) endorse it accordingly (Para 200). (Australian Law Reform Committee 1975).

It is readily conceded that the special difficulties (some of which are identified below) presented by the detection, investigation and prosecution of complex corporate crime and fraud were not dealt with by the ALRC. However, the report on Criminal Investigation highlights the necessity of recognising that the onus lies on those who would depart from the principles articulated in it, to justify why this should be so.

Interestingly, the relatively recent assertion of will to enforce corporate law has highlighted the existence and scope of the ASC's (or its predecessor's) powers, leading to a debate which should have occurred long before now.

Many of the ASC's existing powers were also available to its predecessor, the National Companies and Securities Commission (NCSC). A notable exception is the capacity to obtain documents which may be subject to a claim of legal professional privilege. However, the existence of this power remains unclear notwithstanding the momentous decision of the High Court in *Corporate Affairs Commission (New South Wales) v. Yuill* (1991) 4 ACSR 624.

The perceived difficulty of understanding the complexity of modern commercial activity is said to provide a justification for the existence of the ASC's powers. Among other justifications which are often cited in this context is the notion that it is typically of the very nature of complex corporate crime that the direct assistance of the perpetrator is often required to make sense of the documents which are available, often in circumstances where subordinates may not know the full story. In addition, by characterising the fraud or misconduct as an abuse of the corporate form as a vehicle of commerce, primacy is ascribed to the interests of innocent members of the public and creditors whose money has been lost over those of the alleged wrongdoer.

Another justification, and one which undoubtedly enjoys popular support, is the notion that, after all, we are talking about intelligent, wealthy, powerful (or at least not entirely defenceless and weak as those subject to the general criminal law are presumptively considered to be) business people, who are extraordinarily well placed to look after themselves. A good example of an expression of this view appears in remarks made by the trial judge in the trial of Mr Seelig and others (arising out of the Guinness affair) in circumstances where the admissibility of a self-incriminating statement was in issue:

> . . . general protection is designed to be wide enough to protect the weak, the inarticulate and the suggestible from having to answer in the strange and hostile environment of a police station and less obviously needed to protect those likely to be major witnesses in a s. 432 investigation, who will usually be intelligent, sophisticated, self-confident and articulate, usually accompanied by lawyers, giving evidence by prior appointment in an environment not so foreign to them (reproduced in [1991] 4 All ER at p. 441).

In upholding the trial judge's finding that it was fair to admit the statement in all the circumstances, Watkins LJ on behalf of the Court of Appeal said:

> The present case is . . . concerned with extremely astute, professional men who have been advised at one time or another by very experienced City solicitors (*R v. Seelig* [1991] 4 All ER at p. 442).

Anyone who has been involved in a corporate investigation of any complexity could readily attest to the difficulties one encounters marshalling and absorbing many thousands of documents. Innovative investigative techniques are plainly required to be able to do so and this will inevitably lead to some modification or departure from traditional principles governing the conduct of investigations and the admissibility of material in evidence.

However, reliance upon perceptions of the typical white-collar criminal is misconceived. The vast majority of individuals suspected of commercial misconduct have little or no capacity to stymie the investigative process. They would probably count themselves members of that ill-defined (and one suspects contracting) group, the middle class, and they may even regard themselves as intelligent and articulate, but to ascribe to this group, as a general proposition, the capacity to seriously match or challenge the ASC's resources is not tenable.

Moreover, particularly in connection with the derivative use immunity debate and the erosion of legal professional privilege, little or no hard evidence has emerged of these privileges, without more, being responsible for either meritorious prosecutions not being brought or, having been brought, failing after a trial.

Rather, the reasons for prosecutions failing or not being brought are far more complex than that. In my submission, the principal reasons include the numerous practical and legal (mainly evidential) issues which arise in actually bringing a complicated fraud case to trial before a jury. These issues were extensively ventilated at a three-day conference organised by the National Crime Authority in July 1991 entitled 'The Presentation of Complex Corporate Prosecutions to Juries' (for a brief summary of the conference proceedings *see* Phillips 1991).

A different philosophical imperative should be driving how we think about law enforcement in this area. Moreover, and importantly, it is difficult to be too sanguine about whether the right balance has been achieved (between the ASC's powers and individual rights) when a consensus is still emerging on what principles ought to govern the creation and allocation of criminal responsibility for perceived commercial misconduct.

Self-incrimination and Derivative use Immunity

What the debate is about

Before the recent amendment to the ASC Act, a person subject to compulsory examination under the provisions of the ASC Law was not excused from making an oral statement or producing a book on the ground that doing so might tend to incriminate that person. However, where the person claimed, before complying with such requirements, that doing so 'might in fact tend to incriminate the person or make the person liable to a penalty' (Section 68(2) of the ASC Law before amendment) then:

> Neither the statement, or the fact that the person . . . has produced the book . . . *nor, in the case of the making of a statement or the signing of a record, any information, document or other thing obtained as a direct or indirect consequence of the person making the statement or signing the record, as the case may be, is admissible in evidence against the person in*:
>
> (a) a criminal proceeding; or
> (b) proceeding for the imposition of a penalty;
>
> other than a proceeding in respect of:
>
> (c) in the case of the making of a statement—the falsity of the statement; or
> (d) in the case of the signing of a record—the falsity of any statement contained in the record (Section 68(3) of the ASC Law before amendment) [emphasis added].

The italicised words are the source of the derivative use immunity (also found in section 597(12) of the Corporations Law) which has been the subject of debate in recent times.

The Joint Committee on Corporations and Securities recommended that the derivative use immunity be abolished. The ASC, in a joint submission with the Commonwealth Director of Public Prosecutions, said that it was advised by senior counsel that the derivative use immunity created 'a difficulty so profound . . . that an examination of those who are suspected may have committed an offence should not take place until' the relevant provisions were amended (paragraph 2.4.3).

The major difficulty identified by the joint submission was that as the prosecutor must prove that the evidence sought to be lead against the defendant is admissible, the prosecuting authorities are likely to be put to strict proof that the evidence that is being led was not derived in breach of Section 68(3). 'In such cases proof of a negative is not easy. It is conceivable that the prosecution may not be able to prove that certain evidence was not derived from the person's testimony even if in fact that

evidence was not so derived' (paragraph 2.6.2). The joint submission went on to say that in 'its present form the provision may have the effect that prosecutions simply cannot proceed. The matter is as serious and as urgent as that' (paragraph 2.6.4).

Other submissions to the joint committee opposed removal of the derivative use immunity. The opposing view is succinctly stated in the submission (at p. 7) of the Commercial Law Section of the Law Institute of Victoria which had this to say:

> There is little use in rejecting the tree when the fruits of the tree are freely admissible. Any attempt to admit as evidence in criminal proceedings indirect consequences of the person giving the answer or information, document or thing, would clearly undermine the protection granted in respect of the answer itself. It would make such protection meaningless in many cases.
>
> In any event, there is no evidence that the present protections have, in any way, hampered the authorities in criminal investigations or prosecutions. In the absence of such evidence, the legislator should err on the side of civil liberties and retain the protections introduced by subsections 597(12) and 68(3).

So who is right? Curiously, the ASC has said that 'it is plain to us that the limiting of the ASC's investigatory powers by the derivative use immunity misconceives the role of the ASC' (joint submission paragraph 2.6.6).

The derivative use immunity debate makes clear that the ASC relies very heavily on individuals incriminating themselves in order to successfully bring prosecutions. It is a different thing altogether to permit the existence of such power for some other purpose, for example to arm the ASC with the evidence required to pursue what it has said is the real priority–civil action to recover assets and damages for the benefit of aggrieved creditors and shareholders. It seems wrong to clothe the executive with power for the express purpose of prosecuting those being examined more effectively.

Whatever the merits of these arguments might be, the immunity has now been repealed and sections 68(2) and 68(3) replaced by:

> 68. (2) subsection (3) applies where:
> (a) before:
> (i) making an oral statement giving information; or
> (ii) signing a record;
> pursuant to a requirement made under this Part, Division 3 of Part 10 or Division 2 of Part 11, or under a corresponding law of another jurisdiction, a person (other than a body corporate) claims that the statement, or signing the record, as the case may be, might tend to incriminate the person or make the person liable to a penalty; and

> (b) the statement, or signing the record, as the case may be, might in fact tend to incriminate the person or make the person so liable.
>
> (3) The statement, or the fact that the person has signed the record, as the case may be, is not admissible in evidence against the person in:
> (a) a criminal proceeding; or
> (b) a proceeding for the imposition of a penalty;
> other than a proceeding in respect of:
> (c) in the case of the making of a statement—the falsity of the statement;
> or
> (d) in the case of the signing of a record—the falsity of any statement contained in the record.

The modern law's debt to Freighters Limited

The legislative history of Section 68 of the ASC Act provides some interesting insights. It appears that express provision for the manner in which the privilege against self incrimination was to be dealt with in company investigations began with subsections 146(5) and (6) of the *Companies Act 1958* (Victoria). The Victorian Parliament was the first in the Common Law world to make express legislative provision for the issue. It did so as a result of a report made by the Statute Law Revision Committee of Victoria following an investigation of the affairs of Freighters Limited conducted by Mr P. D. Phillips QC.

During the course of Mr Phillips' investigation, directors of Freighters Limited refused to answer questions on the ground that the answers to them would possibly be self-incriminating. Mr Phillips wished to test the issue in Court (there not being any judicial authority determinative of the issue at the time) but, at the last moment, the individuals concerned decided to answer the questions rather than, according to Mr Phillips, expose themselves to poor publicity which 'would not do them much good . . . (Minutes of Evidence, p. 7).

The Minutes of Evidence disclose a wide ranging review of the issues arising out of a need to balance the interests of the state against those of the individual. The starting point was observations made by Mr Phillips as follows:

> All I wanted to do by way of referring to this, is to indicate what had begun as a very narrow investigation of people directly related to the company, is now directed to everybody who can give information. Now that has raised a real problem, the problem of privilege, because whilst the investigation was limited to very small classes, nobody worried very much about privilege, but now that it can extend to anybody and everybody, there is perhaps a more real problem as to privilege (Minutes of Evidence, p. 7)

Ultimately, the Committee concluded that the Companies Act should be amended to provide:

- That no director officer agent or auditor of the company or former director officer agent or auditor of the company the affairs of which are being investigated by an inspector shall have the right to decline to answer any relevant or material question on the grounds that his answer might tend to incriminate him; and

- That evidence given before an inspector in answer to a question which the person answering claims at the time to be liable to incriminate him shall not be admissible in any subsequent criminal proceedings except a prosecution for perjury.

- The Committee further concluded that it was of the opinion 'that any person other than a present or former director officer agent or auditor of the company, the affairs of which were being investigated by an inspector, should have the privilege of declining to answer a question which may tend to incriminate him and recommends that the present doubts as to the existence of such privilege be dispelled by legislation'.

Notably, the Committee distinguished between those people most directly connected with the management of the affairs of a company and those who were only indirectly related, the latter being admitted the full protection of the common law. Successive legislative amendments since then have abandoned this distinction so that, today, in effect anyone can be required to give information on oath to the ASC.

It should also be observed that the Committee proceeded on the assumption that corporate investigations of the kind being considered were not at all common (Minutes of Evidence, p. 11) and that, in any event, such investigations were reserved for serious instances of alleged contraventions of the law.

A basis for a different approach and some conclusions

We should not be too ready to cast aside the values underlying the right to silence and the continuing importance of the privilege against self-incrimination in our system of justice. The High Court in *Petty v. R* (1991) 102 ALR 129 recently reaffirmed the importance of these concepts in Australia. The Judicial Committee of the Privy Council in *Law Chi-ming v. R* [1991] 3 All ER 172 at 179 observed that the privilege was '"deep rooted" in English law . . . It is better by far to allow a few guilty men to escape conviction than to compromise the standards of a free society'.

Judicial support for the importance of the right to silence given in circumstances where the individual concerned would plainly offer material assistance if he or she chose to answer questions, is still evident, even in the corporate area. (*See*, for example, the judgment of Marks J in *Attorney General for the State of Victoria v. Ian Malcolm Johns*, unreported, 20

January 1992 in connection with the Royal Commission into the affairs of the Tricontinental Group of Companies but compare the trenchant observations of Cole J in *Spedley Securities Ltd (in liquidation) v. Bond Brewing Investments Pty Ltd* (1991) 4 ASCR 229 at 247 where His Honour concluded: 'If there be conflict between the private rights of individuals in the conduct of companies in which the public invest, and the rights of members of the investing public, in my view that conflict should be resolved in favour of the members of the public' (*generally, see* Baxt 1991).

The history in Australia of the provisions in question suggest a different approach is open and worthy of consideration. Although redrawing the powers of the ASC in this area to approximate more closely with the position taken by the Victorian Law Reform Committee in 1957 may not be regarded as a serious option, it is not at all clear that section 68 of the ASC Law, as amended to remove the derivative use immunity, should be the last legislative word on the subject.

The onus should lie on the ASC to produce compelling evidence to justify departure from what is regarded as a fundamental value underpinning our system of criminal justice. It is not enough to say that the ASC's investigative work will be hampered, or that more traditional techniques will have to be adopted, if the privilege is restored altogether (at least for those indirectly involved in the affairs of the company in question), or the derivative use immunity (which seems to reflect the position at common law in any event, *see Sorby v. Commonwealth* (1983) 46 ALR 237) is restored. Although clearly there is no consensus on these issues, the present position is not satisfactory.

Legal Professional Privilege

Legal professional privilege protects the confidentiality of certain communications between lawyers and their clients from compulsory disclosure except where there is a clear statutory provision abrogating the privilege. It is not difficult to find strong statements expressing the importance and value of the privilege (*generally, see* Wigmore on Evidence McNaughton Revision 1961, Volume VIII at paragraphs 2290 to 2292). A good example is the following from the judgment of Deane J in the High Court of Australia in *Attorney-General (Northern Territory) v. Maurice* (1988) 161 CLR 473 at pages 490-1:

> That general principle is of great importance to the protection and preservation of the rights, dignity and freedom of the ordinary citizen under the law and to the administration of justice and law in that it advances and safeguards the availability of full and unreserved communication between the citizen and his or her lawyer and in that it is a precondition of the informed and competent representation of the interests of the ordinary person before the courts and tribunals of the land. Its efficacy as a bulwark against tyranny

> and oppression depends upon the confidence of the community that it will in fact be enforced. That being so, it is not to be sacrificed even to promote the search for justice or truth in the individual case or matter and extends to protect the citizen from compulsory disclosure of protected communications or materials to any court or to any tribunal or person with authority to require the giving of information or the production of documents or other materials. The right of confidentiality which the principle enshrines has recently, and correctly, been described in the European Court of Justice as a 'practical guarantee' and 'a necessary corollary' of 'fundamental constitutional or human rights' . . . Indeed, the plain basis of the decision of the majority of this court in *Baker v. Campbell* was the acceptance of the principle as a fundamental principle of our judicial system. Like other traditional common law rights, it is not to be abolished or cut down otherwise then by clear statutory provision. Nor should it be narrowly construed or artificially confined.

In *Yuill* (supra) the High Court held, by a majority of 3:2, that assertion of the privilege was not a reasonable excuse for refusing to produce documents, or to answer questions, in response to being required to do so under Part VII of the Companies (New South Wales) Code. Although the decision construes provisions providing for special investigations under the Companies Code, it seems probable that *Yuill* applies to investigations held by the ASC under the ASC Law. However, the matter is not free from doubt and the decision has already generated a significant amount of commentary (*see* Kluver 1991; Castle 1991). For present purposes it is not necessary to analyse in detail the reasoning of the High Court in *Yuill*. (Much of this section is adapted from Longo 1991).

A startling aspect of the High Court's decision in *Yuill* is that none of the judges spent any time considering the policy and philosophical issues at stake in finding that legal professional privilege was abrogated under the Companies Code. The decision, with great respect to the majority, represents a profound erosion of legal professional privilege in Australia.

It is extraordinary, given the fundamental and historically enduring importance of legal professional privilege in the common law world, that the High Court did not consider it fit to consider and weigh this aspect in juxtaposition to the obvious importance the majority placed on ensuring the efficacy of the investigative purposes of the legislation in question and the desire to detect and deal effectively with misconduct on the part of companies and their officers and employees. In light of the *Yuill* case legal professional privilege faces an uncertain future in Australia.

The ramifications of the *Yuill* case are far reaching. Once one accepts that the ASC's powers of investigation may arise in a wide variety of circumstances, and given the extraordinarily broad scope of the concept of 'affairs' in respect of which books and records may be demanded, no company in Australia, nor its officers or employees, can now assume that communications with the company's lawyers will remain confidential in all

circumstances. The situation is exacerbated by the realisation that s. 298(6) of the Companies Code (cf s. 25(1) of the ASC Act) empowers the ASC to give a copy of a written record of an examination, together with a copy of any related book, to a person's lawyer if the lawyer satisfies the Commission that the person is carrying on, or is contemplating in good faith, a proceeding in respect of a matter to which the examination related. It is quite possible that documents which would otherwise be privileged could come into the hands of third parties pursuant to this provision. Another way in which privileged documents could come into the hands of third parties is pursuant to a subpoena duces tecum on the Commission. In this way a party to litigation may obtain access to privileged documents in the possession of the ASC which would otherwise be privileged from production under the general law of discovery.

It is beyond the scope of this paper to explore fully issues arising out of

- whether the ASC has power to use a privileged document in litigation to which it is a party;

- whether the ASC can itself be required to produce or allow inspection of privileged documents which it does not intend itself to lead in evidence (assuming it can) and;

- the extent to which in purported exercise of its powers under s. 25 of the ASC Law, the ASC is required to exercise its discretion in a manner which would preserve claims of legal professional privilege or privilege against self incrimination.

In these circumstances, it appears prudent to still claim legal professional privilege over documents at the time of production to the ASC so that there can be no dispute subsequently as to whether privilege has been waived and to otherwise preserve the ability of the person producing the privileged documents to challenge their later use in litigation or otherwise by the ASC or a third party. Finally, it is important to note for present purposes that s. 127 of the ASC Law (cf s. 27 of the National Companies and Securities Commission Act 1979 (Cwlth)) imposes a general duty of confidentiality on the Commission.

There needs to be an urgent reappraisal of the operation of legal professional privilege in ASC investigations. No other regulator or law enforcement body in Australia operates on the basis that it may compel disclosure of confidential communications between lawyer and client (for example, the important work of the National Crime Authority proceeds without it, *see National Crime Authority v. S* (1991) 100 ALR 151). Foreign regulators, most notably the Securities and Exchange Commission

in the United States, have also performed very well without abrogating the privilege.

The ASC has not shown itself willing to support amendments to the ASC Law which would put beyond doubt the availability of the privilege. However, in a paper presented to a seminar in Perth last year Mr Samaha, who was a Consultant to the ASC at the time, made clear that the ASC would take into account a range of factors when deciding whether to release what would otherwise be privileged or confidential information to third parties:

> It will assist if I commence with a generalisation (hopefully not an oversimplification) of the policy position of the ASC in relation to use and disclosure of confidential information. Generally, the ASC is pre-disposed to disclose to the full extent permitted by law, information obtained by it in the course of its enquiries and investigations, for the purposes of the performance or exercise of its functions and powers. This proposition will no doubt find favour with a person whom a particular disclosure is likely to assist. I acknowledge that it is likely to be controversial to one detrimentally affected or embarrassed by such a disclosure. This policy reflects a desire to avoid the ASC becoming the repository of a vast amount of information, collated at great expense and effort, but serving no corporate regulatory (and therefore public) purpose. There is however a countervailing policy at the forefront of the ASC's considerations in such matters. The ASC is concerned to encourage full and frank disclosure to it of information which may alert it to contraventions of relevant laws or which will enable it to more effectively investigate possible contraventions. To that end, it is also a policy of the ASC to protect to the extent appropriate in a particular case, the source and confidentiality of information disclosed to it (both voluntarily and, in certain circumstances, by compulsion). As we shall see, the ASC Law contains certain important discretionary powers of disclosure which provide the opportunity for carefully weighing the relative importance of these competing policy considerations. Further, as an agency affected by the provisions of the Privacy Act 1988 (Cwlth), the ASC is concerned to comply with the Information Privacy Principles which regulate dealings in certain unpublished information about individuals (Samaha 1991, pp. 1-2).

One of the rationales for the existence of the privilege is that it promotes a frank exchange between lawyer and client thus facilitating compliance with the law. The complexity and volume of the Corporations Law and related legislation highlights the continued need for the privilege rather than its abrogation. There are sufficient safeguards in the existing common law to deal with abuse. Communications between lawyer and client, or between either one of them and a third person, which are in furtherance of the commission of a crime or fraud and documents prepared in furtherance of either a crime or fraud, are not privileged (*generally, see* Gillies 1991, 440 fol.).

The Law Council of Australia and the Law Society of NSW have recently written to the Attorney-General, Mr Duffy, arguing that individuals and companies have the right to confidentiality in dealings with lawyers and, in the case of the Law Council, proposing a new provision in section

68 of the ASC Law to make it a reasonable excuse to rely on legal professional privilege for failure to produce books, sign a record or give information.

Notices requiring production of documents

A recent decision of the Federal Court highlights the breadth of the ASC's power to require production of documents.

In *ASC v. Zarro and others* (1991) 6 ACSR 385, Westpac Banking Corporation was ordered to comply with a notice requiring production of certain bank statements for the account of Mr Pasqual Zarro. Spender J observed that Westpac's concern was its obligation of confidentiality to its client, which is '. . . one of profound importance and is one which, one suspects, is more honoured in the breach by many corporations and government bodies' (6 ACSR at p. 390). The notice in question simply required production of the bank statements notwithstanding that there was no apparent relationship between those documents and the affairs of the named corporations being investigated. His Honour observed, 'is Westpac to be like St Thomas, that is to say, not liable to produce documents unless it is satisfied that the statutory basis for production has been made out to it?' (6 ACSR at p. 393). Spender J then stated (6 ACSR at pp. 393-4):

> Alternatively, is Westpac to conduct its affairs on the basis that the ASC simply says 'Trust us; the documents that we are seeking relate to the affairs of a body corporate that we are investigating.'
>
> However odious the conclusion may be, in my opinion, if objectively the documents sought do relate to the affairs of a body corporate the subject of an investigation by the ASC, the bank is obliged to produce them.
>
> It may be of some comfort to a financial institution in the position of Westpac that s. 92 of the Act makes provision for compliance with notices which purport to be issued under Part 3 of the Act . . .
>
> In my opinion, it would be an impossible imposition on the ASC if its inquiries were to be predicated on an obligation in every case to detail the basis of the asserted connection between the documents sought and the bodies corporate the subject of investigation.

These principles apply equally to individuals and companies who receive notices to produce their own documents.

It should also be observed in this connection that it is extraordinarily difficult to object to production on the ground of irrelevance. In *MFI v. National Crime Authority* (1991) 5 ACSR 353 it was argued that there was a reasonable excuse for the non-production of some documents 'because a substantial part of them . . . could not conceivably be relevant to the subject matter of the investigation' (5 ACSR at pp. 356-7). Heerey J

applied *Melbourne Home of Ford Pty Ltd v. Trade Practices Commission* (1980) ATPR 40-174 adopting a very broad view of relevance because of the special nature and needs of the investigative process.

Notices Requiring Attendance at a Private Examination

Another recent case underscores the breadth of the ASC's powers. In *ASC v. Graco* (1991) 5 ACSR 1, Mr Graco was served with a notice requiring him to give evidence 'in relation to an investigation of Titan Hills Australia Ltd'. Although Jenkinson J ultimately upheld Mr Graco's contention that the notice was invalid, His Honour rejected a submission that section 19(3)(a) of the ASC Law, which provides that such a notice 'shall state the general nature of the matter' that the Commission is investigating, requires the ASC to disclose with some particularity what the matters being investigated are. Jenkinson J stated (5 ACSR at p. 5):

> In my opinion the legislative intention disclosed in s. 19(3) is that the person served with a notice may be forewarned of circumstances likely to make it desirable that in his own interest he consider before the day fixed by the notice for his examination whether he should take legal advice and whether he should have his own lawyer present at the examination. It accords with that intention that the 'general nature of the matter' being investigated, or to be investigated, should be disclosed in the notice. And it is, I think, not surprising that no more specific or detailed information about that 'matter' was required to be disclosed.

Then, in a passage which highlights the protean nature of complex corporate investigations His Honour said (5 ACSR at pp. 5-6):

> While it is unwise to express any concluded opinion on the point, I think that the nature of the function conferred by s. 13(1) would move a court strongly to a construction of that subsection which would authorise the Commission to change the 'matter' under investigation as information from time to time derived from the investigation gave it reason to change its opinion as to what was 'expedient for the due administration of a national scheme law'. If the investigation of a 'matter' afforded the Commission reason to suspect that there may have been committed a contravention of a kind specified in the lettered paragraphs of s. 13(1) which had not been suspected when the investigation commenced, that would no doubt enliven again the power conferred by the subsection. But, even if no such a suspicion was engendered by the investigation, a construction of s. 13(1) which would authorise a modification from time to time of what the Commission should think expedient, and so a modification of 'the matter' to be investigated, would in my opinion accord well with the legislative purpose in conferring investigative power of the kind described in the subsection. If such a construction were adopted, definition or description of 'the matter' for the purposes of s. 21(3) would not be possible until the question, the relevance

> of which fell for determination, was asked, for the content of 'the matter' might have changed after service of the notice.

As previously indicated, the notice on Mr Graco was held invalid, but on the basis that there was a failure to include in the statement, in compliance with section 19(3)(a), any temporal limit on the subject of the investigation it being 'safely inferred that the investigation proposed is not of [the company in question] throughout its life' (5 ACSR at pp. 8-9).

Legal Representation

The right to be represented by a lawyer in an ASC investigation is well recognised. However, some interesting questions have arisen regarding whether there is an unqualified right to be represented by a lawyer of one's choice in the course of a private examination. Section 22(1) of the ASC Law empowers an inspector to give directions about who may be present during a private examination. Section 23(1) of the ASC Law entitles the examinee's lawyer to be present.

In *Wood v. NCSC* (1990) 1 ACSR 779 the question was whether the NCSC had the power to preclude a firm of solicitors acting for more than one person in the course of an investigation. Wallwork J held that there was such power and accepted the NCSC's contention that:

> . . . there was no absolute right to counsel of first choice when, in pursuance of its statutory function, the NCSC determines that a particular legal practitioner's presence at the private hearing may prejudice the inquiry . . . it was within the power of, and reasonable for, the [NCSC] to reach the view that there was a real risk that a legal practitioner who was anxious to do his duty to his clients might, quite unintentionally, perhaps subconsciously, reveal to one or more of the clients, matters which would forewarn them of what they might expect to be asked (1 ACSR at p. 792).

Essentially, the NCSC was concerned to protect the confidentiality of its investigation so that the effectiveness of individual examinations would not be undermined.

The issue was recently reconsidered by the Full Court of the Federal Court in *ASC v. Bell* (1991) 6 ACSR 281. The court unanimously upheld the ASC's contention (which had been rejected at first instance by Pincus J) that, in a proper case, the inspector could direct that a particular lawyer not be present at an examination. Lockhart J stated the relevant principle by saying that an ASC inspector 'may decline to allow the lawyer to appear before him if there are reasonable grounds for a bona fide belief on his part that to allow the representation will or is likely to prejudice the investigation which he is obliged to carry out pursuant to the requirements of the Act' (6 ACSR at p. 286). Significantly, however, the Court held that the onus lay on the ASC to show why a particular lawyer should not be

permitted to appear, emphasising the value underlying the examinee's right to choose his or her own lawyer. Sheppard J observed that the public interest in ensuring that the ASC be able to properly discharge its functions did not (6 ACSR at p. 296):

> . . . entitle an inspector simply to announce that he is in possession of unspecified information which may involve the solicitor appearing for a person being examined in misconduct himself. There is no reason why the person being examined or the solicitor should be required to accept the statement at its face value. The statutory right of representation which is conferred is an important right and it is not lightly to be cast aside.

Natural Justice

It will be readily seen from the foregoing that a person or company involved in an investigation is likely to find the experience not only bewildering but feel compelled to endure it with a real sense of vulnerability.

The High Court recently held it 'can now be taken as settled that, when a statute confers power upon a public official to destroy, defeat or prejudice a person's rights, interests or legitimate expectations, the rules of natural justice regulate the exercise of that power unless they are excluded by plain words of necessary intendment . . .' (*Annetts v. McCann* (1990) 170 CLR 596, p. 598).

The principles of natural justice or procedural fairness have application to ASC investigations. To say that, however, is not to meaningfully convey what rights an individual or company may have—the principles in this area being notoriously vague and not susceptible of ready definition particularly having regard to the protean nature of most investigations in the sense suggested above.

It is instructive to begin with what rights an affected person does not have. There is no right to be given notice of the commencement of an investigation, what the matters being investigated are (*see Bond Corporation Holdings Ltd v. Sulan* (1990) 2 ACSR 97, on appeal (1990) 2 ACSR 435) or an opportunity to be heard or make submissions on any of these issues. A recent decision in the United Kingdom is illustrative (the extract which follows is taken from Kluver 1992). In *R v. Serious Fraud Office ex parte Nadir* (*The Company Lawyer Digest*, vol. 12, no. 4; 1991 at 76) a suspect argued that he had natural justice rights, both to a preliminary hearing, and by necessary implication, to obtain particulars of the transactions in respect of which the Serious Fraud Office suspected him of criminal conduct. Steyn J held that 'The applicant had no legal right to be heard on the question whether an investigation by the Serious Fraud Office should be commenced or continued, nor had he a legal right to be heard on the question of whether criminal charges should be brought'. His Honour thought it would be 'extraordinary' to recognise such rights saying

that it would be 'contrary to the public interest to supply information which might enable a suspected fraudster to interfere with witnesses or destroy documents before the investigation had been completed'.

A now classic statement of the position is the joint judgment of Mason, Wilson and Dawson JJ in the High Court in *NCSC v. News Corp Ltd* (1984) 156 CLR 296 at 323-4:

> It is of the very nature of an investigation that the investigator proceeds to gather relevant information from as wide a range of sources as possible without the suspect looking over his shoulder all the time to see how the inquiry is going. For an investigator to disclose his hand prematurely will not only alert the suspect to the progress of the investigation but may well close off other sources of inquiry.

As a result of the recent decision of the High Court in *Annetts v. McCann* (1990) 170 CLR 596 it now seems clear, at least in connection with inquiries which may lead to the publication of findings, that personal reputation has 'been established as an interest which should not be damaged by an official finding after a statutory inquiry unless the person whose reputation is likely to be affected has had a full and fair opportunity to show why the finding should not be made' (per Brennan J at 170 CLR p. 608). (*See also Mahon v. Air New Zealand* [1984] 1 AC 808 and *Alan Bond v. John Robert Sulan* (1990) 3 ACSR 172).

The major concern of a person affected by an investigation (assuming he or she knows of its existence) is to find out as much as possible about it. The ASC, depending upon all the circumstances, will normally be very reluctant to release any details. However, in the writer's experience, the ASC is sometimes willing to at least confirm, in general terms, the status of an investigation and to provide an undertaking not to take any action adverse to the affected person, for example launching a prosecution, without first giving that person some opportunity to be heard. Notably, in an address given to a seminar in Perth last year (*ASC Digest*, Rep. Spch. 106 1991), Mr Stephen Menzies, Special Adviser, National Investigations, stated that the ASC was amenable to "Wells" submissions which originated from an informal procedure adopted by the SEC to enable persons under investigation for possible violations of the US securities laws to present their views to the SEC before an enforcement proceeding was authorised. Mr Menzies noted that such submissions are intended to deal with matters of policy or law, rather than contested factual matters which were more likely to be resolvable by recourse to litigation.

This is a difficult area. The fundamental requirement of natural justice or procedural fairness in the course of an examination is to put the affected person in a position of knowing whether he or she is at risk of an adverse finding or conclusion being made against him or her, and to be informed of the basis of the investigator's belief for being able to do so. The concept of fairness which underlies this principle may need to be

moulded to the particular circumstances of the case (*Salemi v. Minister for Immigration and Ethnic Affairs* (1977) 14 ALR 1 at p. 38, per Stephen J in the High Court of Australia). Other than the foregoing, there does not seem to be any legal requirement that the investigator should, as a general rule, provide any intimation, formal or otherwise, of the possibility of a finding adverse to a particular person being made (this is part of the approach which, in all the circumstances of the Western Australian Royal Commission into Commercial Activities of Government, that is presently being suggested by the Commissioners : Statement on Rules handed down by Commissioner Brinsden on behalf of all Commissioners on 21 January 1992 inviting comment from counsel).

In practice, the demands of fairness are said to be met if, during the course of an examination, the witness is given an opportunity, whether in the course of questioning by the inspector, or if the witness chooses, while being re-examined by his or her counsel, to deal with and comment upon such facts and circumstances as might form the basis of an adverse finding or conclusion.

It is not necessary, on this view, for the inspector to spell out, in terms, what the adverse finding or conclusion might be. Generally speaking, there is no right to cross-examine other witnesses whose evidence may be relied upon by the ASC to make an adverse finding or conclusion. (*Generally, see Beveridge v. Dontan Pty Ltd* (1990) 23 NSWLR 13 for a good recent discussion of the principles governing whether not being given an opportunity to cross-examine may constitute a denial of natural justice).

Although the ASC has shown itself ready to provide for some involvement from affected persons (other than through formal examinations on oath), whether to take the opportunity to make submissions, and if so, what to say, calls for considerable judgment. In any event, the introduction of "Wells" submissions in all investigations is a procedure that ought to be both welcomed and encouraged.

Timing of Investigations, Civil and Criminal Proceedings

A person or company who has allegedly contravened the Corporations Law may be:

- Investigated by the ASC or other administrative tribunal in relation to the alleged contravention or as part of a wider investigation or enquiry;

- Subject to civil proceedings by the ASC or any other person who has suffered damages as a consequence of alleged contravention; and/or

- Subject to criminal proceedings by the ASC or one of the many other statutory investigative bodies.

There is no particular order in which these proceedings must be commenced. However, there are some rules and practical considerations which may influence the timing of each proceeding:

- It will be a contempt of court and an improper interference with the administration of justice if a person who is the subject of pending criminal proceedings in a court of law is also subject to a parallel inquisitorial enquiry by an administrative tribunal with powers to compel the giving of evidence and the production of documents which largely correspond or exceed the powers of the Criminal Court (*Hammond v. The Commonwealth* (1982) 152 CLR 188 per Deane J, p. 206).

- This does not mean that a person may be able to refuse to appear before the ASC or other administrative tribunal merely because there are criminal proceedings pending. It must be shown on the balance of probabilities that the person will be required in the examination to answer questions relating to specific existing charges. It is permissible that there may be areas of common subject matter between the examination and the pending criminal proceedings (*Hugall v. McCusker* QC (1990) 2 ACSR 247).

On the other hand, the existence of civil proceedings in respect of certain alleged actions will not ordinarily preclude proper administrative enquiries as to whether penal proceedings should be instituted in respect of those alleged actions. (*Hammond* per Deane J, p. 206).

Assessment is often required of the desirability of bringing quick civil action in the interests of creditors and shareholders where doing so might prejudice or delay criminal action.

It seems clear that the pendency of criminal (or indeed civil proceedings) will not, without more, preclude an investigator from requiring production of documents which relate to matters in issue in such proceedings. The fundamental principle which seems to emerge from the cases is that a real and definite tendency to prejudice a fair trial must be shown to establish that a purported exercise of statutory power is a contempt of court. This 'involves a balancing exercise between competing matters of public interest' (*Burrill v. Jolly* (1990) 2 ACSR 817 at 830 per Tadgell J). The issue has the potential to arise more frequently in the current environment of prosecutions and investigations being conducted simultaneously (*generally, see* Kluver 1990).

Conclusion

There appears to have been, in the short time since the Freighters Limited investigation in 1957, and presumably in response to the perceived problems presented by subsequent corporate collapses and the misconduct of those involved in them, a steady increase in the legal powers available to corporate law enforcement agencies (although not always matched by financial and other resources). Yet, there is no evidence that as a result, criminal law enforcement against serious commercial wrongdoers was, or would have been (even with more resources), more successful. Rather, this process has led to an erosion of the civil liberty rights not only of those involved in the management of the affairs of corporations, but to any body corporate being the potential target of an investigation, whether or not the public might in any way be adversely affected by its activities.

There are numerous bodies in the community, entrusted with the management of other people's money, which are not subject to the same regulation. Examples include local government instrumentalities, the civil service, political parties, unions, charitable institutions and many others (Siopis 1992).

As the ALRC observed in 1975, to maintain a proper balance between protection for individual rights and liberties on the one hand and the community's need for practical and effective law enforcement on the other, is a 'time-honoured nostrum . . . easier to state than to apply' (Australian Law Reform Commission 1975).

It is important to encourage the use of proper investigative techniques, and to avoid 'the concomitant moral deterioration in methods of obtaining evidence and in the general administration of justice' (from a Canadian case, referred to by Gibbs CJ in *Sorby v. Commonwealth* supra, 46 ALR at p. 246) which overreaching investigative powers risks creating. Four specific suggestions are made which, it is submitted, can be adopted without emasculating the ASC's ability to discharge its functions and responsibilities effectively:

- The derivative use immunity privilege should be restored.

- Consideration should be given to the position of those indirectly involved in the affairs of companies being investigated with a view to restoring a level of protection envisaged in Victoria in 1957.

- Any doubts about legal professional privilege should be immediately dispelled in favour of its retention.

- The ASC should formalise procedures:

(a) pending unqualified restoration of legal professional privilege, to make clear the circumstances which it believes justify disclosure of material otherwise subject to this privilege to third parties with a view, in particular, to giving the persons who may be adversely affected by such disclosure an opportunity to be heard;

(b) to give effect to "Wells" submissions.

In conclusion, there needs to be a far greater sensitivity to the rights of the individual in company investigations.

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Chapter Five

A Constitutive Conception of Regulation

Clifford D. Shearing

As the blush of deregulation begins to fade regulation is being dusted off and returned to policy agendas. Stiglitz (1989, p. 20) makes this point as follows:

> Deregulation is no longer viewed as an unmitigated success. After the initial flurry of entry, the airline industry has, for instance, begun to settle down to the kind of oligopolistic practices, characterised by high prices, which economic theory—at least the theories of those not completely indoctrinated in the competitive religion—predicted. Scandals in the banking and securities industries have led to calls for greater regulatory surveillance (cited in Groenewegen 1991, p. 18).

As this happens there is a danger that this merely will reintroduce the problems that prompted deregulation in the first place and, in time, usher in another round of deregulation. If this happens no progress will have been made. Avoiding this requires a fundamental rethinking of what regulation has been and what it can be (Ayres & Braithwaite 1992; Gunningham 1992). Such a rethinking must involve at least four steps.

- an examination of what regulation has meant, and why this has been a problem;
- the development of an alternative conception that can form the basis for re-regulation;
- an exploration of its utility in explicating what regulation does;
- a consideration of the policy directions it implies.

In examining these steps it will be argued that the regulation-deregulation debate rests on a set of untenable and mischievous assumptions: untenable because they fly in the face of what we know, or

rather should know, about social order; mischievous because they mask the critical fact that what is at issue in this debate is not deregulation but regulation.

It is contended here that arguments for deregulation are political moves in a struggle over regulation. In taking this position I accept the public choice theorists claims about the political character of state regulation (*see* the review by Phillips & Zecher 1981, pp. 21-4). However, their assertion that one can escape this political arena by leaving regulation to the 'invisible hand' of the market is questioned (Smith 1976)[1]. In developing these arguments research undertaken by the author on the regulation of securities markets in Canada and the United States will be referred to both as a source of ideas and illustrations.

The Control Conception of Regulation

Beneath the differences that have fuelled the regulation-deregulation debate lies a shared understanding of the nature of social order. It is this understanding that needs to be questioned if we are to move beyond this debate. This challenge is being taken up on a variety of fronts within the regulation literature. In seeking to contribute to this development the essential elements of the shared 'root image' (Blumer 1968) that have driven the debate over deregulation will first be identified. In doing so I will concentrate on its essential elements. This will inevitably caricature the richness of the debate that this understanding has generated but that, after all, is how root images work (Shearing & Ericson 1991). Once this ground work has been completed an alternative understanding of markets and their regulation that draws upon, and seeks to advance, recent scholarship will be presented.

The debate over deregulation has as its basis a conception of social order as a pre-political, pre-social phenomena that creates itself simply through the interaction of innate human characteristics (Burk 1988, p. 7). Human beings have desires and they are rational. Put them together and order will be created. Not only that but this order may well be in the public interest in the sense that what is produced will provide the group in question with the best, most efficient, distribution of the goods required to satisfy their desires. The concept of the invisible hand captures this image well. The invisible hand of the market establishes a process of autonomous or 'market ordering' (Sunstein 1990; Burk 1988, p. 8) that very often creates the optimal individual and collective benefits. Incidentally, while this idea has come back into favour since the 1970s (see, for example, Phillips' & Zecher's 1981 review of public choice

1. As Burk (1988) notes, Smith is more circumspect than many of his disciples in arguing for the idea of autonomous market ordering. He writes in his *The Wealth of Nations* (1976, p. 477) that a market participant: 'Led by an invisible hand by pursuing his own interest . . . frequently promotes that of the society more effectively than when he really intends to promote it' (cited in Burk 1988, p. 13).

theory; *see also* Burke 1988, pp. 2-7), it is an idea with a very long history. Groenewegen (1991, pp. 14-15) cites Turgot (1759, pp. 26-7) as follows:

> [the cheated customer will learn by experience and] will cease to frequent the cheating merchant, who will fall into discredit and thus will be punished for his fraudulence; and this will never happen very often, because generally men will be enlightened upon their evident self-interest. To expect the government to prevent such fraud from ever occurring would be like wanting to provide cushions for all the children who might fall.

The debate generated by this view is a debate over when, whether and to what extent market ordering alone will promote the public interest. At the one extreme are those who put their faith in the market. At the other are those who believe that market ordering always requires correction if the public interest is to be served. In between are those who argue that while market ordering sometimes works it sometimes fails. What is required they argue is to identify when it works and when it does not, so that the proper mix of market and external ordering, or regulation, can be determined and put in place (Phillips & Zecher 1981).

Within this debate, regulation–to the extent that it is necessary–should obviously be undertaken by an entity that will promote the public interest. In liberal democracies the state and the courts are typically regarded as the only sensible candidates (Burk 1988, p. 6; Rose-Ackerman 1992). The notion of private ordering or self-regulation in which some industry regulates itself is, within this conception, essentially a contradiction in terms (Hancher & Moran 1989, p. 273). If market ordering has failed to promote the public interest it is hardly sensible to call on a sectional interest to rectify the problem (Abolafia 1985, p. 313). From this point of view the only way self-regulation can be justified, is by conceiving of it as an arm of state regulation. The reasons put forward for permitting self-regulation under state oversight are practical ones that have to do with the enhancement of the state's regulatory capacity (Condon 1991, p. 136). They include such things as the exploitation by the state of local knowledge and the shifting of the resource burden of regulation away from taxpayers to private entities.

I will term this conception of regulation the control conception (Ayres & Braithwaite 1992, use the phrase 'command and control' to capture essentially what I have in mind) in recognition of the centrality it accords to the idea that regulation involves an interference that seeks to control or impede the operation of market forces (Condon 1991, p. 162). An example of the continuing influence of this conception is a newspaper article on the future of the Australian economy, that appeared recently, under the headline 'Our economy waits at the crossroads' (Cleary 1992, p. 9). The author argued that Australia, in moving beyond deregulation, would have to identify a balance between 'removing impediments to

competition' and establishing 'a role for government in "moderating" market outcomes'.

As I have already argued, while this conception continues to influence regulatory thinking there is growing uneasiness about its viability as a basis for policy. This is giving rise to a search for a new conceptual basis for policy (Braithwaite 1991; Gunningham 1992). As part of this search let us turn now to a tradition that has long questioned the validity of the control conception.

A Constitutive View

Scholars of a variety of persuasions have for a long time argued that the conditions required for social interaction are not given by interaction itself. Interaction, they have argued, is not self-constituting. Markets are not self-ordering. Markets are always and necessarily regulated through careful constitutive work (*see*, for example, Burk (1988) who develops this view).

From this 'constitutive perspective' a policy of deregulation is at worst an intentional hoax and at best a dangerous self-deception. Put very bluntly deregulation is nonsense and so, by implication, is any framework that defines the essential problem of promoting the public interest as finding the right mix between market and state ordering.

These views have until recently carried little weight in regulatory policy forums. The growing uneasiness about the policy framework we have inherited from the 1970s and 1980s, however, suggests that perhaps this might be a good time to take these views more seriously.

Markets as Constituted

In developing this view of markets, and social order more generally, as unremediably and irrevocably constituted let me by way of illustration draw on the story of the prisoner's dilemma that is frequently employed to argue for the necessity of interfering with the invisible hand of market ordering. In this dilemma,

> Two prisoners who have been accomplices in a crime are placed in separate rooms unable to communicate with each other. If one confesses and the other does not, the confessor is set free and rewarded and the one who fails to confess will be more severely punished than if both confess. If neither confesses both are set free with no rewards. Each prisoner has an incentive to confess under these conditions. No matter what the accomplice does, the prisoner is better off confessing. However, .. . the joint maximum is for neither to confess (Rose-Ackerman 1992, pp. 167-8).

The fact that the forces of this market do not produce the 'joint maximum' is used to argue for the necessity of regulation in the form of 'a

coercive enforcement mechanism' (Sunstein 1990, p. 50) of control which will change the rational calculus of the two accomplices so as to produce the 'joint maximum'. Coercive intrusion is justified on the grounds that it will serve to promote the 'outcome that people want [but] cannot attain without government assistance'. (Sunstein 1990, p. 50). The lesson drawn from the dilemma is that there are occasions when market forces alone will not promote the public interest.

This analysis in justifying regulation draws on the same root image as the deregulation argument it seeks to refute. In advancing the argument that market regulation alone is not sufficient to promote a collective good and that a regulatory intervention is therefore necessary, it leaves in place the essential claim that markets do self-order albeit not always as well as they might. What is at issue is what mix of market ordering and regulation is required.

From a constitutive perspective what is missing from this analysis is the recognition that prisoner's dilemmas do not just happen. They are not natural phenomena. Prisoner's dilemmas are carefully constructed through a regulatory process. Prisoners who experience this dilemma do so because police officers, together with a variety of other people, have constructed a situation designed to maximise the likelihood of confessions. Once this is recognised it becomes clear that an intervention that seeks to change the prisoners choices challenges, but leaves in place, the regulatory scheme that produced the dilemma in the first place.

This pre-existing regulatory reality is masked in the 'control conception' by the assumption that the market is simply given. Behind all those mathematical calculations one finds in the regulatory literature lies a regulatory scheme that is obscured by the analytic framework employed. Sunstein expressed this elegantly when he wrote that markets always depend on an:

> allocation of wealth and entitlements in the first instance [so that] the decision to permit market ordering pursuant to that allocation represents a controversial choice about competing values (Sunstein 1990, p. 42).

In other words ordering is irrevocably a political activity. The claim that the control conception makes, via the notion of market ordering, that this is not always the case is essentially a discursive sleight of hand that seeks to win a political victory by denying that there is a battle to be fought.

It follows from this argument that the first and most fundamental lesson to be drawn from an acceptance of constitutive conception of ordering is that there is no escape from the necessity of regulation. There is no unconstituted market to which to turn nor is there market ordering that will relieve us the task of regulation (Burk 1988).

If deregulation has left us with problems their source is to be found in the regulatory schema that were either left in place or that were developed

once the state's regulatory influence was diminished. The legacy of deregulation is regulation not its absence. Put simply, deregulation regulates.

One way of thinking about this is to imagine regulation as taking place in a space in which different regulatory schemes operate simultaneously. The occupants of this space may change but it is never empty. If one set of regulatory influences diminishes this simply changes the relationship between the occupants of this space (Hancher & Moran 1989).

Acknowledging multiple sources of regulation

Each of the conceptions outlined–the control and the constitutive–proposes a different response to the disappointments of the deregulatory experience. For the control conception, what the dissatisfaction with deregulation 'reveals' is that regulation is after all required to moderate market ordering. What is required in terms of policy, therefore, is a return to state regulation but this time with more understanding of the dangers associated with it (for example, capture) and a determination to avoid them this time around. Moving beyond deregulation means returning to what we used to do but doing it better.

From the perspective of the constitutive conception things look quite different. From this vantage point the reintroducing of state regulation is simply one possible response and a rather peculiar and conservative response at that. It is peculiar because it accepts as given the other regulatory schemes at work within regulatory space when it is precisely their 'given-ness' that should be questioned. It is conservative because it is content to leave the shape of the regulatory space in question essentially unchanged and to concern itself exclusively with the presence or absence of the state within 'regulatory space'. (Hancher & Moran 1989, pp. 276-7).

To go back to the example of the prisoner's dilemma, which for the constitutive conception is the most critical issue of all, namely, the constitution of the dilemma in the first instance–this is precisely what the control conception ignores. To shift metaphors this is like restricting questions about responses to lung cancer to the issue of treatment while deliberately ignoring the activities that produced the cancer in the first place. In criticising this, what the constitutive conception insists upon is a recognition that how one sets up the problem of cancer or drunk driving, or markets is a regulatory accomplishment with consequential implications (Gusfield 1981).

This discussion of the constitutive conception has important implications for regulatory policy in a post-deregulation era. It insists that any move to re-regulation should take a much broader view of regulation than the control conception permits. In taking this view it insists that regulatory space as a whole should be made the subject of regulatory policy. In so doing it decentres the state as a source of regulation and points to the role that can be played by a whole host of regulatory

schemes. In commenting, on the significance of this point Hancher and Moran (1989, p. 275) write as follows:

> Economic regulation of markets under advanced capitalism can thus be portrayed as an activity shaped by the *interdependence* of powerful organizations who share major public characteristics. In the economic sphere no dividing line can be drawn between organizations of a private nature and those entitled to the exclusive exercise of public authority.

This stance is one which Ayres and Braithwaite (1992) have already begun to explore in their recent proposals for the inclusion of public interest groups as occupants of regulatory space. In adopting this view they reject the control conception's state-centred focus thereby replacing the narrow concern with 'capture' with a more inclusive concern with the distribution of regulatory influence within regulatory space.

One of the implications of this is that private ordering must be recognised as a central feature of regulation. This conclusion is consistent with a growing body of work that has drawn attention to the fundamental role being played by corporate entities as 'private governments' (Macauley 1986; Hancher & Moran 1989, p. 275) in the social ordering in a whole variety of arenas (*see also* Abolafia 1985). Regulation has never been a state monopoly (Shearing 1992).

This literature also suggests that the state's claim to the apex of a regulatory hierarchy with private regulators performing no more than delegated roles is unfounded. States may attempt to give reality to these monopolistic claims but they seldom are able to realise them (Shearing 1992).

It follows from this analysis that regulatory policy that fails to acknowledge that regulatory space is a terrain in which the state must compete for control of regulation with other regulatory entities is unlikely to be effective.

Regulatory Struggle

For the control conception regulation is by definition a negative affair. It is restrictive rather than productive. Its role is one of interference. It impedes. It is the market, not regulation, that is productive. Regulation may be 'gentle' (Grabosky & Braithwaite 1986), or it may be coercive, but either way ultimately it is controlling.

In contrast, for the constitutive conception regulation is very clearly a productive enterprise. It does not simply restrain a market 'it is what constitutes the market'. (Condon 1991, p. 162). Its power lies in its productive capacity (Foucault 1977). However, the constitutive conception also acknowledges constraint by recognising that in regulatory space regulatory schemes often compete with each other for control of the ordering process. More specifically, it recognises that this may result in state regulation seeking to limit or reverse the effects of other regulatory schemes. In short, the constitutive perspective accounts for constraint, just as the control conception does, but it does so within a framework that acknowledges that this is certainly not all there is to regulation.

This broader conception provides the basis for a recognition that an endemic source of conflict between state and 'private' regulators is a difference in orientation that reflects the control-constitution dichotomy. State regulators tend to view what they are doing as control because much of what they do involves seeking to limit the impact of the activities of private regulators. This contrasts with the perspective of private regulators who are more inclined to focus on market constitution. Thus, we find on the one hand, state regulators complaining that private regulators are constantly trying to breach regulatory requirements, while, on the other hand, private regulators complain that state regulators fail to understand that what regulation must ultimately do is not constitute a market. Within regulatory organisations this contrast of perspectives can also be found between 'the lawyers' who tend to embrace a control perspective and 'the street' that leans towards a constitutive perspective.

This analysis suggests that conflict between the state and private regulators should not automatically be interpreted as an illegitimate conflict between public verses private interests. Such an interpretation needs to be weighed against the alternative, namely, that it may be a conflict that has its roots in the failure of the control conception to recognise the constitutive work of regulation. If future regulatory policy is to take a step beyond the regulation-deregulation framework this issue is one that will have to be addressed.

Rules and the Regulatory Process

One of the areas in which this conflict between control and constitution finds expression is in the place accorded rules within the regulatory

process, because the control conception rules set boundaries for market ordering and thus establish the agenda for regulatory interference. From this perspective regulation is a matter of rule enforcement and the success of regulation is determined by the extent of compliance with these rules. Private interests are regarded as being opposed to these boundaries so that regulation becomes the process whereby private preferences are made to comply with the public interest. Rule enforcement thus becomes synonymous with the promotion of the public interest.

This picture changes significantly when rules, and rule enforcement, are viewed from the perspective of the constitutive conception. From this viewpoint the essence of regulation is not compliance with rules but rather the constitution of an order understood as a state of affairs. In the case of securities markets, for example, liquidity is such a state of affairs. Regulators concerned with the constitution of securities markets fix their gaze on such things as liquidity and measure their success as regulators on the basis of their presence or absence. Order is defined in terms of output criteria not rules.

For the constitutive conception, rules may function in a manner consistent with the control conception but only to the extent that they are being employed as sources of restraint in the struggles that take place in regulatory space. For instance, when the state seeks to intervene to limit the operation of other regulatory processes. In this case rule enforcement and compliance are essential concepts. However, the constitutive conception also recognises that rules, when they work within the context of regulation as market production, function quite differently. In this context they operate as guidelines, that reflect past regulatory experience, that are constantly subject to revision on the basis of experience. As guidelines rule, violations can be justified if it can be cogently argued that rule-following would have undermined rather than enhanced market constitution.

From the point of view of regulatory policy what this suggests is that policy makers should be very wary indeed of an approach that regards compliance with rules, whether achieved though cooperation or coercion, as hallmarks of sound regulatory practices. Regulatory policy should be goal rather than rule-oriented (Ayres & Braithwaite 1992).

The Market of Assurances

The final implication of the constitutive conception of regulation to be discussed here is the place of assurances in regulation.

Both a control and constitutive perspective recognise that an essential focus of regulation must be the shaping of motives or preferences (Sunstein 1990, pp. 60-1). What the constitutive conception draws particular attention to, however, is that markets are fragile phenomena which depend on a sustained willingness on the part of market participants

to trust each other and that, accordingly, it is trust that lies at the heart of regulation (Sunstein 1990, p. 50; Burk 1988, p. 4; Shapiro 1984).

The seventeenth-century British political philosopher Thomas Hobbes (1968) made this point, with respect to the provision of security, when he argued that peace was not the absence of war but the absence of the threat of war in the same way that fine weather is not simply the absence of rain but the absence of the likelihood of rain. The constitution of social order requires a promise, an assurance, a guarantee that some way of doing things exists and will persist. Order is a state of affairs you can count on, that you can trust (Pettit 1989, pp. 9-12). It requires a 'tranquillity of mind' (Montesquieu (1977, p. 202) cited in Pettit 1989). One source of this tranquillity, as already argued, is the presence of a guarantor, a regulator, with the will and capacity to offer credible assurances (Shearing 1992).

There are at least two consequences of this recognition of the centrality of trust that have implications for regulatory policy. The first is that regulatory space is a 'marketplace of assurances' in which multiple guarantors often compete with each other for the confidence of persons who are faced with decisions as to where and how to act.

As security markets make clear one of the consequences of this feature of regulation is that the success of regulators depends on their ability to inspire confidence (Shapiro 1984, p. 2). If they do not inspire confidence the order they seek to constitute will not be realised and persons who require such an order will turn to other regulators for the assurances they seek. This is explicitly recognised, for example, by The Toronto Stock Exchange (The Toronto Stock Exchange 1985, p. 1) in its promise to traders that they can count on its markets being 'fair and open'.

In marketing confidence, regulators take their cues from the consumers of their assurances whose trust they seek to gain. Thus, for example, the attention securities markets regulators give to the issue of 'timely disclosure' and insider trading arise out of their sensitivity to traders' concerns about access to information (Condon 1991). It is these concerns, not the arguments of economists (Carlton & Fischel 1989), or lawyers (Brudney 1979), that motivate securities regulators to provide traders with assurances about equal access to information.

The policy implications of this analysis are that policy should take its direction more from the lay theories of market participants than from the theories of professionals when it comes to determining regulatory objects. In terms of the earlier metaphor, it is ultimately the 'street' that should determine objectives of regulatory assurances.

A second implication of this analysis of the importance of 'preference formation' (Sunstein 1990, p. 60) to market constitution is that it draws attention to the temptation regulators face to be content with creating appearances that will promote confidence and to be less concerned with ensuring that this confidence is actually warranted. This predisposition to manage appearances rather than underlying market conditions goes a long

way towards explaining the recurrent cycle of scandal and reform that has plagued so many regulatory arenas (Condon 1991).

The implication here is that policy should be sensitive to the danger of permitting appearance management to 'capture' the regulatory process. The introduction of public interests groups who do not directly offer guarantors but who have the capacity to assess the effectiveness of regulation on an ongoing basis proposed by Ayres and Braithwaite (Ayres & Braithwaite 1992) is an innovative proposal that responds to this danger.

Conclusion

By way of conclusion the main points of this analysis will be reviewed. It has been argued that a move beyond the deregulation-regulation debate requires a shift from a control to a constitutive conception of regulation. The essential elements of this perspective, although well established–especially within the sociological literature–have nonetheless had relatively little influence over regulatory policy. A policy framework that took a constitutive perspective as its basis would include the following elements.

- The abandonment of the notion of market ordering as a basis for regulatory thinking.
- A recognition of multiple sources of regulation and a concern with the conflicts and alliances between them.
- A shift from a focus on compliance with rules to a focus on goals.
- A recognition of regulatory space as a market of assurances.
- An acceptance that the criteria for assurances arise out of lay rather than professional theorising.
- A recognition of a regulatory temptation to focus on appearances as an endemic problem in regulation.

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Chapter Six

Responsive Regulation for Australia

John Braithwaite

Everyone agrees that Australia's regulatory processes could be better designed to promote efficiency, effectiveness and equity. But that is about all everyone agrees upon. The diagnoses of our regulatory malaise that enjoy popular currency in Australia are mutually contradictory to a degree that makes it difficult to discern how to move forward. This paper will contend that the dominant ways of thinking about regulation in Australia are myopic and have led to tunnel-visioned policies. The different myopias take turns to prevail in policy debates. The plea here will be for a transformation of the business-governmental-community culture of regulation to defeat this turn-taking. This will be a plea for a regulatory culture that is more genuinely committed to dialogue between competing concerns and to constituting win-win regulatory solutions.

Three myopias are identified which are obstacles to a more constructive regulatory culture in Australia. These are regulatory legalism, deregulatory rationalism and knee-jerk opposition to self-regulation. Most lawyers subscribe to the first credo, most economists to the second and most ordinary citizens of Australia to the third. While all three represent myopic positions that are the fundamental hindrances to efficient, effective and just regulatory design in Australia, lying behind all three are legitimate concerns that must be addressed in a responsive regulatory culture. My contention is that we will all do better by our concerns if we abandon these entrenched positions.

Regulatory Legalism

Regulatory legalism construes business regulation as an enterprise that is fundamentally about the just enforcement of laws. The job of regulatory

agencies is to enforce the laws that are passed on to them by the parliament. The most
extreme of regulatory legalists may view it as an improper activity for a regulator to look behind these laws to the public purposes for which the laws were written and then to pursue those public purposes by means other than law enforcement.

The Commonwealth Attorney-General's Department is an institutional bastion of regulatory legalism. In recent times, some deregulatory rationalists have gained a toehold in some senior positions in that department. But as argued in the next section, we should see that as no great progress. In the darkness of the bureaucratic corridors of Barton, what we mostly see is that legalists and rationalists take turns to throw each other on the mat on questions of regulatory policy.

Trade Practices compliance policy illustrates the clash of the myopias. The Trade Practices Commission sees a looming problem that will cause the anti-competitive conduct which their act is intended to prevent. To take a currently topical example, they see a risk of the airline duopolists controlling airline booking systems or terminal space in a way that erects barriers to the entry of a third competitor. The Commission then diverts resources away from enforcing compliance with its Act to work on preventive policy measures to protect the competitiveness which is the objective lying behind that act. When this happens, there is a history of regulatory legalists in the Attorney-General's Department complaining to their minister that the Commission is overstepping its mandate. 'They complain that they do not have the resources to take serious breaches of the act to court, but then they divert their resources into policy questions that are outside their statutory mandate'. The Law Council of Australia has been another aggressive proponent of that view, especially in arguing that it is beyond the statutory mandate of the Commission to advocate deregulatory measures to increase the competitiveness of the market for legal services. Partners in some of the major law firms specialising in Trade Practices law have also been influential advocates of this view.

When the Trade Practices Commission diverts resources into the monitoring and evaluation of self-regulation schemes that operate as an alternative to government regulation, the legalists have on occasion joined forces with the knee-jerk opponents of self-regulation within certain public interest groups to sabotage this work. Fortunately, this sabotage has had only limited success and the Commission cannot keep up with the demand to assist with, monitor and evaluate self-regulation schemes.

Some legalists view regulators as having a duty to enforce the law when significant breaches of the law come to their attention. Some environmentalists and radical criminologists also believe that it is simply wrong to reach the kind of settlement agreement with a corporate environmental criminal that Professor Fisse discusses in Chapter Eighteen of this volume. It is wrong because it is inequitable enforcement of the

law that grants wealthy law breakers a privilege that is not extended to common criminals. This is a view at one with the stance of certain feminists that it
is wrong not to punish a man who assaults his wife. These views are based on a myopic understanding of how policing common crime works in practice. Very little common crime is dealt with by sending criminals to gaol. Consistent adherence to such a policy would be absolutely unworkable. If perpetrators of domestic violence were consistently apprehended and sent to gaol, a good proportion of the male readers of this volume would have served some time in prison.

In the case of the Trade Practices Commission, 51,454 complaints were received in 1989-90, a fair proportion of them involving likely breaches of the Act, but only 14 new court cases were initiated. Beyond complaints, if the Commission decided to be proactive in its enforcement work, it is easy to prove with data on the known incidence of certain types of breaches of the act that with unlimited resources the Commission could detect hundreds of thousands and probably millions of breaches of the Act in Australia each year. This empirical reality makes rhetoric about the obligations of the Commission to use its resources to litigate the breaches of the Act that come to its attention unworkable humbug. The obligation of regulatory agencies is to use their resources strategically to find the least cost ways of maximising regulatory objectives while respecting the legal rights of alleged offenders.

It is a useful exercise to confront the myopia of legalism with the perspective of economic rationalism on the same phenomenon. Legalism on questions of law-breaking has a rather stronger grip on US than Australian policy. The economic rationalist can look at the phenomenon of half a million blacks in American prisons and ask: 'What kind of human capital policy is it to have more young black males in prison than in college?' Then, the economic rationalist might go on to ask whether it is an intelligent use of human capital to go down the same track with white-collar crime, as the Americans have progressively been doing over the past 20 years. When a financial genius like Michael Milken breaks the law, might it be better to design his punishment to harness his talents for some public good rather than waste such an extraordinary talent in prison? In Australia, buckets of taxpayers' money and the energies of some of our most talented lawyers have been devoted to unsuccessful campaigns to put some of our most talented business people in gaol.

It is not argued for a moment that the human capital perspective on criminal law is a superior one to the justice perspective. Getting criminal convictions of some high profile business malefactors is a top priority for this country. My suggestion is simply that better policies are likely in such an area when one is open to pondering both perspectives (and others as well). The reaction of some economic rationalist critics of the regulatory legalism of the Attorney-General's Department in its oversight of the

Trade Practices Commission is to argue that the Commission should be taken away from the Attorney-General and handed to Treasury, for example, or a Ministry of Competition. My argument is that if such a move substitutes a legalism that is oblivious to economic efficiency and pragmatism with an economism that is oblivious to the rule of law, then we just swap one myopia for another.

Deregulatory Rationalism

Deregulatory rationalists seek business regulatory policymaking that is economically efficient. For the deregulatory rationalists, the issues which are the central concerns of the legalists—the rule of law, justice, respect for rights as constraints that cannot be trumped by considerations of utility—are obstacles in the path of economic efficiency. Deregulatory rationalism is an ideological package prone to defeat its own objectives. One reason is its contempt for the concerns of the legalists. Any regulatory order that does not take justice, rights, and the rule of law seriously risks rejection by the regulated as procedurally unfair. A regulatory order that is so myopically focused on economic efficiency that it views human life or environmental quality as just other commodities on which a price can be placed will be denied legitimacy by the broad mass of citizens. Regulatory orders that are viewed as unfair by the regulated or illegitimate by the community are likely to fail. In these two ways economic myopia sows the seeds of its own failure.

The institutional embodiments of deregulatory rationalism in Australia—business regulation review units in state and federal governments—have tended to exemplify these self-defeating propensities. This is not just because their myopic obliviousness to values other than economic efficiency have made them easy bodies for interest groups to discredit.

Australian business regulation review units have been ironic institutions in a number of ways. Their professed mission is to attack regulation; their preferred weapon for achieving this mission is regulation—regulating the regulators. They stand for smaller government; they advance this stand by making governments bigger—as business regulation review units proliferate across the land. Reducing the paperwork burden of government is a major concern; a remedy is to get governments to fill in returns on the paperwork burdens of their regulation, returns which require business to fill in returns on what the paperwork burdens are. Cost-benefit analysis is a methodological icon for these units; therefore they lobby for rules to require cost-benefit analysis for new regulations. In doing so, they pay no attention to the fact that credible cost-benefit analysis is expensive and they have never been known to produce an analysis of the costs of cost-benefit analysis and whether producing these analyses actually deliver benefits.

The deregulatory rationalists have also myopically been closed to the possibility that a great deal of the regulation we have is economically efficient as well as serving values other than economic efficiency. When organisations such as the American Enterprise Institute produce their influential studies on the comparative costs and benefits of regulation in the United States (for example Hahn & Hird 1991), they conveniently exclude from the analysis regulatory agencies that have small costs but near-infinite economic benefits. Examples are companies and securities regulation and prudential regulation of the finance sector. Both these regulatory regimes have near-infinite benefits because without them there would be no capital formation, no modern capitalism as we know it. Another (more controversial) exclusion of this ilk from the study is antitrust regulation. Like companies and securities regulation, antitrust not only regulates markets; it constitutes markets where markets would not otherwise exist.

Michael Porter's (1990) massive study, *The Competitive Advantage of Nations*, illuminates how strong regulation can actually increase the competitive advantage of advanced economies. Empirically, it is simply not the case that it is the countries with weak business regulation that are flourishing in the world economy. To find the toughest environmental or consumer protection legislation in the world on any given hazard, we will usually find it in the United States, Japan or Germany. Porter provides an account of some of the reasons why this is the case. BHP spent a 9-figure sum during the 1980s on new doors to reduce the hazardous emissions from its coke ovens. The doors were bought from Japan. Why? Japan was the leader in tightening regulatory controls over coke oven emissions, and as a consequence it was Japanese steelmakers that developed the control technology and sold it to the rest of the world. The Japanese Energy Conservation Law of 1979 set demanding standards for energy saving in air-conditioners, refrigerators and cars resulting in a variety of product improvements that have benefited Japan's international position (Porter 1990, p. 648). America more than Japan has historically led the world in the export of pollution control equipment and services as a result of their tough environmental regulation. However, when certain deregulatory tendencies in the US allowed Germany, Sweden and Denmark to move ahead of the US on some environmental standards, these countries increasingly came to supply world markets for the relevant technologies. Sweden led the world in regulations requiring special access and aids for handicapped persons. Consequently, Swedish companies dominate world markets in technology to aid the disabled.

Eastern European pharmaceutical producers are quite unlikely to challenge the dominance of the US and European pharmaceuticals transnationals. Why? The answer lies not so much in a failure of the market in these countries, but in the failure of regulation. The world's hospitals and health authorities will not buy their drugs from them in large

quantities, even though they are cheap, because they do not trust Eastern European regulatory systems to provide satisfactory guarantees of product safety and efficacy. Indeed, one of the reasons Australia has a better chance than Bulgaria of being the home of a couple of thriving international pharmaceutical companies is that our regulation has some international credibility.

Porter makes a clear distinction between regulation of *standards* of the sort just discussed and regulation of *competition*. Regulation of competition destroys economic efficiency by placing restrictions on entry, restricting prices, restricting seat capacity in an industry like airlines, and the like. Regulation of standards, on the other hand, can nurture economic efficiency:

> Stringent standards for product performance, product safety, and environmental impact contribute to creating and upgrading competitive advantage. They pressure firms to improve quality, upgrade technology, and provide features in areas of important customer (and social) concern . . .
>
> Particularly beneficial are stringent standards that anticipate standards that will spread internationally. These give a nation's firms a head start in developing products and services that will be valued elsewhere . . .
>
> Regulation undermines competitive advantage, however, if a nation's regulations lag behind those of other nations, or are anachronistic. Such regulations will retard innovation or channel innovation of domestic firms in the wrong direction (Porter 1990, pp. 647-9).

Unfortunately, for all the rhetoric of the dangers of regulatory capture that we hear from the business regulation review units in Australia, they themselves have tended to be captives of firms who take the short-term view that reducing all regulatory costs is a good thing. These units have been captives of business interests who want the lowest regulatory costs possible, who want the least pressured, least demanding business environment obtainable. The regulation reviewers have not seen themselves as natural allies of the consumer movement, which is very much in the business of making life more demanding for business by insisting on regulation that requires high product standards, by exposing green marketing claims that are not true, by giving consumers the information to put more pressure on producers through *Choice* (the monthly publication of the Australian Consumers' Association), by opposing monopoly and oligopoly and insisting on the deregulation of competition. Rather the regulation reviewers and the consumerists have each tended to view the other as natural adversaries.

My own bias could be reflected in all of this by saying that a vital, aggressive consumer movement is much more important to securing regulation that promotes international competitiveness than are business

regulation review units. But the message being projected here is a different one. It is that we all should recognise our biases and actively promote the legitimate concerns that lie behind them while struggling for a regulatory culture where constituencies with different biases are put in a constructive dialogue, a creative tension. Hence, we have a better shot at international competitiveness if we have both effective, balanced regulatory review and effective, balanced consumerism. We have a greater chance of efficient and effective regulation if we have a regulatory culture where regulation reviewers and consumerists actually listen to each other and respect the concerns of the other; we have a lesser chance of cost-effective regulation if these two constituencies see their mission as to destroy the other, taking it in turns to win battles without either side winning the war. There is a loser from this war, however, and that is Australia.

It is noted with interest that the Australian consumer movement, through its representative on the Economic Planning Advisory Council, Louise Sylvan, has put to Australian business and political leaders the proposition that it should consider the advice Michael Porter has to offer. If our economic leaders listen to our consumerists, then this will be a double triumph for openness to dialogue with the enemy. Michael Porter is, after all, not a guru whose work the average Australian consumer activist might be expected to embrace—an establishment economist from the Harvard Business School, an economic adviser to Ronald Reagan, an admirer of the economic reforms of Margaret Thatcher. We would expect him to have adoring fans among the Canberra econocrats of Treasury and the Industry Commission (which he does), but not in Marrickville at the offices of the Australian Consumers' Association. It is a hopeful sign for the kind of dialogue the Australian economy needs that Michael Porter, who was first invited to speak in Australia by the Business Council, got his best hearing from Australian consumer activists. And there is reason for optimism that some in the Australian business community are actually beginning to listen to the consumer movement when they quote Porter's provocative advice on product standards:

> *Establish norms of exceeding the toughest regulatory hurdles or product standards*. Some localities (or user industries) will lead in terms of the stringency of product standards, pollution limits, noise guidelines, and the like. Tough regulatory standards are not a hindrance but an opportunity to move early to upgrade products and processes. Older or simplified models can be sold elsewhere . . .
>
> *Find the localities whose regulations foreshadow those elsewhere*. Some regions and cities will typically lead others in terms of their concern with social problems such as safety, environmental quality and the like. Instead of avoiding such areas, as some companies do, they should be sought out. A firm should define its internal goals as meeting, or exceeding, their standards. An advantage will result as other regions,

and ultimately other nations, modify regulations to follow suit (Porter 1990, pp. 586, 588).

Recently, we have seen in Canberra a curious alliance of the deregulatory rationalists of the Trade Practices Commission and the Treasury plus the consumer movement putting the case to the government that Australia needs a less stringent test before the Trade Practices Commission is able to move to stop mergers. Those on this side of the debate in part were persuaded by Porter's argument that an activist antitrust policy is needed to dismantle the regulation of competition. International competitiveness, according to Porter, arises when there is vigorous domestic competition between clusters of local firms in an industry. The international success stories are not to be found with the one big local firm that gets economies of scale early, but with the many small local firms that put each other under such competitive pressure that ultimately a few of them succeed in becoming large international firms.

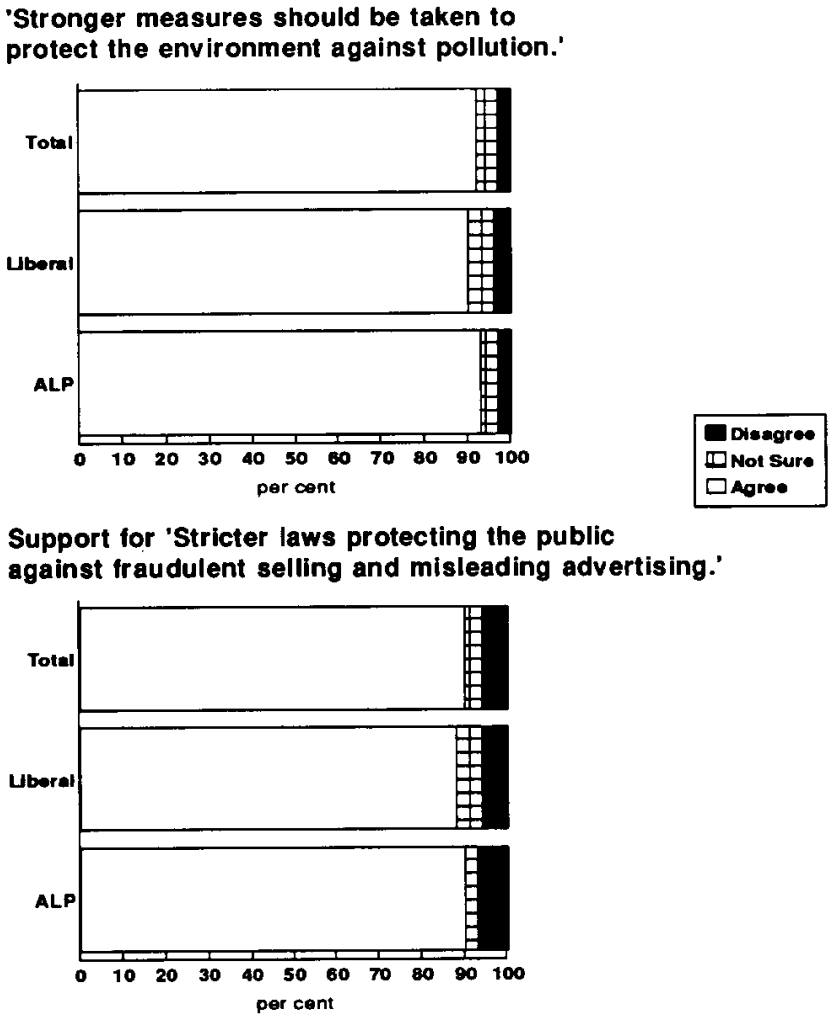
On the other side of that debate were most of the industry groups, including the Business Council. Similarly, while there has been an alliance of the deregulatory rationalists and the consumerists in arguing for a deregulation of markets for professional services in Australia, there are not many doctors and lawyers signing up for this campaign. So when rapprochement between consumerists and deregulatory rationalists has occurred, neither side has been very successful in persuading producers that an unpressured business life of low standards and oligopolistic quietude is not in Australia's interest, nor in the producers' interests in an international economy where the quiet life simply cannot last. If local professional monopolists persist in giving consumers a poor and unaffordable service, one day international firms from the relevant profession will sweep into Australia and snatch their consumers from them. We cannot ask producers to love thine enemy—it is hard for manufacturers to love the consumer movement after their work has been excoriated in *Choice*—but at least we can suggest to business that they would be well advised to listen to thine enemy. While some breaking down of the barriers to the regulatory dialogue we need has occurred, there is still a long way to go. One of the barriers that remains is some persistent attitudes of resistance to dialogue with business among public interest movements such as the consumer and environmental movements. To this obstacle to effective and efficient regulation, we now turn.

Knee-Jerk Opponents to Self-Regulation

One of the reasons social movements like the consumer and environmental movements get reasonably strong community and political support is that ordinary Australians do not trust business. They tend to view Australian business as greedy, rapacious, irresponsible and including a goodly proportion of crooked entrepreneurs. There are institutions in which the public have less confidence—such as trade unions and the press—but Australians have less confidence in business than they have, for

example, in institutions such as the police and universities (Headey 1988, p. 167). As a result of the lack of trust citizens have toward business, they strongly support tougher regulation in areas such as consumer and environmental protection. Repeat surveys by the National Social Science Survey at the Australian National University show that this support is strong among both Labor and conservative voters (*see* Figure 1).

Figure 1: Attitudes towards environmental and consumer protection regulation by political affiliation



Source: National Social Science Survey, urban sample (from Braithwaite 1988)

These attitudes are a considerable part of the basis for consumer and environmental movement power. Little wonder, then, that these constituencies play to community belief in the untrustworthiness of business. It is highly likely that most Australians believe that industry self-regulation is a joke. So when consumerists and environmentalists attack the naivety of self-regulation, they do no more than reflect community attitudes. One of the interesting changes that occurs in the beliefs of consumer advocates and environmentalists after a number of years of hands-on dealing with business is that they begin to conclude that in some areas government regulation is an even bigger joke than self-regulation.

For all its limitations, self-regulation sometimes delivers the goods better than government command and control.

Let me illustrate with an example from my own history as a consumer advocate. During the 1980s I devoted quite a bit of energy to lobbying for stronger government regulation of promotional claims made in medical journals and other outlets about the safety and efficacy of pharmaceutical products. In principle, I still believe that this is one of those areas that can be more efficiently regulated by government than by an industry association. But the experience of the past decade in Australia has proved this hope misplaced. The responsible government regulators—the Department of Health, Housing and Community Services and the Trade Practices Commission—failed totally to enforce the law against misleading promotional claims by pharmaceutical companies. Since 1988, the Australian Pharmaceutical Manufacturers' Association has put in place a self-regulation scheme that has actually done quite a lot to clean up misleading claims in the industry. The scheme is far from perfect, as a recent evaluation of the scheme by the Trade Practices Commission has reported (Trade Practices Commission 1992). But what Australian activist with extensive hands-on advocacy experience in this industry would not concede, if only privately, that the self-regulators have achieved more than the government regulators in recent times.

Advocates can respond to this kind of realisation in two ways. They can pat industry on the back, give credit where credit is due, and say publicly that they were pleased to be proven wrong. Or they can persist with vilification of the self-regulation as a scheme to con the public. Unfortunately, in these circumstances, public interest groups sometimes go for the latter option. This may be the safest way to cultivate political support within the movement. Advocates hate to be accused of going soft or being captured by business. But public interest advocates have a heavy responsibility in such cases. The fact is that if they say that a self-regulation scheme is a con and the industry says it is a success, it is the public interest group that will be believed by the community and the mass media. The responsibility is a heavy one because it is terribly dispiriting for socially responsible business people to work hard in a sincere effort to make self-regulation work, only to have the press and the community treat their efforts with the same contempt that is heaped on the crooks of the industry.

There is a problem of demagoguery among environmentalists who cultivate political correctness by denouncing business regardless of the amount of effort they are putting into environmental auditing (*see* Gunningham, p. 142 of this volume) and cleaning up their act. Yet right-wing business ideologues who say that public interest groups are the cause of anti-business attitudes in the community are wide of the mark. The public interest groups are followers, not leaders, of community opinion against business. It is negative encounters that citizens have directly

experienced with business that have caused this cynicism. Business should give some credit to consumer and environmental activists who will stand up publicly and congratulate a company for cleaning up its act. This is not the best way for activists to maximise their public profile and cultivate community support. Activists must choose responsibly between maximum public profile and maximum effectiveness in encouraging business and government to become more effective in cleaning up the environment and protecting consumers. Maximum effectiveness comes from giving credit to business where credit is due.

Self-regulation schemes often fail, probably even more often than government-regulatory schemes. Self-regulation is frequently an attempt to deceive the public into believing in the responsibility of a irresponsible industry. Sometimes it is a strategy to give the government an excuse for not doing its job. Equally, however, sometimes it does work better than government regulation because the industry is more committed to it and because it is more flexible than the law. When this is the case, it is the public interest campaigners who are identified in the public mind as responsible for exposing the abuses that the self-regulation scheme is designed to address who are uniquely placed to persuade a cynical public that the scheme is an improvement for which the industry deserves credit.

While public interest groups deserve criticism for sometimes choosing to pander to anti-business feeling in preference to getting runs on the board, they deserve credit for being more constructive in their relationship with business than they would be if their only concern were to maximise their community support. This leads to the key issue for moving toward more cost-effective regulation in Australia. What is needed is the cultivation of mutual respect among the key constituencies in any arena of regulation. This means each side giving credit when credit is due to the other. It means business giving credit to advocacy groups that pass up a golden opportunity to take a cheap shot against an organisation that is sincerely trying to improve its regulatory performance. It means advocacy groups giving credit to industry and governments when they accomplish regulatory improvements. It also means respecting the obligation of the other to engage in public criticism of one's performance when it is in fact sloppy. The stakes are too high with questions of business regulation for anyone to expect or demand that the community be cut out of a robust public debate on regulatory standards. A regulatory culture where neither punches nor pats on the back are pulled is what a healthy democracy should aspire to.

When such a culture is achieved, what we can have is a policy space where mutually respecting interest groups really talk to each other about their concerns. Then genuinely creative ways of constituting win-win solutions to the regulatory game can be explored. In Australia, we have a long way to go before reaching such a pass. On the other hand, there is much more of the makings of such a constructive regulatory culture in

Australia than in many other countries. There exists in Australian regulatory communities a kernel of mutual respect and fair play that can be nurtured.

Beyond Entrenched Positions

We have seen that regulatory legalists, deregulatory rationalists and knee-jerk opponents to self-regulation suffer from different types of myopia. The formula for a disastrous regulatory order is gladiatorial battle among protagonists who 'stick to their guns' in defending the purity of these positions. There are three risky outcomes from such battles. One is that the different protagonists win some and lose some, so the community puts up with living with one myopia in this area, another myopia in that. Worse still, regulatory policy oscillates between the ascendancy of one myopia and then another. A third disastrous outcome arises where there are two coherent policy packages on offer—ABCD and WXYZ. One constituency lobbies for the first because it likes features A and B of this package. Another constituency lobbies for the second because it likes Y and Z. The politicians then attempt to give everyone what they want by opting for a policy package ABYZ. Unlike the original two policy packages, ABYZ turns out to be totally incoherent. For example, A and Z are mutually contradictory: the purpose of A is defeated when it is put together with Z.

Dialogue between the competing constituencies is what is required to avert such disastrous outcomes. We need, in other words, regulatory institutions which get the conflicting parties around the negotiating table explaining to each other that while A is a preferred option, it is useless in combination with Z; if they have to have Z, X becomes a better option than A. The beauty of dialogue is that it can iterate toward a win-win solution or at least away from a lose-lose solution.

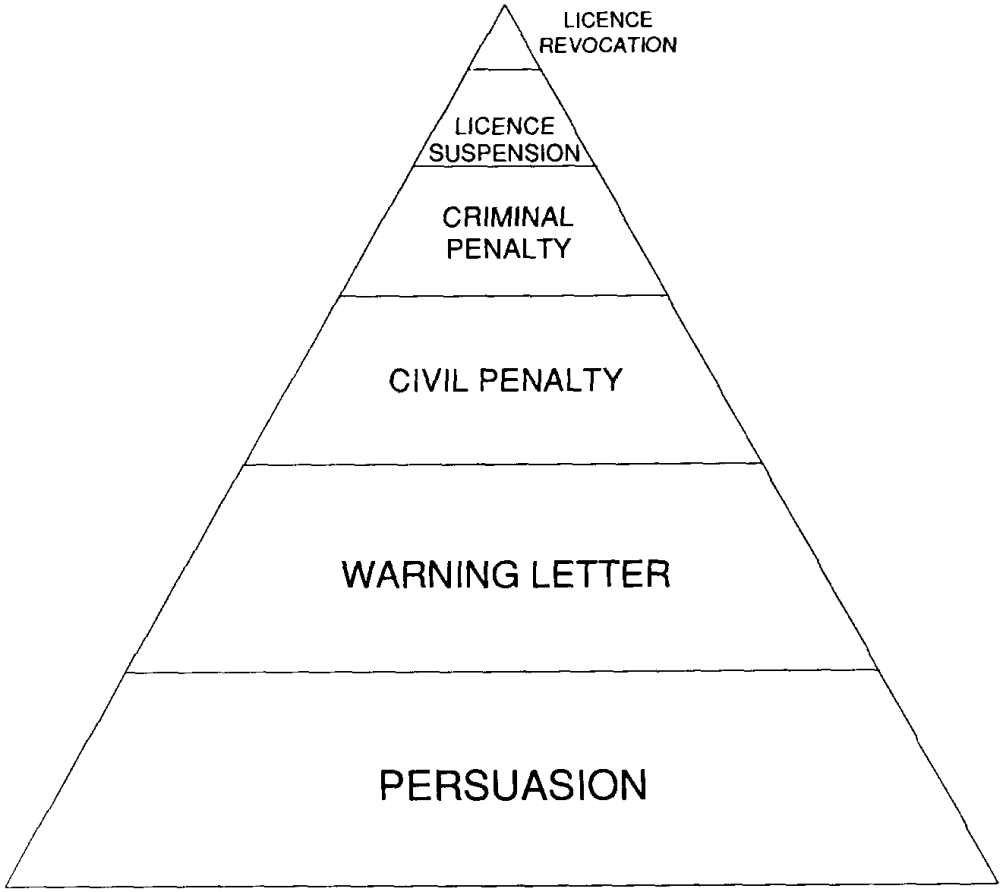
While the regulatory legalists, deregulatory rationalists and knee-jerk opponents to self-regulation all promote myopic positions, lying behind each position is a legitimate concern that should be weighed in any regulatory deliberation. The proper concern of the regulatory legalist is to protect the institutional integrity of the rule of law, to protect rights and justice. The legitimate concern of the deregulatory rationalist is economic efficiency. The reasonable concern of the knee-jerk opponent to self-regulation is suspicion that trust will be abused. Dialogue among these parties is needed to enable each to come to an understanding of the legitimacy of the concerns of the other.

Ian Ayres and I recently completed a book in which we argue that once we establish a dialogic regulatory culture, a variety of responsive regulatory solutions can be crafted that shatter the divide between the proponents of regulation and deregulation (Ayres & Braithwaite 1992). By responsive regulatory institutions, we mean, among other things, responsiveness to how responsibly others are playing the game. Our hope

is that in a dialogic regulatory process, deregulatory rationalists might engage opponents of self-regulation by saying, for example: 'This self-regulatory regime can be conducted with twice the flexibility and half the cost of government regulation. But we understand your concern that the self-regulatory standards will be unenforceable and ignored. Therefore, we propose to respond to your doubts by (a) supporting representation of your organisation on the self-regulatory body that makes enforcement decisions if you want it, and (b) agreeing on performance indicators for the self-regulatory program that are transparent and easily monitored by you, so that (c) if the self-regulation scheme does not meet those performance indicators, we will agree to support your advocacy of a shift to a governmental regulatory scheme.'

In a dialogic regulatory culture, we suggest that the participants will talk to each other in terms of regulatory pyramids. Figure 2 is an example of a regulatory pyramid. The presumption is that participants, the most important of which is the state, will accept that self-regulation is a preferred mode of regulation, but only if it can be made to work. Because it cannot be trusted to work, regulatory institutions should be designed to build in incentives for it to work. Incentives for effective self-regulation come from other players (the state, the environmental movement) signalling to the industry that they will press for an escalation of regulatory intervention up the pyramid if self-regulation is not implemented with energy and with results. What are the different stages that one escalates through is no great concern here. They will be quite different in different regulatory arenas. The important thing is that there be signalling to the industry of a commitment to escalate regulatory intervention whenever lower levels of intervention fail. This signalling gives the industry an incentive to make regulation work at lower levels of intervention.

Figure 2: Example of an enforcement pyramind. The proportion of space at each layer represents the proportion of enforcement activity at that level



The key to cost-effective regulation is this kind of mutual signalling in a regulatory culture where punches are not pulled, but nor are congratulations for voluntary goal attainment. Public interest groups and the state signal that if the industry is sincere, self-regulation will be given a chance. There will be no knee-jerk opposition to self-regulation. At the same time, the state and the industry signal to the public interest group that their reward for cooperation with giving self-regulation a try is an assurance that documented self-regulatory failure will be responded to with escalating state regulation.

There are some interesting paradoxes for all the players when regulatory pyramids are being displayed. John Braithwaite believes that as a general proposition government regulation of pharmaceuticals' promotion is likely to be more cost-effective than self-regulation. Yet by propounding this belief as he enters a regulatory negotiation in which he grudgingly accepts that the industry should be allowed a three-year trial of self-regulation, he maximises the chances of his general belief being proved wrong.

An industry lobbyist wants to avoid a regulatory regime where draconian penalties like corporate capital punishment (licence revocation) are imposed on law-breakers. The best way to achieve this objective may be to accept the terms of a regulatory pyramid that includes escalation to corporate capital punishment and throwing executives in gaol if regimes based on lower levels of intervention fail. This is because the way to get the government and public interest groups to agree to self-regulation may be to accept dire forms of escalation should self-regulation fail. This is the paradox of the pyramid. Lop the top off the pyramid and one might destroy the capacity of the pyramid to channel the regulatory action down to the cooperative base of the pyramid.

There is no standard or optimal pyramid advanced here as providing a simple model for solving all our regulatory problems. Standard answers will lead us astray when we are dealing with the regulation of changing technologies and an international economy in constant flux. The pyramid is just an example of an aid to thinking more interactively, responsively, dialogically about the solving of regulatory problems. Other examples are provided in our book (Ayres & Braithwaite 1992). The important conclusion is about the need to move our regulatory institutions away from the simplistic and mechanistic models of economic rationalism, legalism and government command and control. This means genuine empowerment of all the stakeholders in a regulatory dialogue where each stakeholder comes to understand the concerns of the other and stands ready to respond positively to them so long as their own concerns are responded to positively by others.

Only then will creative, workable, economically efficient Australian solutions to Australian regulatory problems be devised. For too long, Australia has allowed itself to be buffeted back and forth by the pre-packaged regulatory and deregulatory solutions fashioned in the US and England. Our national interest is in a fair-minded dialogue to find our own ways of transcending the sterile debate between regulation and deregulation. However, we suffer from being a culture that expects an easy fix and an unpressured life. For business, this means state nurturance of an orderly market where competition is not allowed to have overly destructive effects. For public interest groups, this means the comforting illusion that governments actually solve problems by writing laws. Nevertheless, it might be that we have a culture with sufficient elements of fair play and pragmatism to fashion win-win solutions better than others. The alternative is to allow our economic and environmental futures to slide from under us as we see-saw between deregulation and re-regulation, forever pushing up and down, never settling on a direction for moving forward.

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Chapter Seven

The Role of Regulatory Enforcement in the Australian Economy

Eric Mayer

This paper discusses an economic perspective on the role of regulation in Australia. Regulation itself is a tool—to achieve social, political and economic objectives which cannot be delivered by the market system of resource allocation.

There is a balance to be struck, between giving markets free rein and safeguarding the public interest. Often we try to strike this balance using a 'carrot and stick' approach. However unless regulators have a very deep understanding of the activities or businesses to be regulated, they will get it at least partly wrong. To put it simply, a carrot and stick will not do the job if you do not know which way the donkey should be facing.

Regulation by an external body, like a government, is therefore an exercise which entails some risk. The risk is that regulation will not hit the mark and will be counter-productive. There is also a real risk that the courts will interpret legislation narrowly, which can defeat the original purpose. Indeed, it is rare to see the common law upholding the spirit of legislation when the wording can be interpreted more narrowly. The courts' interpretation of the section 128 insider trading provisions is a case in point—it is virtually impossible to have offenders convicted.

These kind of risks give rise to higher costs for the consumer. Regulation which is not properly targeted can cause companies to incur administrative and compliance costs for limited public benefit. Similarly, literal interpretation of the law is costly in terms of litigation, despite the fact that the letter of the law does not always effect the most just outcomes.

Even when the spirit of the law is implemented, litigation may not be a viable option. Graham McDonald, the Banking Ombudsman, has pointed out that the high cost, procedural complexity and delay involved in litigation, as well as the inequality of resources available to the individual

customer against those available to a bank, have made access to the courts largely illusory for ordinary citizens seeking redress against banks (Australian Banking Industry Ombudsman Limited 1991).

Market Failure

The need for some degree of regulation is something we must all take as given, because not everyone is honest or altruistic and because markets do not always work, nor do they always work in a time-scale which is practicable.

There are many examples of market failure. One occurs when the community is faced with the problem of pricing non-traded goods and services—like the environment. The basic problem society faces in coming to terms with environment protection is that we do not know how to measure the benefits, economic and social, of our natural assets. So whether or not a new mine in an environmentally sensitive area should go ahead or not is not a decision only for the marketplace—there has to be an *assessment* made of how the economic benefits of the proposed mine in terms of job creation, growth and the flow-on effects to other industries compare with any social and environmental costs which may result; for example pollution, loss of biodiversity and land degradation. If the benefits exceed the costs, the mine should go ahead, but since the marketplace does not have any mechanisms to determine what the acceptable trade-offs are between environment protection and economic development in this situation, governments have to step in and lend a helping hand. In the absence of acceptable and generally accepted criteria for a cost/benefit analysis it is likely that political considerations will outweigh other considerations.

Public goods and services highlight another type of market failure. An educated, healthy, peaceful society is something that we all value being part of. Something like law and order is the source of collective benefit once it is provided. The problem is that the market does not make sure that it is collectively funded. The individual does not gain enough benefit from the existence of a police force to want to pay for its upkeep single-handedly, yet there is no market mechanism to ensure that law and order is funded collectively. It is up to the government to step in and levy taxes for funding these activities.

Thirdly, the marketplace does not deal satisfactorily with the issue of poverty. There is nothing to stop people starving if, for any reason, they are without an income stream. This is where most governments come in, with a social security 'safety net'.

There are other problems which markets cannot deal with efficiently, like poor information, poorly defined property rights and firms or individuals with too much market power. In other words, there is plenty of scope for regulatory solutions.

The Regulatory Alternatives

Given the need for regulation, however, it does not necessarily follow that government regulation is the only alternative. It does not really matter who does the regulating, or what form the regulation takes, so long as it has the desired effect. In the context of the Australian economy, that means achieving society's objectives in the most efficient way.

Governments certainly play a valuable role in the regulation of markets, but there's no rule that says 'governments only'. The most efficient economic and social outcomes are not always achieved through direct government regulation. For any industry or activity requiring regulation, there needs to be a cost-benefit analysis of government regulation versus self-regulation, as well as different kinds of co-regulation.

Having alluded to some of the problems that arise when governments do the regulating, let us now run through some of the alternatives.

Regulatory policy alternatives

The issue of the environment is a good example because this is an area where many countries are experimenting with different kinds of regulation. The Industry Commission has identified a range of policy instruments for protecting the environment. These range from social pressure against harmful activities, through command and control mechanisms like government regulations or specifications, to market-based instruments like taxes, charges and tradeable permits, to the reallocation of property rights and government provision of facilities and information (Industry Commission 1991). The diversity of policy instruments is illustrated by the following examples:

Examples of command & control policy instruments:

- Regulations preventing specified uses of resources;
- Regulations limiting the permissible levels of pollutants, or the permissible level of use or extraction of resources;
- Specification of mandatory processes or equipment;
- Regulations preventing certain activities and sale of certain goods;
- Specification of the use and/or disposal of certain types of materials.

Economic instruments:

- Taxes and charges based on environmental damage and emissions of pollutants (for example, effluent charges);

- Taxes or tax exemptions on goods and services to influence demand (for example, product charges);
- Charges to cover costs of provision of services (user charges) and administration;
- Subsidies and taxation allowances based on reductions in emissions or the use of more environmentally friendly equipment;
- Refundable deposits;
- Rehabilitation and performance bonds;
- Tradeable permits and licences.

(Source: Industry Commission 1991)

Command-and-control regulatory interventions have been the norm. But some economic instruments have been and are used in a number of countries (OECD 1989).

For example in the USA, an approach of regulatory intervention failed to control acid rain emissions, but marketable permits for emissions have been very effective. In addition, the cost savings attributable to the implementation of a tradeable permit scheme, as opposed to command-and-control instruments, have been put at US$3 billion annually (Hahn & Stavins 1990).

In contrast, there is a total ban on forestry in our World Heritage areas, and that seems to be the most effective and politically acceptable approach to regulating environmental impacts, provided that the World Heritage areas have been properly defined.

Sustainable development is a complex issue, and will not be discussed in any great depth here, but it is important to stress that different activities may be most efficiently regulated by different policy instruments.

It is clear that the circumstances of particular cases will determine whether a command-and-control technique, an economic instrument or a pure market approach is appropriate (Industry Commission 1991).

This also applies to other activities. Years of negotiation and compromise by members of the European Community (EC) have proven the difficulties of harmonising insurance regulations of different countries. The EC insurance directives do not provide for uniform standards of regulation of supra-national regulatory authority for the EC.

How do we Decide which Policy Instruments are Appropriate?

Self-regulation

There is a deceptively simple point: for the chosen activity, which kind of regulation will achieve the desired objectives at least cost?

Governments and industry as a whole are expressing greater interest in self-regulation. In 1988 the Trade Practices Commission surveyed self-regulatory schemes in 12 industries and professions, to explore their role and evaluate their contribution to industry efficiency and public benefit. The Commission found evidence of considerable scope for self-regulation to contribute to an optimal cost-benefit solution (Trade Practices Commission 1988).

Experience with self-regulation in Australia has shown that it can deliver a range of benefits, including higher ethical standards of conduct, enhanced business efficiency and overall consumer benefit (Trade Practices Commission 1988, p. 1).

Self-regulation can be defined as the adoption of codes of practice which embody the mutual obligations of competing members of an industry or profession. These obligations are generally designed to complement federal and state regulations.

Industry associations have a pivotal role to play in the self-regulation process. They are in an ideal position to know which operations need to be regulated; and also to pinpoint where regulatory pressure should be targeted for maximum effect. In addition, peer pressure is a powerful weapon if it can be harnessed properly and used to promote compliant conduct. Certainly in my experience, many members of the business community have always valued their ethical conduct. Since the 1980s some that were outside this category have become more concerned about the social and financial stigma attached to unethical conduct.

Nevertheless, self-regulation itself is not without disadvantage. It can be difficult for an industry association to enforce regulations against members. For a start, expulsion might not pose much of a threat if membership of the industry organisation is not compulsory and/or not a prerequisite for legal accreditation.

In Germany, membership of local chambers of commerce is compulsory, which is one way to solve the problem. These operate under the umbrella of the Deutscher Industrie und Handelstag, whose function is to advise member and foreign companies in the locality or region on a wide range of matters which could include structural as well as legal problems. However, that kind of approach simply substitutes one problem (inflexibility) for another and is not advocated here.

Secondly, even if a company or an individual does require accreditation by its industry association in order to practice (for example, doctors and the Australian Medical Association), there is always a risk that expulsion from the association, or any other income-affecting action by

the association against someone who violates the industry code, will expose the association to litigation brought by the injured party.

As it happens, industry associations will generally resort to expulsion only as a last resort. Part of the reason is because industry associations have many purposes not associated with self-regulation. They are also funded by their members.

From the company perspective, regulations which do not have the force of law and are administered by industry organisations can present something of a dilemma. The fact is that directors' duties, which are becoming steadily more and more onerous, are duties primarily to the shareholders. Ordinarily this does not pose an ethical problem. However, directors can be faced with conflicting duties. They have a legal duty to act in shareholders' best interests and pursue opportunities for profit which can sometimes conflict with a standard of conduct expected by society generally.

These are significant issues and only serve to underline the fact that self-regulation must operate within a legal framework, and that it must have 'teeth'. Self-regulation can only be effective in the right legal environment.

The Legislative Framework for Self-Regulation

What kind of framework is being advocated? Clearly, industry associations such as the Life Insurance Federation of Australia would need to be able both to encourage and to exert powerful pressure on members to comply with industry codes and initiatives.

Compulsory membership is not the solution. From an economic efficiency point of view, as much flexibility as possible should be enshrined in the marketplace. Preferably, there should be a more formal and publicised system of name accreditation of members. This would enable companies to 'opt out' of the system, should they choose to do so, but without sufficient credibility to disrupt the regulatory achievements of industry at large.

Dispute-settling mechanisms are a very necessary part of dealing with market failure. The life insurance industry has tackled this issue in a positive way. Last year the Life Insurance Federation of Australia established a 'Fast Track' system for handling policyholder inquiries and complaints which are not solved at the life insurance company level.

It is a four-tiered system of self-regulation following discussions with the regulators—the Insurance and Superannuation Commission and the Minister for Justice and Consumer Affairs. The new system is on a 12-month trial period. At the end of 12 months, the Federal Government will decide whether legislation is required, or whether self-regulation is just as effective.

The system has four aspects:

- an upgraded complaints service, which will not only address the enquiries and complaints of policyholders, but will alert the Federation to any 'hot-spots' in customer relations. It will also notify individual member companies of products and services attracting complaints, nationally and state by state;

- a Code of Industry Practice: this prescribes minimum standards of conduct which members of the Federation have agreed to adopt when dealing with policyholder inquiries and complaints;

- a Complaints Review Committee, consisting of an independent chairperson and a representative of consumers and a representative of the life insurance industry;

- the Insurance Industry Complaints Council—to oversee the operation of the Complaints Review Committee and to make sure it retains its integrity and independence.

So far, it looks like the system is working. In the end there are always the courts, but as the Banking Ombudsman said, this is not always a viable option for consumers. Such institutions as the Small Claims Tribunal, the Ombudsperson and the Life Insurance Federation of Australia's system are generally more accessible to consumers than the courts. Nevertheless, there's no point having a referee if no-one knows about the referee. Dispute-settling mechanisms can only be effective if there is public and customer awareness, both of the processes and their intentions.

Public attitudes and acceptance are also important. Without public support for legally unenforceable dispute-settling mechanisms, there can be no authority to make decisions. And there will be no peer pressure to abide by the decisions made.

Regulatory Developments in Insurance and Superannuation

There have been other recent developments in the regulation of the insurance and superannuation industries.

The legal framework for the insurance and superannuation sectors was strengthened in the 1990-91 financial year. Minimum capital requirements were increased, and the supervisory powers of the Insurance and Superannuation Commission were enhanced. There is no doubt that these measures were partly in response to the perceived crisis in financial markets, and the difficulties experienced by Regal Life and Occidental Life.

With Australia's pool of superannuation funds growing at an astounding rate, the government's regulatory objectives are changing. The standard line now goes that because of the tax concessions provided to superannuation, the industry has an obligation to invest savings for the well-being of the nation, not just policyholders.

Investing in the best interests of policyholders results in investments that are in the long-term best interests of Australians generally. However, even if it is wrong we should distinguish between regulation to avoid bad practices and regulation designed to enforce a particular point of view.

Australia's Path

There are already a number of legal checks and balances in place in Australia's insurance industry, but the spectre of further government regulation is having an effect.

If we look at the regulatory situation of the insurance industry in other countries, Australia is relatively under-regulated. The leader in the range and complexity of regulation is the US, where regulation varies state by state, followed by the UK and other European countries (Brend 1990).

Our comparative situation is the same in Asia, as shown in Table 1. Hong Kong is the only insurance market less regulated than ours (although in the table it is shown as being the same).

Table 1: Stringency of Life Insurance Regulation by Nation

	Entry	Regulation
Australia	***	***
Japan	**	**
Singapore	**	***
Hong Kong	***	***
Taiwan	*	***
South Korea	*	*
Malaysia	*	*
Thailand	*	**
Philippines	*	*
Indonesia	**	**

Source: National Mutual

In Japan the Ministry of Finance has the power to order an insurance company to change its methods of operations, to deposit its assets, or comply with any other supervisory orders which the Minister considers necessary. Should a company contravene the law, the Minister can order

that company to dismiss the responsible directors or auditors or to suspend business activities. A 'poorly managed' insurance company or a company in difficulties can be ordered to amalgamate with another company; the Minister can also entrust the management of its business and assets to another company, or transfer its portfolio to another company.

There is plenty of scope to 'catch up' in this area if we really want to.

International Competitiveness

Probably a better and more rational focus for international comparisons of regulation is Australia's competitiveness. Our industries are being urged to become internationally competitive, but as has been demonstrated, even self-regulation needs to operate within a legal framework. How competitive is Australia's legal framework in achieving our objectives? How efficient are our regulatory arrangements?

Governments demand that self-regulation operates efficiently, or legislation will be introduced. But governments have to be competitive too.

Industry consultation is an important contributor to efficient legislation. It can help avert some of the problems inherent in regulation by external parties, by allowing governments a greater insight into the activities they wish to influence.

Government regulation in countries like Japan and Germany seems to be more of a cooperative effort between governments, industry and other groups, more of a working partnership.

That is the real opportunity for efficient regulation - industry must work with governments, whether setting up legislation or the framework for self-regulation. The growing interest in self-regulation is welcome: not because it is always appropriate, but because it ought to be considered.

The major achievement which industries and governments need to pursue wholeheartedly is the recognition of what industry has to offer the regulatory process. There is a definite synergy about industry-government cooperation which enhances the efficiency and effectiveness of any regulatory framework. Industry self-regulation supported by appropriate legislation will work best in an environment where there is good public understanding of the process.

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Chapter Eight

Self-Regulation and the Australian Stock Exchange

Ray Schoer

This chapter will address the topic of self-regulation and the Australian Stock Exchange. As a preamble, it is worthwhile referring briefly to the history of regulation of the Australian securities industry.

Historical Perspective

For 100 years the six state capital city stock exchanges regulated the market and their members without the benefit of legislative backing and largely without government oversight. That changed following the 1969-70 share market boom and bust, the report of the Rae Committee (Senate Select Committee on Securities and Exchange 1974) on the excesses of that boom, and introduction by some states in the early 1970s of securities industry legislation.

In 1980 the six states and the Federal Government set up the National Companies and Securities Commission (NCSC) with its attendant national companies, securities industry and takeovers codes. The NCSC took a hands-on approach to the regulation of the securities industry in what was called coregulation.

In 1987 the Australian Stock Exchange was formed by an amalgamation of the six stock exchanges. In 1990 the Federal Government enacted the corporations law and set up the Australian Securities Commission (ASC).

In the two decades since the boom and bust of 1969-70 we have seen more and more government intervention in the regulation of the securities industry, including the current proposals by the companies and securities advisory committee to legislate some of the stock exchange listing rules into black letter law.

What then is the Future of Regulation of the Securities Industry?

Since the crash of 1987 there have been many revelations of the greed and excesses of the 1980s. There have been enquiries/investigations/royal commissions by governments, the ASC and administrators of failed companies. There has been a call by many, encouraged by the media, for more black letter law to deal with the miscreants and to put in place rules to prevent future crashes and rorts.

In his news release on 13 February 1992 when releasing many pages of proposed new legislation, the Attorney-General, Mr Michael Duffy, said:

> The Bill .. . is a major element in the government's ongoing response to the corporate excesses of the 1980s.
>
> The aim of this legislation is to redress deficiencies in the law which contributed to those excesses, and to give companies the efficient and effective laws they need to get on with doing business in Australia.

The Attorney-General went on to say that:

> We need to put in place laws to ensure that the damage to our national reputation resulting from those collapses is never repeated.

If only that was possible. If only we could legislate away the gullibility of investors and financiers, and dishonest and irresponsible conduct.

As early as the beginning of the 18th century, Defoe, observing the delusion of crowds, wrote:

> Some in clandestine companies combine, erect new stocks to trade beyond the line, with air and empty names beguile the town and raise new credits first, then cry them down, divide the empty nothing into shares and set the crowd together by the ears.

For as long as there are easy credit and people to beguile, there will be promoters of empty names and crowds to trade them. Nothing the stock exchange nor the government can do will prevent it. Over the last two decades the rule books, laws and regulations have exploded in size and complexity. Harsher and harsher penalties have been introduced and yet the behaviour of some has worsened, seemingly in inverse proportion to those well-intentioned measures.

The more complex the law, the more it creates signposts to guide those who want to find their way through the legal restrictions and confound and confuse those who have to investigate and enforce the law, including the courts.

It is worth noting the recent comments on the Corporations Law by the Chief Justice of the High Court. He described the Corporations Law as incomprehensible and is reported to have said:

> The vast magnitude of our corporations legislation is a wonder to behold. Its Byzantine complexity is a testimony to the subtlety of mind of those who brought it into existence (Mason 1991).

He said that there was an over-emphasis on the need for detailed regulation and that the remedy may be as discouraging as the malady itself. Importantly, His Honour noted that:

> Complexity, inconvenience, delay and high costs, so often the targets of media criticism, may indicate that our approach to legal regulation and enforcement requires overhaul.

The future of cost-effective regulation does not lie exclusively in trying to enforce black letter law; over-emphasis on detailed legislation does not adequately address the real problems we are facing and business is struggling under the burden of complex and often ineffective and unnecessary regulation.

Every time we have a cyclical boom in the market some people will find flaws and loopholes in whatever is the current law. They will be assisted by the best legal, accounting and other professional advice money can buy. The law will be hurriedly amended—often opening more loopholes in the process—and ultimately the boom will bust. Then we will have great soul-searching, an extensive overhaul of the law and introduction of new restrictions or prohibitions on honest commerce to stop what happened last time happening again, and we wait for the cycle to repeat itself.

The trouble is that the next cycle is never the same as the last. Each presents new opportunities to get-rich-quick operators, and new scams are worked out that were not foreseen in the last overhaul of the law. The new law is almost always more complex than the last, and therefore more difficult to understand and enforce.

And so the dog of corporate law chases its tail round and round in circles. Just occasionally it makes an extra lunge and manages to get its tail in its mouth, only to discover that it is toothless.

We must do something to break this cycle of ever increasing complex and unnecessary legislation or we will legislate our securities industry out of business.

Self-Regulation and the Australian Stock Exchange (ASX)

There is no such thing as 'the legislative fix'. While a legislative framework in which the securities industry must operate is desirable, it is only through good business ethics and practices that the integrity of the market can be maintained. Those ethics are applied in the securities industry by imposing on oneself the rules and restrictions of the public market, that is through self-regulation.

Self-regulation has a number of advantages over black letter law.

- One of the most important is the nature of the relationship.

  A stockbroker or a listed company, for example, voluntarily complies with the rules of the ASX because that is the price of participation in the market. If the rules are too onerous, or change in some undesirable way, a participant is free to withdraw. If enough participants withdraw or the stock exchange is perceived as not fulfilling its purpose, it would not be long before an alternative market was established with rules that are more acceptable to the market.

  A consequence of this more or less voluntary submission to regulation is that the regulations themselves do not have to cover every fine point of detail, or try to close every possible loophole, as black letter law does. Rather, self-regulatory rules can be expressions of general principles.

- Another characteristic of self-regulatory organisations is that they tend to be market-driven and competitive. As a result their rules are more flexible and responsive to the needs of the market. Self-regulatory organisations can bring to the regulatory task the deep knowledge of and expertise in the business they are regulating, and thus can regulate in a way that is least disruptive to the efficiency of the market they are regulating.

- Because they are competitive, self-regulatory organisations must be conscious of the costs of regulation—not only to themselves but, in the case of stock markets to investors, issuers and users of the market.

- Self-regulatory organisations are able to react quickly to changing circumstances which, in a dynamic industry, is an important attribute.

- One characteristic of self-regulation that probably counts on the negative side is that, to be effective, it requires a more conscious

> effort on the part of the self-regulatory organisation to enforce its rules than it does on a government enforcement agency to enforce black letter law. In this regard, it could be said that the exchange was rather lax during the 1980s in taking action against companies which breached the listing rules. That is no longer the case and the ASX is spending around $5 million a year on enforcement of its rules.

The ASX regards surveillance of the market as an essential element in achieving its objectives of ensuring that the market is fair and efficient and of good repute. Its market surveillance department monitors the market using a sophisticated computer program called 'SOMA' (surveillance of market activity).

'SOMA' alerts ASX when there is an occurrence in the trading of a security that is outside pre-set values of any of a number of parameters. In addition, the ASX has developed a computer program called 'SEATSCAM' which allows it to replay the whole market in a stock at a sufficient pace to allow an analyst to examine in detail the trading that has occurred.

In addition to detecting breaches of the listing and business rules, the outcome from surveillance activities has included evidence of insider trading, breaches of duty by company officers and examples of warehousing by intermediaries. In parallel with this greater emphasis on enforcement, ASX has devoted considerable effort to improving the rules themselves, to fulfil the ASX primary regulatory role of ensuring a fair, efficient and well-informed market.

One of the principles underlying the listing rules is the regulatory principle which requires that every listed entity must operate to the highest standards of integrity, accountability and responsibility. It requires the adoption of practices which protect the interests of holders of securities, including ownership interests and the right to vote, and that holders of securities must be consulted on matters of significance.

Self-regulation is of little use unless the rules can be enforced. For listing rules the following are the range of enforcement possibilities:

- moral suasion;
- public and private enquiries of listed entities;
- issue of press releases;
- suspensions; and
- delisting.

Under the Corporations Law it is open to the ASX to seek court orders to enforce its listing rules. Neither ASX nor its predecessor exchanges have sought court orders. The major problem in taking court action is liability for damages in the event that the action is unsuccessful. We have, however, been prepared to defend our position in court in several recent cases—Adsteam and Enterprise Gold for example.

ASX has asked that the Corporations Law be amended to provide that where ASX makes application to the court for an order in respect of enforcement of the listing rules, the court should not require ASX to give any undertakings as to damages and that ASX should not be liable for any action or damages in relation to any proceedings it takes.

Regulation of broker members of ASX ('stock brokers') is governed by the provisions of the articles and business rules of the exchange which deal with the following issues:

- membership

  The rules relating to becoming a member and which apply to the business of a member, require professional indemnity insurance and ensure that members have the appropriate qualifications to conduct the stock broking business.

- client relations

  The rules which regulate brokers acting as principal, operating discretionary accounts, issuance of contract notes, acting for an offerer in a takeover, and the supply of information to the exchange.

- dealing

  The rules which regulate arbitraging, dealing in securities before they are quoted, excessive transactions, fictitious transactions, forward delivery transactions, entering into put and call options, reporting of transactions, shortselling, and dealing in the securities of suspended companies.

- delivery and settlement

  The rules which deal with the mechanics of delivery and settlement of transactions entered into by ASX members.

- accounts and surveillance

  The rules which set out the capital liquidity requirements for stockbrokers, accounts and records to be kept, the surveillance, inspection and investigation of members, and the information to be

given by the member to the exchange in respect of the conduct of their business.

The articles of association provide for disciplinary action in respect of the violation of articles or rules of the exchange. If a breach occurs, the exchange may

- censure the member;
- impose a fine not exceeding $25,000;
- suspend the member from the privileges of membership or prohibit the member from transacting any business for a period not exceeding three months upon such terms and conditions as may be required.

In addition, a member can be charged with 'prohibited conduct' which is conduct that is not efficient, honest or fair or is otherwise conduct prejudicial to the interests of the exchange or its members. In addition to the sanctions just mentioned, the exchange may also expel the member for such conduct.

In June 1991, the ASX released for public discussion a set of principles and code of conduct for stockbrokers. These principles and code of conduct are at the heart of the self-regulatory role of the exchange. They are an 'overlay' to the articles and business rules and spell out the high standards of integrity, efficiency and fairness required of all members of the ASX. The code of conduct elaborates on the requirements for dealings with clients, their operations in the market and the conduct of their businesses. The principles and code of conduct conform to the recommendations of the International Organisation of Securities Commissions and are an important element in ensuring that the Australian market is internationally competitive.

The Future of Self-Regulation

The future of self-regulation by the ASX will be affected by the general debate on self-regulation versus black letter law.

There are three broad approaches to making people behave in ways that the community regards as desirable. You can regulate them, you can induce them to submit to self-regulation, or you can rely on social imposition of ethical standards.

There are the same number of reasons why we should use self-regulation, but not exclusively, for the control of corporate behaviour. The first is that regulation through legislation does not work in all situations. The second is that pressure for ethical conformity may have worked once,

but largely does not work any more. The third is that self-regulation can work and is working now.

This may seem to be a slight over-simplification, so let us elaborate on the three approaches.

- Governments have been trying to regulate the activities of corporations since the collapse of the South Sea Bubble Company. While they have had notable successes, they have also had notable failures.

  One view is that legislation merely adds to complexity which leads to sustained effort to find loopholes in the law. The constant cycle of the regulated finding loopholes which are closed by the regulators leads to very complex laws and one does not have to go past the corporations law for an illustration. Unfortunately, the regulated find such laws all but impossible to understand (notwithstanding plain English), while the regulators find that it is very difficult to enforce such laws through the courts and an impossibility to foresee every loophole and close it in advance. This leads to the perception that the government is always shutting the 'stable door after the horse has bolted'.

  An alternative hypothesis to the legislative approach was argued by Peter Robinson in the *Australian Financial Review* last year. In essence, his case was that the law in general, and corporations law in particular, was bound to fail in any free, self-governing society. He argued that the law must remain a bulwark against unacceptable behaviour, not a weapon of retribution against those who find ways of behaving unacceptably and getting away with it. It is therefore not going to punish all those whom we might feel should be punished. Robinson suggested that while it would be feasible to equip the Australian Securities Commission with sufficient power to put a stop to all financial wrongdoing overnight, few Australians would be willing to accept the consequences of a government agency having the amount of power that would be required.

- Another approach is the imposition by society of ethical standards. However, while this may have worked in the past, it does not any longer. This is obvious from recent events. Social pressures for ethical behaviour are no longer as effective a deterrent as they used to be.

- That leaves self-regulation. It is only if the government regulators and the self-regulators work closely together, each supporting the

other, that it will be possible to avoid the failures of the past repeating themselves in the future.

It is the characteristic of self-regulation that the rules involved are general and expressed more as principles, rather than as black letter law. Thus, there should be fewer loopholes and the rules should be able to be changed quickly to meet emerging situations in the needs of the market. Normally self-regulatory rules impose a higher standard of behaviour than the law, because the law is a minimum standard.

Finally, it should be mentioned that the effects of globalisation and internationalisation of securities markets on regulation is such that it is imperative that Australia maintain the flexibility provided by self-regulation to ensure that the Australian market continues to prosper and develop, so as to provide the required services to Australian companies and investors.

This paper began by trying to bury black letter law. Hopefully, it has at least been demonstrated that it is not adequate on its own but requires the enforcers of black letter law and the self-regulators working side by side and supporting each other's efforts.

There will be another stock market boom and when it comes there will be people trying to exploit every opportunity to make illicit profits. The lesson of history is that they cannot be entirely prevented, but the future of regulatory enforcement in Australia should be directed towards containing their activities to the minimum. This will only be achieved if self-regulation has a significant role.

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Chapter Nine

Thinking about Regulatory Mix¾ Companies and Securities, Tax and Trade Practices

Robert Baxt

For there to be a future for regulation in this country there is a very real need for regulators to enforce the law. Failure to do so will provide idle speculation that they have been captured by their specific industries (more likely in the case of industry specific regulation), or certain influential sections of them. The public is entitled to expect that their tax money, which is after all the basis of the funding of these agencies, is being properly expended in the pursuit of the aims of the relevant legislation the agencies are responsible for and which has been voted to them by the Parliament (Senate Hansard, 15 October 1991, pp. 2010-22).

But, regrettably, through a combination of inadequate laws, or laws which are 'poorly' drafted, unrealistic penalties to fit 'the crime', inappropriate courts to adjudicate on some of the major issues, grossly inadequate funding of agencies and courts, unimaginative and often mixed-up policies and interstate jealousies, we have a scenario in which the agencies operating in the areas referred to in this paper (and indeed the same applies to a number of other agencies) have failed their charter over the last decade or so (or for part of that time), causing irreparable damage to the confidence of the community and to our regulatory framework. No matter what happened in the last few years, the 1980s and 1970s have provided a sad picture of inadequate attention to these areas. This paper will give only a few examples of the deficiencies existing in the regulatory mix addressed here.

Governments must take much of the blame. For they failed (and still fail) to act when there were clear messages coming from different sectors which tell them to do otherwise. Before embarking on this exercise, however, it is necessary to make a few assumptions which are central to

the approach to the philosophy of regulation and the needs of the community expressed in this paper.

The best system is one which allows the market to operate, with as few impediments and regulations in place to interfere with the free operation of the market as are deemed necessary in the public interest. However, the Chicago School of Economics and those who suggest that the market should operate at all costs without reference to the interests of the public are not being advocated here. It is recognised that there are going to be situations where some form of compromise will be necessary to deal with special scenarios that may arise. By supporting compromises one should not be seen as compromising a general view. Just what those compromises are to be and when they are to be put in place represents, the greatest difficulty in this debate. The 'all or nothing approach' taken by those at either end of the spectrum is not, sensible or affordable in any community, let alone this community.

When I was appointed Chairman of the Trade Practices Commission in February 1988 I came to that position with a good deal of scepticism about the permissive attitude that had been taken by both the Trade Practices Commission and the National Companies and Securities Commission in the mid-1980s towards corporate practices. I recognised that those in charge of those organisations had to measure their particular reaction to specific challenges in the light of the very clearly stated objectives of both Federal and state governments. Deregulation was the key to the future of the development of the Australian economy. We had deregulation of the banking and financial sector; we had been given promises about deregulation in other areas of industry. Mr Hawke and certain state premiers had clearly indicated that they were determined to free up the operation of all sectors of the economy wherever possible.

In so far as taxation was concerned it is disturbing that there is a lot of grandstanding, and, by and large, inappropriate action on the part of the Australian Tax Office. Of course it is always preferable to negotiate a problem away; but some leadership has to be provided in the administration of our laws and this has to be done in different ways. Discretions are necessary but they can be easily 'overused'. Sometimes we need to see a case pursued in the courts so that we can judge for ourselves if the interpretation adopted is correct.

Until recent times, and with varying degrees of enthusiasm by the three 'regulators' concerned, there has not always been displayed that degree of dedication to enforcement which is the bottom line in measuring the success of the regulatory framework. If there is no enforcement, or if it is heavily curtailed, there had better be a good explanation for that fact.

The Laws and their Language

There is little doubt that the laws we have in place in the three areas under discussion are for various reasons inadequate and in many instances inappropriate. The very technique we adopt in Australia in overcoming perceived deficiencies in our statutes are so neanderthal and inappropriate, the laws are so badly drafted and structured, and the response to exposed deficiencies so mixed and unpredictable, that unless we see a complete change in approach in some or all (preferably all) of the areas under discussion, we will continue to provide a bonanza for lawyers and some other professionals and a nightmare existence for most other people.

Governments should not be ashamed to admit when appropriate that where there has been an oversight in the way laws have been drafted, or where things have changed so that the basis upon which the previous laws have been built is no longer relevant, that significant changes should be made. On the other hand they should be quite adamant in not shifting their approach to a particular theme unless there are clear and strong reasons for doing so.

There is a good deal of sense in requiring some form of cost benefit analysis to be undertaken before laws are changed, for without it we will simply drift from one perception to another, often unbacked by any kind of evidence whatsoever or evidence that is so slight as to be almost unrecognisable. Some recent attempts to amend laws in the corporate area, some suggested changes to the Trade Practices Act, and some of the tinkering with the Income Tax Assessment Act, merely reflect knee-jerk reactions to particular pressures, some of which are highly artificial.

Rather than simply building on a corporate law framework that was introduced in the 19th century—a framework which may be inadequate for our current economic climate—we should reassess that framework. If that shows the framework is still appropriate (which is highly unlikely), and that the necessary changes can be introduced through some minor renovations, then call the builders in and let's start to work.

To find a classic example of failure to do the job properly, one needs only to look at the complete mess that has been made of the share buy-back provisions of our companies legislation. These changes were introduced because of certain pressures which were being engineered in the share markets. Instead of looking at the whole area of company capital maintenance, dividend law, return of capital and related matters (which are fundamental to the way in which the modern limited liability company is structured) what we produced was pages upon pages of the most obtusely drafted and technical legislation. In the UK and Canada in contrast the job was done in half a dozen pages at most. So technical and obtusely drafted is our legislation that in a recent paper by a leading firm of chartered accountants it has been indicated that the sections are hardly ever used. Indeed, the drafting is dense, badly structured, and very long.

In particular, the changes brought about in the *Income Tax Assessment Act 1936* (Cwlth) legislation to cope with problems of interpretation and attitudes to language taken in the 1970s by the High Court are often quite unnecessary and indeed counterproductive.

Work done for the Law Reform Commission of Victoria suggests that most of the legislation that is included in the Income Tax Assessment Act, and the Corporations Law (fortunately, the *Trade Practices Act 1974* (Cwlth) has been spared this particular 'medicine') is so difficult that you would need over 20 years of post-secondary education to be able to understand it.

During my membership of the Law Institute of Victoria Commercial Law Committee in the early 1980s we conducted a survey of Victorian politicians to ascertain their understanding of certain tax legislation that had been introduced to overcome a tax avoidance scheme—legislation which had universal support. Ninety per cent of them had not understood the legislation and could not tell us what it was about. Recently complex legislation amending the Corporations Law has been persistently guillotined through the Federal Parliament so that only a total of two and a half hours debate was allowed in the House of Representatives to discuss hundreds of pages of legislative amendments. One can be pretty certain that a vast majority of the politicians who considered that legislation did not fully appreciate what the full impact of the legislation was. However, ignorance of the law is no excuse!

This may be a cynical view, but it is a disgrace that we have to put up with this kind of law-making in this country. There is no excuse for it and the time has come for the people to tell the governments in no uncertain terms that enough is enough.

Another example makes the point very well. Recently the High Court of Australia in dealing with a provision of the capital gains tax legislation in the case of *Hepples v. Federal Commissioner of Taxation* ((1991) 91 ATC 4808) was hypercritical of the drafting techniques adopted. In throwing out the Commissioner's case against the taxpayer three judges made some very interesting comments. Sir Anthony Mason, the Chief Justice, noted:

> The provisions of [the relevant provisions of the Act] are extraordinarily complex. They must be obscure, if not bewildering, both to the taxpayer who seeks to determine his or her ability to capital gains tax . . . and to the lawyer who is called upon to interpret them (91 ATC at 4810).

Toohey J commented that the subsections were located:

> In a part of the [Income Tax Act] that is a minefield for the taxpayer . . .' (91 ATC, p. 4827).

And Deane J, in the most perceptive decision on the particular provisions made this very important statement about drafting, tax policy, and the obligations of both Parliament and the regulator in dealing with the relevant issues:

> Statutes imposing taxation derogate from the ordinary rights of the citizen in that they represent a compulsory exaction of money. . . . [T]he framing of the provisions of such legislation is essentially within the control of government. Indeed, insofar as provisions of the Act are concerned, it would seem that, particularly in relation to technical matters, the content and drafting of such provisions may, on occasion, reflect the advice and views of officers of the Australian Taxation Office itself . . . . In circumstances where the heavy burden of legal costs is likely to constitute an insurmountable obstacle to the challenge by the average taxpayer of an assessment in the courts and where successive administrations have allowed the [capital gains tax provision of the] Act to become a legislative jungle in which even the non-specialist lawyer and accountant are likely to lose their way in the search to identify the provisions relevant to a particular case, the least that such a taxpayer is entitled to demand of the Government is that, once the relevant provisions are finally identified, a legislative intent to impose tax upon him or her in respect of a common place transaction will be expressed in clear words' (91 ATC, pp. 4818-19).

Many other judges have commented upon the labyrinthine complexity of the Income Tax Assessment Act (and of other statutes). When asked to be creative in their response to the criticism they have answered (generally) by saying that their responsibility is to give the statute its normal statutory meaning. If we are to achieve a sensible approach to these issues—a key feature of any simplification program which must be at the heart of the creation of an atmosphere of appropriate ethical behaviour in this community—we need a change of culture in the way in which judges interpret legislation. Perhaps we can adopt the New Zealand approach of looking at the spirit of the legislation. Mr Justice Richardson, a member of the New Zealand Court of Appeal, in the speech that he gave when he presented the Wilfred Fullagar Memorial Lecture in 1985 stated:

> But as we all know legislation may be incomplete or ambiguously expressed. In explaining what the statute means the Court makes law just as if the explanation given were contained in a new Act of Parliament. The interpretative approach taken inevitably depends on the perceptions judges have of community values and attitudes in their own society and on any statutory directives. Different jurisdictions have at different times reflected a variety of approaches. The strict construction rules, the mischief rule, the golden rule, and in more modern terms, the literal approach and the purposive approach are familiar to all law students. In New Zealand one test and one test only is mandated by statute. Under our Acts Interpretation Act we are required—and have been since 1988—to accord to every Act and every statutory provision such fair, large and liberal interpretation as will best ensure the attainment of the object of the legislation according to its true intent, meaning and spirit (Richardson 1985, p. 36).

Whilst s. 15AA of the Australian *Acts Interpretation Act 1901* (Cwlth) has now been in force for nearly ten years we still have a long way to go to change 'attitudes'.

The New Zealand approach is so much more sensible although there may be occasion when some technical drafting may be needed to overcome tax avoidance schemes or schemes of a similar nature in other legislation.

The Trade Practices Act in contrast is drafted in simple language although there are sections in it now which are very complex. The first bill introduced in 1973 was a straightforward piece of legislation which would have created some sort of first in the context of modern commercial legislation. But because of the concern that the legislation was too general it became much more specific and that trend has continued. But there are gaps in that legislation. The recent changes to section 50, introduced by the Federal Government because of certain difficulties thrown up by the decision of Lockhart J in *Trade Practices Commission v. Australian Iron and Steel* ((1990) ATPR para 41-001) did not deal with some of the most obvious of issues thrown-up by comments made by the Trade Practices Commission and its counsel to Government. The legislation does not pick up the way in which through financing arrangements a lender or a person that is in a position of a lender can exercise significant control over the activities of the borrowing corporation.

That was a particular issue that was not addressed by the Government when it was considering what reaction it should have to the bids for the Fairfax Newspapers. It has not been picked up in the recently released Broadcasting Bill. What is amazing is that despite the fact that leading lawyers in commercial practice continue to tell the Government that they have not picked up this particular 'problem area', the Government continues to ignore that suggestion.

From time to time we need to go back to basics. But we have to be careful that we do not go rushing back to basics every time there is a change of government, a change of personnel at a regulatory agency, or some hysteria caused by a temporary downturn in economic activity. The recession has been a terrible period for many Australians. But it does not provide the kind of excuse that is being used by many to suggest wholesale changes to legislation such as the Trade Practices Act in areas where it is working quite effectively. Senator Barney Cooney, the Chairman of the Senate Standing Committee which recently suggested that section 50 of the Trade Practices Act should be amended, admitted recently that the basis for the Committee's recommended changes was not any concrete evidence, but because of the hype that had been built up around the work of an American economist who may not have spent any time in Australia let alone done any research here!

That change has been proposed at a time when the law that is in place has been shown to be effective and where the problem is not the question

of looking at dominance of companies (there are a number of those around), but rather the impact of their operations in the market. The Committee chose not to support the kind of reforms that might be regarded as necessary if you want to do something about powerful bodies misusing their power.

It is not suggested that there is conclusive evidence that companies are misusing their power, but the relevant Committee walked away from that particular issue because it was just 'too hard'. Incidentally, I do not share the reported comments attributed to the Trade Practices Commission that the Commission should have the power to break up companies in the event of misuse of market power nor have those statements been made by officers of the Commission. No such power should ever be vested in any regulatory agency. That power should be vested in the courts.

Let me provide a final example to illustrate the way in which the laws are inadequately drafted to deal with the kinds of problems that we face. This illustrates the perennial dilemma we face in handling the notion of the *corporate form*. Corporations which have their shares listed on the Australian Stock Exchange are obliged under the contract they enter into with the Stock Exchange to observe those rules and comply with them unless they are given some kind of relief. Section 777 of the Corporations Law attempts to encapsulate that particular obligation in a statutory 'code'. Yet the courts continue to read that section in the most peculiar and narrow way. Who would doubt for one moment that corporations (or companies as we more commonly refer to them) can only act through the agency of human beings. The persons who usually ensure that the corporation does whatever it does is the company director or board of directors. Yet in a bizarre decision of the Queensland Court of Appeal in *Hillhouse & Ors v. Gold Copper Exploration N.L. & Ors* ((1989) 7 ACLC 332) section 777 of the Corporations Law (or rather its predecessor) was interpreted to mean that the directors of a company did not have an obligation to ensure that the corporation complied with the listing rules—as if the corporation would obey it by itself. That kind of approach to legislation and its interpretation leads to much concern not only about the appropriateness of our laws, but also raises the further question of the suitability of regular courts to handle commercial and economic questions.

It is clear from the above that I am very sceptical about how the law deals with many of the problems that arise in the areas under consideration. It would be possible to discuss at some length the most important area in corporate law that is yet to be tackled—the rules that govern disclosure of information (that is, the basic rules of what the figures should tell us—the accounting rules). Mark Burroughs the chairman of the Companies and Securities Advisory Committee has recently recognised that this is a major area of concern and yet it has not been tackled properly either by the accounting fraternity or the law.

Hopefully, these examples have given an insight into some concerns about the way we go about the creation of the legislative framework against which the regulators have to work. The framework is often outdated; it is often in serious disrepair; it is often the subject of minor renovations which do not work; we need to go back to the foundations to see just where we should go if we want the laws to work properly.

Penalties

When we talk about penalties only the trade practices law will be referred to in detail. The penalty regime in tax is quite meaningful (penalty tax of up to 200 per cent may be imposed), and the issues raised on the trade practices cases are equally applicable to corporate law.

Unless we have adequate penalties, and a regime of sanctions which clearly indicates that we understand the problems that we face, we are going to continue to face cynicism and a reaction on the part of those who want to get around the laws, which typified not only the 1980s but also occurred in years before. The tax evasion and avoidance scene of the 1970s was driven to a large extent by the fact that the laws were not being enforced, the penalties were inadequate, and the Commissioner of Taxation seemed to be absolutely mesmerised by what was going on. It is safe to say that he is not mesmerised any longer but he still needs to be more positive and certain in the way in which he approaches the particular problem.

In so far as the area of corporate law is concerned, it is clear that Tony Hartnell is on the right track. He does leave himself wide open, however, if he outlines in one of his first public speeches that there are 16 named companies 'in the gun', and then finds he cannot deliver the kind of results at the pace expected by the community with respect to these companies. The ASC deserves sympathy. Everyone expects it to achieve miracles; the system does not permit it to do so. It would have been better to have been less ambitious in the nomination of targets—Hartnell's achievements would have been given much greater recognition than they have by the press. He has achieved major successes and one needs to be patient in seeing just how he can achieve some further successes. The penalties in the corporations law will be significantly increased if current draft legislation is pursued, as is likely.

In the area of trade practices my comments are probably well known. The scene that we face in Australia in March 1992 is abysmal. In 1989 the *Griffith Report* (House of Representatives Standing Committee on Legal and Constitutional Affairs 1989) recommended significant increases in the penalties under the Trade Practices Act. Judges in courts have continued to lambast the government on the basis that the penalties in the Trade Practices Act are grossly inadequate and that the government should do

something about them. When I was chairman of the Commission people got sick and tired of hearing me comment about the inadequate funding of the Commission and the inadequate penalties.

Lionel Bowen, the first Attorney-General I served under, did nothing about penalties; Michael Duffy, the current Attorney-General, announced in August 1991 that penalties would be increased for certain provisions of the legislation and that other provisions would be examined later. Those increased penalties have now been incorporated in trade practices legislation which has been passed by Parliament, and, at December 1992, awaits Royal Assent.

The Government seems absolutely paralysed in doing anything about penalties in trade practices generally. One can only assume (and we have no proof either way but the assumption is a pretty good one) that it is not the Government that is dictating the terms in this area but the Australian Council of Trade Unions (ACTU). The common view is that the ACTU does not want to have the secondary boycott provisions subject to increased penalties. The Government cannot find a compromise. The message that the community gets is that the penalties remain the same, and those who want to break the law can do so knowing that the penalties are still small. We will probably have some changes, but given the way in which parliaments work, nothing may be done this year, and it may take the next government to bring about a change in this area.

The importance of a proper penalty regime cannot be over-emphasised. The words of French J in the *CSR* case is a good reminder of this point. His comments bear repetition because they illustrate the importance of penalties and the importance of getting the culture of compliance right in this area, the corporate law area, and in other areas. In *Trade Practices Commission v. CSR Limited* ((1991) ATPR para 41-076) he made these comments about the attitude of CSR Ltd in relation to its obligations:

> There was little convincing evidence of a corporate culture seriously committed to the need to comply with the requirements of the [Trade Practices Act]. The compliance program as indicated by the evidence appeared desultory and in need of reinforcement. No indication of any corrective measures or revitalisation of that program was offered. The corporate culture was, I think, reflected in CSR's dealing with the Commission and the conduct of this litigation. . . . I have no doubt that the preparation of the case by the Commission has consumed an enormous amount of time and financial resources. CSR's conduct in its dealings with the Commission and in relation to these proceedings, when viewed in the light of the admissions it now makes, is an aggravating factor. (1991 ATPR, pp. 52, 155-52, 156).

That the penalty regime in the trade practices area has been inadequate can be illustrated by two comments from courts in 1990 and 1991. They capture the frustration that the Commission experienced during my term (and still is experiencing) in dealing with its function.

The first is a comment by Mr Justice Pincus in the resale price maintenance case of *Trade Practices Commission v. Sony (Australia) Pty Ltd and Ors* ((1990) ATPR 41-053).

> Were it not for the desirability of setting penalties conforming to the level found in the authorities (and in particular in the recent decision of the Full Court in *Commodore Business Machines Pty Ltd v. TPC* (1990) ATPR 41-019), I should have been inclined to assess penalties at higher sums than have in fact been fixed. When one finds deliberate breaches of the price maintenance provisions of the Trade Practices Act committed by a subsidiary of one of the greatest manufacturers of electronic consumer goods, after years of attempts to enforce compliance with these provisions, one can only suspect that the penalties have not been taken very seriously. Their deterrent effect has been insufficient, it appears, to counterbalance the profit apparently derived from protecting recommended prices against the effects of competition between their dealers (ATPR, pp. 51, 690-51, 692).

These sentiments were echoed in slightly stronger language by Mr Justice French in *Trade Practices Commission v. CSR Limited* referred to earlier where he noted as follows (at p. 52, 154):

> . . . each case will fall to be decided according to its own circumstances. But the approach taken in the CUB case [*Trade Practices Commission v. Carlton and United Breweries Ltd and Ors* ((1990) ATPR 41-037)] suggests, and I think it right, that large corporations contravening s. 46 of the Trade Practices Act can expect penalties in the upper reaches of the range for which the law presently provides. Indeed having regard to the size and strength of some of the corporations to which the section is addressed, it may be concluded that the present day value of the maximum penalty no longer reflects the seriousness with which Parliament intended contraventions of Pt IV to be treated when the Act was passed in 1974.

The Commission has indicated that it finds it rather futile to bring prosecutions, especially in resale price maintenance and price fixing cases, as well as in consumer protection cases, if the penalties that the courts can hand down are limited by the constraints that the two judges have echoed. Clearly these are matters that need to be addressed very urgently. There must be a similar ethos at the ASC which is 'rewarded' by penalties of $500 or $1000 in cases where the court finds a director guilty of failure to act honestly!

The whole question of sanctions needs to be imaginatively addressed. Treble damages is an option that should be considered seriously for this country. The disgorgement of pecuniary gains made by corporations that breach the law, whether it be trade practices law, corporate law or whatever, is another alternative that has not been adequately addressed. John Braithwaite and other contributors to this volume have done an enormous amount of imaginative work in this area. That work is to be applauded and it is suggested that these issues be addressed in a much more creative and adventurous way than we have in the past. The call by

the Senate Standing Committee on Legal and Constitutional Affairs in December 1991 that this is an area that needs to be addressed is one of many calls that have been made on government. My guess is that call, together with previous calls, will, to coin an appropriate phrase, 'go through to the keeper'. In that kind of climate the scepticism of all concerned will continue to exist and the encouragement needed by those who want to 'get around the law' will in no serious way be deflated.

Funding

There is inadequate funding for both the Trade Practices Commission and the Australian Securities Commission.

The accepted wisdom is that the Australian Securities Commission is now adequately funded. It is not—for a number of different reasons. It is not just simply a question of dollars being handed out to a regulator in the hope that it can achieve government policy. It is the nature of the funding —the quality of the people that the organisation is able to hire (because of restrictions imposed through outdated and completely unjustified rules as to levels of appointment and so on); it is inadequate because the agencies cannot pay the professional fees that are sometimes demanded by leading experts (including lawyers) who are asked to act for government agencies. Whilst agencies are in a better position today because of the economic downturn, that position will not remain and certainly was not the case during my term on the Commission. Stories are legend about the inability of the Commission (and presumably this applies to other agencies) to obtain counsel of first choice because the fees offered were below the market rate or even anything near the market rate.

Resources are important too for the courts. We do not have enough courts. This raises an issue which is far more important for society than that being addressed here. Judges are poorly paid and the resources that they are given to support their work are not as good as they should be. One gets the impression that court administrators, together with regulators, have to go cap in hand far too often to government. Obviously they cannot be given limitless funds but the approach in dealing with this whole area is wrong. If the regulators are to do their job properly and if they are to operate in the mechanism where they can proceed with speed and with confidence, then the resources that have to be provided to them and to those that deal in the area have to be adequate.

There have been a number of players in the market who have contributed to the very poor reputation that Australian corporate regulation enjoyed in the 1980s, but spare a thought for the regulators. They were given inadequate resources; there was continual bickering between the Commonwealth and state governments with neither 'party' being big enough or sensible enough to take the initiative and say that the policies

were more important than the power that they all sought. Indeed governments must take much of the blame for the tragedy of the greedy 1980s. They did little to solve the problem. It is not surprising that there was inadequate prosecution of the appropriate persons at the time. Whilst that can be only a partial excuse (the Trade Practices Commission had far less resources than it needed but was able to achieve some success), it does go a long way to explain why there was inadequate action in this area.

As far as taxation laws are concerned, there was a complete breakdown in the 1970s and there has been a difficult mix of policies adopted by the Taxation Office in the administration of the legislation in the 1980s and early 1990s. We need less grandstanding and more positive action than we have seen in the past. Perhaps the Commissioner of Taxation has been hamstrung to a very large extent by the language of the legislation he has to administer. The High Court decision in *Hepples* case referred to earlier is a clear example of that. Section 160ZZS (a fundamental provision in the Tax Act) has not yet been tested in the High Court by the Commissioner of Taxation because of the uncertainties as to the result.

The Courts

The courts are inadequately funded to deal with the issues that they have to address and they are probably not as well equipped in some respects in dealing with the areas under consideration.

Specialist courts should handle areas where they are dealing with specialist legislation. The trade practices area is a classic example. There should be a specialist court to handle trade practices matters or at the worst the opportunity to appoint expert lay members to the court to deal with the particular issues on hand. The New Zealand experience with this latter suggestion has been positive and successful. We need to move along similar lines in Australia.

Now that the Federal Court has become the virtual final court of appeal in the tax area we should see greater consistency in the interpretation of legislation in that area. But in the corporate law area we are going to continue to see forum shopping between state (and territory) Supreme Courts and the Federal Court, and that is something that we just cannot afford. We need to have a clear and concise approach to the adjudication of the disputes where these disputes arise, and petty state jealousies should not prevent the creation of appropriate courts to deal with these areas. Just as in regulation we cannot afford a race to the bottom.

Judges need to recognise that they, in line with all other professionals, need updating of knowledge and skills. Compulsory continuing education

for judges is something that is undertaken in the United States; it is encouraged in many states and in Canada where it is not compulsory; it is something that should be embraced by our judiciary here. In that regard I had some success when I was the Dean of Monash Law School in attracting to our trade practices and corporate law workshops judges who were working in the area, although the judges came in small numbers. There needs to be more interchange and an education in the areas where law and economics converge.

Policies

The policies followed by government in the relevant areas are to say the least not always clear and often illogical. This is discussed at some length in my valedictory chapter which was excised from last year's report of the Trade Practices Commission but has been written into the record of Parliament (*Senate Hansard*, Tuesday, 15 October 1991, pp. 2010-22).

There has been a lot of talking about how important competition was and is in the areas of deregulated industries. Yet there has not been a consistent approach by Government in relation to telecommunications, airlines, the waterfront and other areas. The Trade Practices Act which passed in 1974 did not deal in two major provisions with the service industries and yet it is these areas that are now the subject of this call for competition. The Trade Practices Act needs reviewing—the Government has been told this on many occasions but has still shown no sign that it is prepared to move in that regard. We have seen greater cooperation between the states and the Commonwealth in endorsing the plea that I made from the number of years as chairman of the Commission that the Trade Practices Act should be universal (a plea that had been made before me by my predecessors). Time will tell whether the new Keating Government will take this forward with as much vigour as the Hawke Government did.

Finally there is far too much duplication the way in which policies are structured and regulators operate. Whilst I was at the Commission we tried desperately to get coordination in between the Trade Practices Commission and the state Consumer Affairs Agencies (by for example the establishment of CADMAC (Consumer Affairs Directors' Meeting on Agency Cooperation) the consumer organisation of the various states and territories and the TPC working together on common issues etc); we issued a joint press release with the Australian Securities Commission on how we would handle matters where our work overlapped (and a good working relationship was established with Tony Hartnell and the ASC); we persuaded the Government that there should be cross appointments between the TPC and the Prices Surveillance Authority (that matter has now been taken one stage further with the Government discussing the

possible fusion of the two organisations); the Government has accepted my recommendation that there be cross appointments between the Australian Broadcasting Tribunal and the TPC, and hopefully there will be further cross appointments with other agencies.

If the Martin Committee recommendations on banking are accepted (Australia 1991) the TPC will become the 'roof regulator' for the banking area where consumer issues are involved (a very sensible move in my view). Where there are industry specific regulators (such as in telecommunications) it is important that cross appointments should be used between agencies as has been done with Austel. Where competition is the central theme of the work of a regulator then perhaps we should think differently. The same applies of course in relation to the ASC and the taxation area.

All of this suggests that there is a good deal more innovation and lateral thinking to be adopted in government, both at federal and state levels, to ensure that we have a more effective method of regulating.

A major concern is that we are so intensively driven in this country by state versus federal jealousies, inter-departmental jealousies and other inward looking policies, that we cannot see the wood for the trees. Hopefully, that complaint is one that will become part of a distant chapter in the history of regulation in the not too distant future.

When one considers what has happened in Australia in the 1980s there is a fairly simple message. If you tell the community that it is all right to break the law, some in the community will take the hint and do it. Lets get on with enforcement and take a good look at how the fundamentals in this area can be adapted for the 21st century. What we do not want or need is the ridiculous patchwork quilt we tend to manufacture by lengthy, inappropriate and unnecessary legislative change for change's sake.

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Chapter Ten

Thinking about Regulatory Mix: Regulating Occupational Health and Safety, Futures Markets and Environmental Law

Neil Gunningham

Traditionally, the central policy mechanism invoked by government to achieve its goals in areas of social policy has been the law. More specifically, the favoured mechanism has been 'command and control' government regulation, whereby legislatures proscribe certain behaviour and set up a regulatory agency to monitor and police compliance with the legal standards. Although this mechanism never completely displaced other forms of social control, it was nevertheless the 'reigning conception' that guided policy making for many years. It still has many adherents today (for example, Latin 1985).

Yet the use of regulatory agencies to control the behaviour of business and corporations is fraught with difficulty. By the late 1970s it was evident that much 'command and control' regulation had not turned out the way policy-makers had planned. It was alleged that many regulatory agencies were characterised by unnecessary adversariness and delay, that regulations were often inflexible, unduly strict and excessively costly for industry to comply with, and that many regulatory programs were either ineffective, or achieved modest results at an unjustified social cost. Moreover, some economists argued that many regulatory programs, ostensibly enacted in the public interest, operated in practice to defeat that interest.

The perceived failure of this 'first wave' of regulation, paved the way for a 'second wave', deregulation: a dismantling of the regulatory state. Deregulation has had some considerable successes (interstate trucking and airlines in the USA) and some serious failures (in Australia, the banking industry and the financial markets, which alongside an under-resourced regime of companies regulation, facilitated a series of corporate scandals). Today, deregulation has lost momentum in some policy domains, having proved inappropriate or unacceptable as a solution to many areas of social

(as distinct from economic) concern. In others, it never gained a firm foothold. Once again there is considerable public support for direct government intervention in areas such as the environment.

The question is, where do we go next in terms of regulatory policy? It may be that the pendulum is swinging back towards re-regulation. If so, this might mean simply a return to the policies of the 1960s and 1970s ('bigger and better' regulatory agencies, more standards, tougher enforcement, and so on).

The establishment of Environment Protection Authorities in a number of Australian jurisdictions, accompanied by an increase in legislation and in the severity of penalties, lends some support to this view. Yet this approach faces two major problems. First, there is little evidence that policy-makers have overcome many of the serious limitations of this approach evident during the 'first wave' of regulation. Second, government resources are necessarily limited. When premises can only be inspected once every few years, when inspectors have to rely on industry to self-monitor, when an agency cannot afford the time or the money to launch prosecutions, then 'command and control' regulation is inevitably limited in its results (*see* Court & Wilcox 1984; Gunningham 1987). In sum, 'command and control' regulation may be neither efficient nor effective. It is, at best, only a partial solution, which should be used selectively rather than 'across the board'.

A crucial policy issue therefore is whether one can avoid the excesses and inefficiencies of direct 'command and control' regulation on the one hand, and the pitfalls of deregulation on the other. Can one devise some optimal combination of market and non-market solutions, of public and private orderings, which facilitates sustainable economic activity whilst also protecting the environment? The challenge is to create a 'third wave' of protective regulation, one which involves government intervention to address serious issues of social policy but selectively, in a more pluralistic, imaginative and flexible manner.

There is evidence that a new paradigm of how business regulation should be transacted may be evolving (*see* for example, Ayres & Braithwaite 1992; Braithwaite 1989; Fisse 1989 1990; Sunstein 1990; Rose-Ackerman 1992). However, this evolution is tentative and uneven. Thus while there has been some highly sophisticated work on enforced self-regulation and tripartism (Ayres & Braithwaite 1992) there has been relatively little work on the overall regulatory mix: addressing the interrelation between government regulation and private orderings, or evaluating the relative performance of different regulatory forms, or the comparative advantage of different mechanisms in different institutional, economic or social contexts.

This paper will explore some possible alternatives to command and control government regulation, taking my examples from three important areas of social regulation: occupational health and safety, futures markets

and environment. The final part of the paper explores broader questions of how these alternatives might best be used as parts of an overall regulatory mix.

Occupational Health and Safety

Until the early 1980s, OHS laws in Australia relied almost exclusively on the prescription of standards and their enforcement by government inspectorates. The defects of the 'traditional system' were numerous and severe (*see* Gunningham 1984, Ch. 6), and contributed to Australia's appalling record of work-related death and disablement.

Among the most serious failings of the traditional system was the performance of the various State OHS inspectorates. These were understaffed, made infrequent inspections of most workplaces, and were reluctant to invoke sanctions against offenders. Indeed, the inspectorates have been characterised as adopting an extreme compliance-oriented approach, which has proved markedly unsuccessful in reducing levels of work injury and disease (*see* Carson 1970, Carson & Henenberg 1988, Grabosky & Braithwaite 1986, Gunningham 1987).

How were these failings to be overcome? The answer, under the 'reformed' approach adopted by the Victorian government (*OHS Act 1985*, subsequently followed in a number of other jurisdictions), was to involve the work force as a countervailing force to recalcitrant employers who were often unwilling to risk profits or competitive advantage by voluntarily implementing OHS measures.

Under the traditional approach, workers were given almost no power to participate in establishing safe working conditions. Yet they are the people with the most vital interest in avoiding work hazards—it is, after all, their lives that are at risk. Moreover, since they work with those hazards day by day, they often have considerable insight into what the worst dangers are, and how they might be curbed.

Recognising this, the Victorian Act made express legislative provision for worker participation. This included:

- provisions which facilitate worker participation in the day-to-day implementation of safety policy (for example, the right to participate in standard setting, to elect safety committees and safety representatives); and

- a statutory right for safety representatives to 'stop the job' without loss of pay and with protection against victimisation.

By providing these rights, workers acquired a substantial measure of protection despite the weakness of an inspectorate of very limited resources, unable or unwilling to prosecute. Moreover, these rights

enabled action to be taken to prevent accidents, in contrast to previous ad hoc rights to sue in tort for negligence or breach of statutory duty after the event.

Necessarily, these worker participation provisions have been more effective in some circumstances than others. For example, they are of immeasurably more value where there is a strong, well-organised and safety conscious union, than where these conditions are lacking. In the former circumstances at least there can be little doubt that worker participation has had a very positive impact on OHS in Australia and elsewhere (for the USA, *see* Bacow 1986).

A second innovation in Victoria concerns the behaviour of the government inspectors. There is evidence that many of the inspectorates had developed an unduly comfortable relationship with the industries they were responsible for regulating. For example, in some jurisdictions it was common to give employers prior warning of inspections, allowing them to disguise hazards and unsafe working practices (*see* generally Gunningham 1987). When inspections did take place, it was only the company's representatives, and not the trade union, who would accompany the inspector on his or her inspection.

As a means of countering these tendencies, the Victorian legislation gives a worker health and safety representative the right to accompany an inspector during an inspection of the workplace and to receive a copy of the inspector's report. One purpose is to counteract 'capture' of the inspectorate by the employer, for now the inspector also feels accountable to, and must justify any action taken (or inaction) to the safety representative as well as to the employer.

A third innovation is the use of information-based strategies to educate the work force, thereby putting pressure on employers to develop safer systems and equipment. In particular, an employer must permit a health and safety representative to have access to such information as is in the possession of the employer relating to actual and potential hazards at the workplace and the health and safety of employees of the employer. Further the employer must consult safety representatives on all proposed changes to the workplace, the plant or substances used in the undertaking that may affect health and safety. (For details of the Victorian legislation, *see* generally Creighton 1986).

Finally, one American initiative which departs from traditional command and control regulation, also deserves mention. This is the landmark regulatory experiment carried out by the Occupational Safety and Health Administration (OSHA) in California between 1979 and 1984 (*see* Rees 1988). This experiment, the Cooperative Compliance Program:

> established a unique three-way arrangement involving unions, management, and OSHA by authorising labour-management safety committees on seven large construction sites to assume many of OSHA's regulatory responsibilities (such as conducting inspections and investigating complaints), while OSHA ceased routine

> compliance inspections and pursued a more cooperative relationship with these companies. The keynote was self-regulation (Rees 1988, p. viii).

The scheme was a substantial departure from OHSA's conventional legalistic and adversarial regulatory strategy, and was considerably effective (Rees 1988).

Futures Regulation

The workings of the futures markets have enormous, if little understood, implications for the economy, providing an essential tool of corporate, agricultural and institutional money management. But the markets also have their darker side. Billions (sic) of dollars worth of financial transactions are processed through them each day under an arcane system known as 'open outcry', which makes surveillance, regulation and social control extremely difficult. The opportunities for deception, fraud and outright criminality are considerable, the potential rewards for such activity are enormous, and the chances of being caught are minimal.

From the standpoint of public policy, these characteristics of the market raise important questions of regulatory strategy. How can crime in such markets be controlled and how, in particular, can they be regulated to ensure that they are orderly, efficient and fair? There are no easy answers to these questions, yet the consequences of a failure to achieve an appropriate level of regulation is potentially disastrous (as the closure and collapse of the Hong Kong market during the crash of October 1987 demonstrates).

In my research on futures markets in three countries, it began with the conventional lawyers' assumption that the most important level of regulation would be government 'command and control', perhaps with significant input from self-regulation and (as an afterthought) from informal mechanisms of social control.

It would come as no surprise to many social scientists to find that the reality was quite the reverse of that anticipated. Government regulation, while symbolically important (in preserving market confidence in the eyes of the general public), had little practical impact. Government regulators rarely understood the complex functioning of the market nor were they able to detect wrongdoing, even if it took place under their eyes. If an occasional regulator did approach any level of sophistication, he or she would become saleable to the market participants and would have no difficulty quadrupling the salary the government could offer. Unsurprisingly, the Commodities Futures Trading Commission was recently characterised by Senator Eagleton as a 'sleeping pygmy'!

In contrast, informal mechanisms of social control often proved highly effective on controlling crime in the pits. To explain how it is necessary to say something about the 'open outcry' trading system. This is a type of free form auction which, in the words of the Chicago Mercantile Exchange

'combines elements of primal scream, aerobic dancing and the Battle of Hastings'. A trader calls out prices until he or she finds another trader who is willing to take the other side of the contract at that price. To communicate with each other in the crowded trading pits, traders use a system of shouting, hand signals, nods and other gestures. A successful trader must be able to get the attention of other traders, in competition with some 50 to 500 others. So traders jump, howl, flail, shove and jostle each other. Occasionally they fight, spit, gouge or jab pencils, and they do this for something like six hours a day.

Under this system of trading, floor participants may use a variety of techniques to avoid competitive order execution, to secure better transaction prices for themselves at the expense of others, and to cheat, or through other criminal practices, exploit their outside customers or each other. What keeps traders relatively honest in this environment is a complex system of informal controls. Between traders cheating is uncommon. The principal reason is that floor traders work closely with each other day by day. They trade with each other and must be able to rely on each other if deals are to be made and honoured. Members who trust each other can trade more quickly and at lower cost. A trader or broker who reneges on his obligations, or who cheats on his peers, causes considerable disruption and disadvantage to other floor members. Thus, at the same time as floor members may compete fiercely, they must also rely heavily on each other.

Because they are mutually dependant, and in response to the need to protect themselves, traders have developed within the apparent anarchy of the pits, a certain order, an unwritten set of rules that govern the day's trading (*see* further Gunningham 1992). The simplest way to enforce these informal mores and tacit understandings is to refuse to trade with any floor member who routinely or seriously contravenes them. Trading depends on eye contact, and with many traders vying with each other to take one side of the contract, it is relatively easy to ostracise an aberrant trader and threaten his livelihood.

Again, outside customers—or at least the big institutions—are also in a position of some leverage where they can usually protect their own interests and avoid being cheated on any scale. Banks, corporations, trust funds, pension funds, mutual funds, 'commercials' who actually use the commodities traded, and insurance companies are frequent users of the market and have a large stake in individual contracts. All these organisations are professionally managed, and often have their own research departments, independent sources of intelligence, and immediate access to private information.

> By virtue of their size, sophistication and experience, these are in a far better position than the individual speculator or retail customer, both to detect abuses, and to take effective action against a corrupt broker. As one institutional money manager pointed out, most mainstream institutions make very clear to their floor

> brokers that 'if they screw up, then we'll walk.' According to one Australian broker:
>
> If you're a professional wholesale client you know if someone is ripping your order off and if you don't you shouldn't be in the business ... *it regulates itself*. If people are front running [cheating clients] ultimately they get fired. [emphasis added]

Large institutional customers also have a range of other mechanisms at their disposal to constrain floor trading abuses. In the Chicago markets these range from 'buying' the honesty of the floor broker by entrusting him with all or most of the institution's business, to using a variety of brokerage firms on the basis that

> since we enter all of the orders at the same time, generally on the open or close, we know pretty well what we are entitled to in the way of fills.

Finally, institutions, because of their great financial power and because they are in the market for the long term, have considerable opportunities for 'pay back'. For example, futures markets are vulnerable to manipulation, which can seriously damage not only unsuspecting market participants, but can also erode confidence in the market itself. The answer, according to many industry participants, is not tighter regulation, but reprisals against the offending firm. In the terminology of the Australian market:

> the ultimate solution is they'll get their balls chopped off because a bigger player will come in and dump on them ... no matter how big a player you are, there's others out there who're bigger and better and can crush you.

Yet even informal mechanisms break down from time to time—and it is then that the futures exchange's formal self-regulatory system is likely to move beyond its normal public relations role and actively intervene to protect the long-term reputation of the market.

For example, in Chicago in the S & P pit in 1986 and 1987, trading was frenetic. The market was overheated, and more and more new traders jammed into the pit to get a slice of the action. Informal social control breaks down because it is impossible to know one's fellow traders, who to trust, how to impose informal sanctions that work effectively, or even to identify what other traders are doing around you. As one trader put it:

> You can't see stuff that's being traded five feet in front of you ... all you're worried about is being poked in the eye.

According to another:

> Open outcry is okay when you have 20 people in the ring. It is questionable when you have 200 people. When you have 400 or more, it is nearly impossible. You have to be able to control chaos.

Moreover, the congestion makes it almost impossible to maintain a single market price, and at times up to four or five different prices could be seen being negotiated in different sections of the pit. As one observer noted:

> When you've got 500 people screaming at the top of their lungs, with the market moving rapidly, prices get out of line . . . it was like different markets being created within that same pit.

These conditions, coupled with considerable volatility, provide floor brokers with enormous scope to cheat customers. Even large institutions who can otherwise readily protect their interests as described above, may be vulnerable. Illegalities can be easily disguised in such congested markets because there is no longer a uniform pit price at any moment, against which the customer can compare the price he receives.

At this point the futures exchange's formal self-regulatory system (disciplinary action, rule changes, formal surveillance of trading) may kick in to constrain wrongdoing, in order to preserve the long-term reputation (and therefore viability) of the exchange. However, whether in practice it does so will depend on how power operates within each individual exchange. For example, in Hong Kong, the mechanisms for election to the exchange's main decision-making body ensured that all the power was placed in the hands of representatives of the small Hong Kong based ethnic Chinese (as opposed to large international) brokers, who then exploited that power to their own ends. In Chicago, particularly at the Board of Trade, the floor traders (individual floor members who trade on their own account and independent floor brokers) used their considerable power to block reforms which threatened their own self-interest. They were able to do so, not only because they 'have by far the majority of the votes and vote themselves into positions of power' but also because they have the tradition, the time and the incentive to dominate decision-making. That power has rarely been challenged by the exchange executive, which might arguably act in longer term interest of preserving the integrity of the market. As one former exchange officer stated:

> No manager or director wants a war the whole time, so the temptation for the Board is to let things go on the way they are. If you do anything that the floor doesn't like, then all hell breaks loose. Often the best thing is just to let it go on.

By contrast, in Sydney, another group dominates, namely the institutions (merchant banks, major trading banks, independent brokerage firms and stockbrokers). These players all have a long-term commitment to the viability and success of the Sydney futures exchange. Those acting

as principals rely on the futures market as a central component of a broader financial strategy as described above. Only if that market is highly liquid can they trade efficiently on it. Brokerage houses have an equally strong interest in generating high trading volume for the commissions they charge on each trade are the basis of their profitability. All these institutions are acutely aware that the reputation of the exchange is crucial to its continuing success. Futures markets suffer from an image problem. Their history is often riddled with scandal and they are still treated with considerable suspicion by investors. A failure to curb abuses, a reputation for market manipulation, or a history of member insolvencies, is likely to deter investors and reduce liquidity, threatening both the efficiency of the market and the profitability of its members. Moreover, given the implications of futures trading for the broader financial system, any failure to curb abuses incurs the risk of more direct government regulation. This is widely feared by traders as likely to bring with it unnecessary and costly restrictions and rigidities, inhibiting innovation and leading to a loss of business to other, more competitive markets. Accordingly, it is no surprise to learn that the SFE, at least since the rise to dominance of the large institutions, has taken considerable measures to tighten its rules and effectively police its markets.

Perhaps the most striking point about futures markets is that there are no simple answers which apply uniformly across different markets, different jurisdictions and different cultures. What works in Sydney—where the market is dominated by large players who are in it for 'the long haul'—is very different from what works in Hong Kong, where the market is less stable, many dealers have no long-term commitment and many of the players are small, unsophisticated speculators, without the knowledge or financial clout to keep floor brokers from cheating. Moreover, there are also major cultural differences which also have implications for the efficacy of any particular regulatory regime (*see* further Gunningham 1990).

Environmental Regulation

Conclusions about environmental issues are tentative at present because my research is at a much earlier stage. Here the question is—what role can and should alternative mechanisms of regulation play in curbing environmental degradation?

Unfortunately, within Australia little energy has been spent on answering this question. At the political level, the response to environmental degradation has rarely transcended the 'knee jerk' response of more regulation and tougher penalties (largely ineffective inducements to environmental responsibility. Neither has there been much systematic scholarship undertaken to examine the alternatives to 'command and

control' techniques, or how these alternatives interconnect with 'command and control' regulation. For example, there is a burgeoning literature on environmental audit, the 'new generation' regulatory tool. Yet this literature is almost exclusively client oriented (addressing issues of confidentiality, how audits should be conducted, by whom, and so on). What is lacking is any serious evaluation of the policy implications of environmental audit or any concern to specify how and under what circumstances audit is most likely to make a substantial contribution to environmental protection. Arguably, the growing economic literature is the only serious attempt to look at alternatives to direct regulation. However, while important, incentive based mechanisms represent only one dimension of the regulatory mix and there has been little attempt by the economists to relate them to other key variables.

Yet despite the lack of any serious attempt to develop alternative regulatory instruments or to articulate the appropriate links between them, such mechanisms have nevertheless developed ad hoc. These are most prevalent in the USA, but a number of them exist already in Australia. Briefly, the main alternative mechanisms include: standards developed by the private sector; self-regulation; monitoring strategies (such as environmental audit); economic mechanisms (pollution charges, product charges, tax differentials, tradeable emission rights, and so on); insurance based strategies (the US 'Superfund'); mechanisms to facilitate public involvement; information based strategies (such as community 'right to know' legislation); mechanisms which empower non-governmental organisations (NGOs) to scrutinise both regulated entities and regulators; liability rules; and citizen suits.

Within the domain of pollution control, alternative regulatory devices have the potential to:

- 'take the heat' off 'command and control' regulation;
- offer cheaper, more cost effective means of achieving environmental protection goals without imposing unreasonable costs on business;
- more efficiently discriminate between serious violators and occasional non-compliers;
- provide better assurances of compliance with regulated entities;
- more efficiently use government inspection and enforcement resources;
- improve cooperation with companies;
- provide better compliance information.

However, these alternative mechanisms of social control can only achieve these ends if their strengths, their limitations and their interaction with other mechanisms are properly understood. Consistent with my findings on futures markets, it seems likely that many of them can work, but only in limited circumstances where key players have appropriate incentives, information and interests and where particular relationships exist between those players.

For present purposes, let us take two alternative mechanisms: environmental audit, and community 'right to know' to illustrate some of the potential that alternative means of social control have in the environmental area.

An environmental audit is a systematic, periodic, objective review of whether environmental requirements are being met. Audits are used for evaluating compliance with regulations, for testing land contamination, equipment performance, for monitoring design and management programs, and for many other purposes. Audits can reduce exposure to litigation, and improve risk management, performance and planning.

How and in what ways can environmental audit complement command and control regulation? First, a distinction must be made between voluntary and mandatory audits. Voluntary audits may make an important contribution to achieving environmental goals. However, they are unlikely to be adequate where companies do not have the incentives, or for other reasons are not willing to comply voluntarily. In these circumstances, mandatory audits can achieve much that their voluntary counterparts cannot.

Mandatory audit might be imposed, for example:

- wherever greater management awareness of the environmental problems of the regulated enterprise would be likely to substantially reduce the likelihood of repeated non-compliance;

- subsequent to discovery of a major breach(es) of environmental legislation and as part of a 'negotiated settlement' between the agency and regulated entity.

A regulated entity might be required to:

- conduct an independent audit (at its own cost);

- fully disclose the audit report to the regulator (and through FOI legislation to the public);

- implement its recommendations/develop an improvement plan (or corporate management plan) to address the most serious problems, identified by the audit.

The conduct of the audit and implementation of the auditor's recommendations might be made a condition for:

- a waiver of prosecution or other enforcement action;
- licence or licence renewal;
- granting of planning approval.

How can mandatory audits complement command and control regulation?

- Government regulatory resources are inevitably limited. The use of mandatory audit can serve to 'take the heat off' regulators, enabling them to use those scarce resources in a more specific and targeted manner. Specifically, the great virtue of mandated independent audit is that it provides a comprehensive, highly skilled analysis of the individual firm's environmental problems and how to rectify them, by a trained independent third party, at the regulated enterprise's expense. That is, it provides a means of policing without the need to expend substantial, and scarce, regulatory resources.

- The results of such audits are disclosed to the public (either directly or through freedom of information legislation). Such disclosure gives companies strong incentives to improve their environmental performance for fear of bad publicity, while at the same time placing pressure on a recalcitrant regulatory agency to take appropriate action against serious offenders.

- Audits give regulatory agencies considerable additional leverage in dealing with recalcitrant firms. Specifically, the costs to a regulated entity of commissioning a government mandated audit may be very considerable. Indeed, they are likely to be far in excess of any penalty imposed by a court for breach of environmental legislation. Once this fact is understood by industry, and provided an agency's willingness to impose audits is also known, then industry will have considerable incentive to avoid even the possibility of such an audit. That is, regulatory agencies will have considerable leverage in achieving compliance, even when (as is common at present) they are very reluctant to pursue prosecution, whether because of limited enforcement resources (prosecutions are costly both financially and in terms of personnel); because the level of penalties imposed by the courts is dispiritingly low, or because of regulatory culture. Faced with a recalcitrant polluter,

the mere suggestion that the agency is contemplating mandating an audit may be sufficient to induce compliance.

- Audits (both voluntary and compulsory) could be integrated into the sort of enforced self-regulation strategy and enforcement pyramid advocated by John Braithwaite in his contribution to this volume and elsewhere. Voluntary audit would be encouraged (or supported by incentives as in the European Commission's proposed eco-audit scheme) for those who are willing (or can be persuaded) to comply voluntarily. Mandatory audit, in contrast, would fit close to the top of the enforcement pyramid for those not prepared to comply voluntarily.

- Audit may in the future become the main vehicle through which alternative mechanisms (in particular, economic incentives, such as pollution charges, tradeable emission rights, and so on) are policed.

It is not suggested that claim audit is without problems—in particular, who audits the auditors? Moreover, audit is heavily dependent for its success on the skills, resources, competence and commitment of the regulatory agency(s) which ultimately, are responsible both for initiating compulsory audits, for ensuring they are conducted appropriately, and that their results are implemented. Nevertheless, as indicated above, the potential benefits of environmental audit are considerable.

Environmental audit might also be integrated with a second alternative mechanism: Community Right-to-Know legislation. Such legislation, while well-established in the USA, is as yet relatively underdeveloped in Australia. However, the Coode Island explosion has now placed the issue more firmly on the Australian legislative agenda, and recognition of the need for a (limited) form of community right to know is included in the Australian Chemical Industry Council's 'Responsible Care' Program.

While space precludes any detailed examination of overseas Right-to-Know legislation one must note the effect of the US statute, the Emergency Planning and Community Right-to-Know Act 1986 (EPCRA) on pollution control in that country. EPCRA involves various measures designed to ensure that information about chemical risks are adequately communicated to the public. Specifically, the legislation requires that manufacturers who produce or use designated hazardous chemicals must compile an inventory of the quantities of such chemicals they are using or storing at their facility; they must provide both the public and the Environment Protection Agency (EPA) with estimates of the amounts of the chemicals they are releasing into the environment annually. In effect, these requirements amount to a compulsory environmental audit in respect of specific environmental effects of the very broad range of chemicals so designated, many of which are otherwise not regulated.

It should be noted that corporate decision-making with respect to toxic substances appears to have been substantially influenced by this legislation. The mandatory provision of such detailed and comprehensive information about spills and chemical emissions, to the general public, has generated considerable public scrutiny and criticism of manufacturers' operations. For example, the first full set of filings under EPCRA suggested that a huge 2.7 *billion* pounds of hazardous pollutants were being emitted to the air alone in 1987. These sorts of figures have not only fuelled community debate about the location and development of industrial facilities close to residential areas (now mirrored in Victoria, following the Coode Island disaster); they have also created a substantial public backlash against industry, particularly chemical industry, emissions.

This backlash has prompted a number of major chemical manufacturers to reassess their own operations and to modify their environmental control strategies even in the absence of government legislation requiring them to do so. For example, both DuPont and Monsanto have made major changes in terms of phasing out hazardous products and reducing hazardous air emissions, well beyond those required by law. While this response may well be based on enlightened self-interest and in part to minimise future compliance and liability costs, this in no way detracts from the effectiveness of the 'Right to Know' strategy. It may well be, as then EPA Chief William Reilly has asserted, that:

> Based on the industry response so far, it is clear that one of the most effective instruments for reducing toxic air emissions has been the Community Right to Know law requiring industries to estimate and publicly announce them, by plant and by chemical.

Towards a Better Regulatory Mix

So far in this paper it has been suggested that under certain conditions, a variety of mechanisms can either substitute for or complement command and control government regulation. What has not been addressed directly, is the question of how those various mechanisms can most appropriately be integrated into the overall regulatory mix. In what circumstances and to what extent can regulation safely be left to industries themselves or to collective bargaining? When government intervention is necessary, what forms should it take? What are the implications of adopting one form of regulation rather than another? How can we explain the interrelation between different mechanisms? What is the comparative advantage of different mechanisms in different institutional, economic and social contexts? To what extent can one identify some optimal regulatory mix,

some combination of mechanisms that will produce cost-effective outcomes?

These are important but, as yet, largely unanswered questions within the literature on regulation. Here we can only begin to address them by asking: what are the lessons for regulatory policy—and more particularly for regulatory mix—from the three areas with in this paper. These include:

- there is a need for tighter government regulation in some contexts than in others. For example, consider Hong Kong vs. Sydney futures markets; non-unionised vs. unionised workplaces; environmental issues where there are no effective non-governmental organisations (NGOs) vs those where there are).

- Accordingly, government regulations should be more precisely 'targeted' to achieve the 'biggest bang for your bucks'. For example, small unsophisticated investors need more protection than larger ones or they should be encouraged to leave the market); small non-unionised workplaces need greater scrutiny than others.

- Sometimes structural solutions can achieve far more than 'policing' (for example, in respect of futures, reduce the size of the trading pit so surveillance by large customers, and regulators, is made easier; abolish the practice of 'dual trading' whereby brokers trade for themselves and their customers, creating conflict of interest; in OHS, provide government funding to train and support OHS representatives and provide them with access to information; in environment, sponsor/provide government funding for NGOs; and give them more leverage, via citizen suits, information access, and so on.).

- Adopt different solutions for different bodies and different cultures (the Chicago Board of Trade needs to be 'leaned on' to change its rules and their enforcement, far more than the Chicago Mercantile Exchange; self-regulation will be much less effective in Hong Kong than in Sydney; voluntary environmental audit is more effective for competent, large and profitable firms, than for marginal incompetents).

- Utilise information-based and monitoring strategies to complement direct government regulation (for example, Community 'Right to Know', environmental auditing).

- Where practicable, seek to empower third parties, to enable them to act as a countervailing force (for example, in OHS, trade

unions; in environment, public interest groups; in futures, large institutional customers).

- Wherever possible, combine complementary strategies to achieve optimal effect (for example, environmental audit, right to know and formal regulation).

- Recognise that to the extent that some mechanisms are dependent on command and control regulation, (for example, environmental audit) that they cannot be effective unless the regulatory agency concerned is itself independent, vigorous and effective.

- Above all, one cannot discuss the virtues or failings of different regulatory mechanisms in abstract terms but only with respect to concrete circumstances. Are we dealing with long-term or short-term interests, small or large players, the politically powerless or the powerful, with enlightened self-interest, or 'free rider' problems? What is the previous institutional memory and experience of alternative regulatory strategies? In order to be effective, mechanisms of social control (whether direct government regulations, self-regulation, informal mechanisms or whatever) need to be tailored to the structural features of each individual market or institution.

This conclusion offers no panaceas. It means we must examine each individual institution closely before making recommendations about what sort of regulatory regime might prove appropriate. It is hoped that this paper at least provides some signposts as to what the most important variables are likely to be.

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Chapter Eleven

Progress Towards a More Responsive Trade Practices Strategy

John Tamblyn

Purpose

Through its administration of the *Trade Practices Act 1974* (Cwlth), the Trade Practices Commission (TPC) seeks to achieve a good deal more than compliance with the provisions of the Act through enforcement measures. Its overall objective is to improve marketplace conduct and outcomes by fostering competition and fair trading practices.

This paper describes the strategies the TPC employs to achieve this objective both through its enforcement of the Act (TPA) and also through a variety of other complementary measures designed to promote widespread understanding of, and compliance with, the standards of market conduct set out in the TPA. These measures include selective litigation, settlements and undertakings, information and education programs, marketplace studies, the use of codes of conduct and contributions to the debate on competition and consumer policy and law.

This paper summarises the main elements of the TPA and the general approaches being adopted by the TPC in pursuing these marketplace objectives through its administration of the Act. Examples are given of strategies the TPC has used in practice to support its enforcement program and to achieve broadly-based improvements in market conduct. Some remaining problems are identified which will need to be addressed in future to enhance the effectiveness of competition and consumer law and of the TPC in promoting improved marketplace behaviour and outcomes.

The TPC's Approach to the Administration of the TPA

The TPC regards its role as going well beyond the securing of case-by-case compliance with the TPA through litigation and other enforcement measures. At the most general level, the Commission sees its overall objective as one of fostering widespread improvements in the competitiveness and efficiency of Australian markets and in their effectiveness in delivering tangible benefits to business, consumers and the community at large. Effective markets in this sense are seen as those capable of the efficient production and supply of quality goods and services to well informed buyers at competitive prices.

While many other forces come into play in the development of more competitive and effective Australian markets, the TPC has an important role to play in promoting competitive conduct and fair trading practices on an industry-wide basis. With this broader market perspective in mind, the Commission seeks to evaluate the effectiveness of its work largely in terms of its impact on marketplace outcomes, rather than in terms of numbers of successful litigation and other compliance actions taken.

The TPA itself provides a set of guiding principles for the TPC in pursuing its marketplace goals. The Act also provides a visible standard of acceptable competitive conduct to guide business by identifying (and providing penalties for) market behaviour which is judged by the community to be unacceptable.

The provisions of the TPA embody the community's belief that competitive markets usually produce the best possible economic and social outcome. The Act is designed to promote competitive, fair and well-informed Australian markets by:

- prohibiting a variety of anti-competitive practices; and
- providing a range of safeguards for business and consumers in their dealings with producers and sellers of goods and services.

Part IV of the TPA prohibits restrictive trade practices including, agreements or arrangements which substantially lessen competition, price fixing, misuse of substantial market power, resale price maintenance, exclusive dealing, price discrimination and mergers likely to result in domination of a market.

Part V of the Act prohibits practices which are likely to disadvantage other businesses or consumers in their dealings with business including, misleading and deceptive conduct, false representations, unconscionable conduct, and use of coercion, harassment and physical force.

The language of the Act tends to give an enforcement oriented impression of the functions of Australian competition law and of the role of the TPC in its administration. This paper provides a more dynamic and

forward looking view of the role of competition law and of its administration by the TPC. This view looks beyond the reactive language of the TPA to more broadly-based strategies designed to achieve industry-wide changes in market conduct and market outcomes.

To appreciate the potential of such strategies and their cost-effectiveness, the enforcement role of the TPC needs to be put into perspective. The most powerful and pervasive influence of the TPA on market behaviour is achieved through voluntary compliance with its provisions by the majority of businesses. The TPC recognises the cost-effectiveness of promoting such voluntary compliance to the maximum extent possible. It therefore uses strategies such as publicity, information and education programs and industry codes of conduct to encourage voluntary compliance on as broad a front as possible.

The TPA is also self-enforcing. Many private actions are taken each year by business acting against competitors, suppliers or buyers to enforce the provisions of the Act. In some cases private actions are also taken by consumers or their representatives. Private actions are encouraged by the TPC as a very cost-effective form of marketplace policing of competitive behaviour and of achieving improvements in compliance with the TPA and in the general standard of competitive conduct.

While the TPC is also charged with enforcing the TPA, it is necessarily selective in deciding which of the tens of thousands of complaints it receives each year it should actively pursue. As a relatively small agency (staff of 170) with limited resources, it gives priority to taking action in areas where it is likely to have the greatest beneficial effect.

In general, the TPC takes action where the adverse consequences of the market conduct are substantial and intervention by the TPC is likely to result in improved market behaviour and outcomes for consumers on a broad front. The TPC therefore gives priority to matters in which:

- the conduct involves a significant public detriment and has a widespread adverse impact on consumers;
- important new marketplace issues are involved, eg arising from economic or structural change;
- there is a good prospect of the TPC achieving widespread improvements in market conduct and outcomes for consumers; and/or
- successful TPC action would have a widespread deterrent or educative effect.

Litigation is one of the more powerful tools available to the TPC in pursuing its marketplace objectives but the Commission is necessarily

selective in choosing the matters it takes to court. As a general rule, the TPC undertakes litigation where there is a blatant breach, the prospects of success are good and there is scope to reinforce the lessons of successful litigation with a much broader audience.

Increasingly, therefore the Commission has supported successful court actions with other complementary strategies designed to achieve widespread marketplace compliance with the TPA and to improved marketplace outcomes quickly and cost-effectively. In practice, these strategies have sought to achieve a variety of marketplace outcomes, including combinations of the following:

- cessation of the conduct by individual businesses;
- deterrence through the demonstration effect of successful litigation;
- industry-wide compliance with the TPA;
- redress for those who were disadvantaged or damaged by the conduct;
- establishment or clarification of acceptable standards of market conduct;
- public warnings and education about unfair or deceptive business practices;
- development of solutions to market problems through changes in the operation of the market and the conduct of its participants; and
- maintaining the TPC's credibility as an effective enforcement body and as an agent for constructive change in the marketplace.

The strategies adopted by the TPC to achieve these market outcomes have typically involved combinations of some of the following elements:

- selective litigation to demonstrate the requirements and sanctions imposed by the law;
- undertakings under deeds of arrangement (or consent orders) with offending companies to prevent recurrence, improve future performance and, where possible, to secure compensation for those who suffer damage;
- targeted publicity and information programs to reinforce the lessons of successful litigation, including industry-specific

guidelines, seminars and speeches on the requirements of the TPA;

- in-house information and training programs for the staff and management of businesses in industries which have been the focus of successful litigation or where there is evidence of widespread non-compliance with the Act;

- promotion of effective codes of conduct to address identified market problems, such as misleading or inadequate information and poor product quality or service and to provide accessible, low-cost, complaint handling for customers;

- marketplace studies and inquiries to identify the causes and consequences of identified impediments to competition or informed consumer decisions and to identify options for improving the effectiveness of competition and consumer safeguards; and

- contributions to the improvement of competition and consumer policies and laws by presenting the results of its own marketplace experience and studies to relevant inquiries and policy forums.

The TPC recognises that enforcement action alone will be insufficient to achieve its broader marketplace goals. It has also recognised that, taken alone, the other marketplace strategies described above are likely to make a limited contribution towards achieving widespread improvements in market conduct and performance.

However, much more pervasive and lasting improvements in market conduct and outcomes can be achieved by employing complementary combinations of the compliance strategies listed above. When well designed 'integrated compliance strategies' are employed, the individual elements of the strategy are likely to reinforce each other and the overall impact of the strategy will be strengthened as a result.

In recent years, the TPC has attempted to implement a number of such strategies with mixed success. In practice, the Commission has sometimes fallen short in the design and/or implementation of the strategies. Evaluation of their effectiveness and of the market outcomes they produce are virtually uncharted territories and there is much more to be done in this important area.

Nevertheless, the TPC remains committed to this general approach to achieving industry-wide improvements in market conduct and outcomes and intends to persevere with the strategic approach described in this section of the paper.

Strategies to promote Widespread Compliance with Competition and Consumer Protection Laws

As noted in the previous section, the TPC has increasingly supported successful litigation and other enforcement actions with a range of complementary strategies to achieve widespread compliance with the TPA and to improved marketplace outcomes. Such strategies, employing complementary combinations of enforcement, guidance, information and research activities, are normally forward-looking rather than reactive. Their emphasis is on identifying and overcoming pervasive market problems rather than on pursuing case-by-case compliance actions after the event.

Examples of such strategies are provided here.

Settlement and undertakings

In a number of recent cases where the TPC obtained evidence of breaches of the Act, it has obtained undertakings from the companies under deeds of arrangement as an alternative to taking enforcement action. These undertakings were designed to prevent recurrence of the offending conduct, to require appropriate corrective action and/or, where possible, to secure compensation for injured parties.

Although in appropriate circumstances litigation can be a powerful tool for achieving corporate compliance, it may not always be the most appropriate measure to achieve future improvements in market conduct and results or appropriate remedies for those affected by the conduct. For example, litigation is very costly and time consuming and it may not be suitable for addressing breaches which involve relatively small amounts of money for numerous consumers, small businesses with limited resources or insolvent companies. In such cases, litigation may divert scarce resources to meet legal and court costs and penalties paid to the state; resources which might otherwise have been devoted to providing compensation for injured parties or to funding industry-wide TPA compliance programs and/or consumer education programs.

In such cases settlements worked out between an enforcement agency and the business and consumers concerned can have the advantage of achieving market solutions which best suit the parties involved. In addition to undertakings to cease the conduct, corrective advertising and compensation for those who suffer damage, settlements can include industry or firm-specific programs designed to prevent recurrence of such breaches. For example, they may include agreed changes to management policies and procedures, introduction of inhouse compliance education programs and/or coordination of an industry-wide compliance education program. Appropriate monitoring of compliance programs is another feature that can be incorporated into settlement agreements.

Examples of such settlements negotiated by the TPC as an alternative to enforcement action are summarised below.

Toshiba (Resale Price Maintenance) The Commission found evidence that between March and September 1988 four Toshiba personnel had tried to stop five resellers advertising or selling Toshiba hardware at discount prices. Toshiba admitted contravening the Act and indicated its willingness to give undertakings about future conduct and staff training.

Those undertakings were the substance of a deed signed in July 1990 in which Toshiba undertook to:

- offer training to executives, relevant staff and agents;
- apply strict performance criteria to the training;
- allow the Commission to monitor the program's effectiveness over three years;
- meet all costs of both the training and the Commission's monitoring;
- write to all its resellers, present and future, making clear their right to discount;
- allow the Commission to publicise the undertakings.

Pacific Dunlop (Misleading Conduct: Place of Origin) In 1990 the Commission investigated allegations that GNB Australia Ltd, a Pacific Dunlop subsidiary, had incorrectly labelled and marketed as Australian-made batteries imported from South-East Asia and New Zealand. After becoming aware of the investigations GNB admitted there had been some cases of incorrect signs, labels and brochures.

Pacific Dunlop gave undertakings in February 1991 which included:

- a commitment to upgrade its compliance education program over five years (with an emphasis on marketing and advertising);
- corrective advertising;
- re-labelling of the batteries.

Solomons Carpets ('Two-Price' Advertising) Commission investigations into Solomons representations about savings on a line of carpet between January 1989 and July 1990 indicated that the representations were misleading. Solomons gave formal undertakings to the Commission in May 1991 which provided for:

- compensation to almost 350 consumers amounting to approximately $35,000;

- implementation of an in-house training program conducted over three years;
- independent auditing of the above program, with annual reporting to the Commission;
- establishment of a trade practices education program for the carpet industry in general, costing $25,000.

An important feature of such settlements and undertakings is that they seek to prevent future recurrence of the offending conduct by removing the causes. They also seek to channel resources into compensation for those who suffer damage and into compliance education programs. In contrast, the litigation approach focuses on penalties for past conduct and tends to channel resources into legal and court costs and fines paid to the State.

Industry Information/Training Programs

The TPC has conducted a number of firm or industry-specific information and training programs in conjunction with other compliance strategies as part of a more comprehensive approach to overcoming identified market problems. Some examples are summarised below.

Environmental Marketing Claims Public interest in environmental issues has promoted marketers of a wide range of consumer products to make claims that their products are environmentally beneficial. While these claims can have substance, many are at best meaningless and some are quite misleading. Such claims are covered by the general prohibitions on misleading or deceptive conduct under the TPA.

To address this emerging problem, the TPC has developed a multifaceted program to raise the awareness of producers and advertisers about the requirements of the TPA.

Early in 1992, the TPC published a comprehensive guideline on the application of the TPA to environmental marketing claims which contains a simple checklist to help suppliers and advertisers avoid breaches of the TPA. The guideline was developed in consultation with business, consumers and environmental interests and is couched in practical, non-legal terms. It will be circulated widely, publicised in industry journals and will also be used as the basis for workshops with targeted industry groups.

The TPC also encourages relevant industries to adopt the principles set out in the guideline in codes of practice dealing with environmental marketing and, whenever possible, the Commission helps industry to develop such codes.

While its purpose has been to prevent breaches from occurring in the first place, the Commission will not hesitate to underpin this compliance information program and relevant codes of conduct by taking court action against companies who make misleading environmental claims.

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MTIA Compliance Education Program In March 1991, the Metal Trades Industry Association and the TPC launched an innovative education program designed to improve understanding of the requirements of the TPA among the staff of MTIA member companies. The program was produced in cooperation between the MTIA and the TPC and is based on a video featuring comedian Max Gillies, an interactive computer-based training (CBT) package and supporting printed material.

Both the video and the CBT draw on the real world market experience of the MTIA members and the TPC's knowledge of the application of the law. Gillies plays six larger-than-life characters caught up in a variety of situations where one or other of the players is likely to run foul of the Act. The CBT is user friendly and does not require the user to be computer literate.

The combination of video and CBT make the package very flexible and easily adapted to the needs of individual companies. An important theme of the MTIA program is that commercial benefits will be greater if companies focus on hard, efficient competition rather than looking for ways to damage competitors through illegal tactics.

This innovative compliance information program will be supported as necessary by selective litigation and appropriate administrative action to address breaches of the TPA which may occur in the metal trades industries.

Industry codes of conduct

Since the publication of its study of self-regulation, the TPC has actively assisted in the formulation or evaluation of a number of industry codes of conduct where they have the potential to improve the efficiency and effectiveness of the marketplace by reducing or eliminating pervasive market problems. In doing so, it has had the following objectives:

- promotion of voluntary compliance with the competition and fair trading provisions of the Trade Practices Act;
- improving the flow of market information between business and its customers, particularly where there are substantial disparities in information between them; and
- reducing the costs of transacting in the marketplace particularly for consumers, by improving communication between buyers and sellers and through accessible, low-cost complaint handling arrangements.

Electronic Funds Transfer (EFT) In consultation with financial institutions, consumers and government, the TPC conducted an evaluation of the EFT code of conduct, which covers all institutions providing EFT services. The broad objectives of the code are to assist in reducing disparities in information between providers and users of EFT services and to reduce the costs associated with the resolution of customer disputes. It does this through dissemination of information to customers about EFT services, by clarifying the rights, obligations and liabilities of suppliers and users of EFT services and by establishing accessible, low cost arrangements to handle customer disputes.

The evaluation report recommended a number of changes to the code, its administration and public accountability which have been implemented by financial institutions. These changes were adopted with the support of Commonwealth and State Governments and have improved the effectiveness of the code and of EFT services for institutions and customers alike.

Computerised Supermarket Checkouts At the request of the Minister for Consumer Affairs, the TPC cooperated with the Australian Retailers' Association and consumer representatives on the development of a national code of conduct for supermarkets using computerised checkout systems. The purpose of the code is to ensure that computerised prices are consistent with shelf-prices and that consumers are provided with information about the operation of the code and with accessible complaint handling arrangements.

The code requires participating supermarkets to maintain the integrity of their computerised pricing systems, to provide items free where the system price exceeds the shelf price and to accept the findings of an

independent complaints committee. There is also provision for regular monitoring of the code and for periodic reviews of its effectiveness.

The supermarket scanning code provides a cost-effective market solution to a problem which potentially involves relatively small losses for large numbers of consumers.

Market-based studies and inquiries

Increasingly the TPC is using market-wide research on competition and fair trading issues as an effective means of identifying the causes of particular market problems and of proposing options for overcoming them. Studies of this kind can be used to persuade market participants to change their conduct and to persuade policy makers to take action to reduce identified impediments to competition. Again these studies can be supported by compliance information programs and selective enforcement actions, as necessary.

This research role has been particularly important in areas of the economy which are affected by the Government's micro-economic reform agenda. Many of the industries being affected, such as telecommunications, domestic aviation, the waterfront and the rural sector, are being newly or more fully exposed to the TPA.

Domestic Aviation Following the failure of Compass Airlines in December 1991, the Minister for Aviation and Shipping, Senator Collins, asked the TPC to conduct a study into the causes and consequences of the failure, having regard to:

- the contribution made by Compass itself;
- the impact of the competitive strategies of the established airlines; and
- any barriers to entry and competition in the domestic aviation market.

The TPC's report on Compass was released in February 1992. Its findings contributed to the Government's decision-making on the reforms to domestic aviation policy announced in the Economic Statement of 26 February. These reforms are likely to increase the effectiveness of competition in the domestic aviation market.

The findings of the report will also be used to provide information and guidance to competitors in the domestic aviation market about the requirements of the TPA in the areas of misuse of market power, predatory conduct and misleading statements and practices which may have adverse consequences for shareholders, creditors and consumers.

The Commission will encourage the airlines to use its Compass report as a case study in their internal compliance education programs on the application of the TPA to the airline business.

Consumer Loan Guarantees The Commission is also undertaking a review of consumer loan guarantees. The study was prompted by:

- evidence that people who agree to act as guarantors are often given insufficient or incorrect information about their obligations and what they are accepting liability for;
- a high level of complaints to the Banking Ombudsman;

and

- the disparity of bargaining power between financial institutions and individuals who agree to act as loan guarantors.

Contributing factors are guarantor literacy skills, misrepresentation of obligations by either the principal debtor or the lender, and insufficient time given for contracts to be considered. Financial institutions contribute to the problem by not evaluating the debtor's or guarantor's actual capacity to repay and, in some cases, by not making obligations clear.

The TPC has investigated a number of cases of misleading or unconscionable conduct in relation to consumer loan guarantees and in 1990 instituted proceedings against the National Australia Bank Limited in which it alleged that the bank engaged in unconscionable conduct in obtaining guarantors for a loan. However, it took the view that a broadly-based study of the problem and options for overcoming it would be more effective in achieving widespread improvements than persisting with selective litigation on a case-by-case basis.

The Commission's study will look at a number of aspects including the legal remedies currently available in Australia and their effects and the type of guarantees used by financial institutions and the extent of their use. The industry will be invited to comment on a Commission discussion paper. It is expected that the final report will be published in the second half of 1992.

The TPC's purpose in conducting the study is to document the nature and extent of the problems which arise in the area of consumer loan guarantees. It will also identify options for changing the policies and practices of financial institutions in this area to overcome or reduce those problems.

Options for further Improvement in the Responsiveness of Trade Practices Regulation

This section comments briefly on some remaining impediments to effective administration of competition and consumer protection laws and suggests options for overcoming them.

Adequacy of penalties

Litigation remains one of the TPC's most powerful tools for achieving corporate compliance and deterrence, for demonstrating publicly the consequences of breaching the Act and for clarifying the requirements of the law. However, to ensure that litigation is effective in practice in achieving these objectives, the penalties available under the TPA should be sufficient to reflect adequately the seriousness of breaches of its provisions and to act as a credible deterrent against future breaches.

The penalties currently available under the TPA are fines up to $250,000 for companies and up to $50,000 for individuals for breaches of Part IV. In the case of breaches of Part V, the current fines are $100,000 for companies and $20,000 for individuals.

In submissions to the Government and to parliamentary inquiries on the TPA, the TPC has argued strongly for increases in the maximum fines available. The Commission considers that the present limits on fines do not represent a genuine deterrent effect for companies that breach the law, having regard to the resources at the disposal of relatively large Australian companies, the financial rewards that can be earned from breaches of the TPA and the aggregate value of the damage that can be suffered by competitors and consumers.

The TPC therefore supports strongly the recommendation by the Senate Standing Committee on Legal and Constitutional Affairs in its December 1991 report on Mergers, Monopolies and Acquisitions that penalties for breaches of both Parts IV and V of the TPA by companies and individuals be increased substantially.

However, in addition to ensuring that the maximum penalties available have a credible deterrent effect, it is important to recognise that the effectiveness of penalties in promoting compliance will also depend on maintaining a meaningful relationship between the seriousness of the offence and the penalty that is imposed. To achieve this, there could be advantages in considering a formula approach to relate penalty to the circumstances of the offence. Factors that could be assessed in applying such a formula include:

- the amount of the 'unjust gains' earned by the conduct;
- the level of detriment imposed on competitors and consumers;
- the likelihood of repetition of the conduct;

- the willingness of the company to provide redress, or to implement a corrective program; and

- the extent of the conduct in the industry and the need for an industry-wide compliance program.

To further increase the effectiveness of penalties as a punitive measure, the TPC should also have the ability to address the court as to the amount of penalty and/or the type of order or other remedy that may be appropriate. This would mean giving evidence on economic matters, the detrimental effects of the conduct and, possibly, the extent to which effective compliance programs were/were not in place.

Enforceability of undertakings

As noted earlier, settlements worked out between the enforcement agency and the business concerned can have the benefit of flexibility in reaching a solution to the market problem which best suits the parties involved. However, the effectiveness of such settlements and undertakings would be enhanced if they were enforceable in the courts.

In August 1991, the Attorney-General, Michael Duffy, said the Commonwealth Government would support the enforceability of undertakings given in the informal merger consultative process and in the authorisation process under the TPA. Government support is also needed to obtain legislative changes to the TPA to empower it to negotiate enforceable compliance deeds in appropriate circumstances and to launch proceedings for non-compliance with a deed of settlement. The furnishment of a bond as an assurance for an agreed settlement is another mechanism worthy of further consideration.

Cease and desist orders

The administrative power of cease and desist orders would provide a further alternative remedy for breaches of the TPA.

The current TPA does not include such a power, although the Australian Securities Commission and Austel do have cease and desist powers enforceable by the court. The Federal Trade Commission and the SEC in the United States also utilise cease and desist orders.

Such an order would be of benefit where the Commission is required to act quickly to curtail, prevent or halt breaches of the Act. A cease and desist power could play a dual role in the Commission's enforcement activities firstly, by providing the Commission with the power to compel transgressors to comply quickly with the provisions of the Act, and secondly, by enabling the Commission to force compliance with the Act in appropriate cases without resorting to the cost, formality and time delays of the court system. Mitigating these benefits is the possibility of the Commission opening itself to a greater level of administrative review in

the appropriate tribunal or the Federal Court and the evidentiary problems that it could encounter in its exercise of the power.

Fragmentation of consumer protection law enforcement

In the area of consumer protection there is a plethora of forums, processes and laws which have been established to enable consumers to resolve disputes and pursue their rights. This fragmentation of laws and enforcement and advisory agencies is confusing to consumers as to which laws and organisations would best serve their needs and can also give rise to considerable duplication of resources, information dissemination, enforcement activities and compliance strategies.

For example, general consumer laws are prescribed in the TPA and the state and territory Fair Trading Acts (FTA), while specialised consumer matters are covered by specific legislation, such as the credit, insurance and building services laws. Similarly, specialised enforcement or advisory bodies exist as well as the general consumer agencies such as the TPC and the state/territory Consumer Affairs Departments.

At the policy level initiatives have been taken to rationalise consumer laws and to reduce inconsistencies. Examples include substantial progress towards uniformity between certain consumer protection provisions of the TPA and the provisions of the state/territory FTAs, the ongoing work towards uniform credit laws and the Special Premier's Conference work on uniform standards and mutual recognition of regulations.

In an effort to reduce the potential costs and inefficiencies of these fragmented institutional arrangements at the administrative level, a coordination mechanism, CADMAC (Consumer Affairs Directors' Meeting on Agency Cooperation) has been established with the TPC as convener to:

- discuss common problems with a view to organising coordinated responses;
- exchange ideas and information on administrative and organisation developments;
- allow all agencies to participate in nation-wide or industry-wide projects to overcome consumer problems;
- recognise emerging problems and act on them before they become entrenched; and
- receive briefings on consumer issues from other organisations (eg Australian Banking Ombudsman, the Insurance and Superannuation Commission and the Australian Securities Commission).

The CADMAC mechanism has been very successful to date in reducing the potential costs of fragmentation and duplication and in providing an effective network for coordination of national compliance programs on selected issues. Nevertheless, these institutional arrangements continue to be an impediment to efficient and responsive administration of consumer protection laws and much remains to be done in this area.

Limited Reach of the TPA

The TPA has restricted application to the anti-competitive and unfair trading practices of Australian business as a result of constitutional limitations on the Commonwealth's legislative authority and other specific exemptions on the reach of the TPA. These sources of immunity from the TPA include:

- the Shield of the Crown doctrine which insulates certain Commonwealth, state and territory bodies and activities;
- section 51 of the TPA which provides for specific exemptions of certain conduct authorised by Commonwealth, State and Territory laws;
- exemption from the TPA for constitutional reasons of the conduct of unincorporated enterprises operating only intrastate; and
- section 172 of the TPA which allows special government regulations for the marketing of primary products.

As a result, many potentially anti-competitive and unfair practices in numerous sectors of the economy are not subject to the provisions of the TPA. The most notable of these are in the areas of state public enterprises controlling the supply of gas, electricity, water and transport, the professions and certain agricultural marketing boards.

The then Prime Minister, Mr Hawke, referred to the potentially adverse impact on costs, prices and efficiency of this uneven application of the TPA in the statement 'Building a Competitive Australia' on 12 March 1991 and to the government's intention to achieve universal application of the Act. The Special Premiers' Conference has been addressing this issue.

The effectiveness of competition and consumer protection laws will continue to be limited while important sectors of the economy are excluded from the reach of the TPA. The TPC is keen to see rapid progress towards universal application of the TPA in 1992.

Conclusion

The TPC sees its role as improving the competitiveness of Australian markets and their effectiveness in providing beneficial outcomes for consumers.

The Commission evaluates the effectiveness of its own work in terms of its impact on marketplace conduct and outcomes, rather than in terms of numbers of court and other compliance actions taken.

The Commission views litigation as a means of achieving its broader marketplace goals rather than as an end in itself. Increasingly, the TPC supports successful court actions with other complementary strategies designed to achieve widespread marketplace compliance with the TPA and improved outcomes for consumers.

In recent years the TPC has attempted to implement a range of compliance strategies designed to have more pervasive and lasting effects on market conduct and on the effectiveness of markets in providing benefits for consumers. These strategies have achieved mixed success and some were illustrated in the paper.

The TPC remains committed to the general approach of seeking forward-looking industry-wide improvements in market conduct and outcomes and intends to persevere with the strategic approach described in this paper.

Some remaining impediments to responsive and effective competition and fair trading laws will need to be addressed in the period ahead. For example, reforms are needed to provide for adequate and appropriate penalties, cease and desist orders, more uniform and coordinated consumer protection laws and universal application of the TPA.

Chapter Twelve

Making the Giant Competitive rather than Crushing¾ Industry Perspectives on Regulation Enforcement

John Martin

> Regulation is developed by lawyers, enforced by lawyers and adjudicated upon by lawyers. The difficulty faced by regulators is their lack of experience in relating to the commercial operators they are regulating. It should be compulsory for all regulators to have spent some time working in the private sector, experiencing at first hand the pressures of competition and compliance. You can reform the laws, you can reform the administrative system but you can't manditorily reform the culture (**Robert Gardini, Gardini & Associates).**

Placing Regulation and Enforcement in Australia's Economic Context

During the 1980s the traditional basis for doing business within Australia changed markedly. All sectors of the Australian economy have become subject to the 'competitiveness imperative' that has emerged as a result of various underlying structural changes, the most apparent of which have been:

- the floating of the exchange rate;
- lowering of tariffs and other barriers;
- the marked decline in Australia's terms of trade.

The barometer of how we have been performing under this new scenario has been measured, to our detriment, in the increasing level of foreign debt that has accumulated during the decade.

In the words of the 'Could have been Champions' all elements of the private and public sectors in Australia are being forced to 'take a good hard look at themselves', in respect of:

- what they do;
- why they do it;
- whether they should continue to do it;
- if they should, how can they do it better.

Regulation, like everything else, must be judged from this perspective. In particular, regulation, and its enforcement, cannot be seen in isolation. The inherent weakness of the Australian economy has been the failure for linkages to work effectively and for sectors and roles such as regulation to be segmented.

Analysis of Regulation and its Enforcement in Australia

As Grabosky and Braithwaite (1986) point out in their book, *Of Manners Gentle*, there has been a dearth of analysis undertaken on the question of regulatory enforcement. The Grabosky/Braithwaite book goes on to make a daunting examination of twelve broad category areas of regulation and to identify and explain variations in regulatory behaviour, and to produce a matrix of regulatory enforcement characteristics.

Of Manners Gentle makes a major contribution to the debate relating to regulation and its enforcement. However, from the perspective of the Confederation of Australian Industry (CAI) there are two key areas in which the approach adopted in the study is felt to be inappropriate. Firstly, the work indicated that it was not concerned at all with 'the content of business regulation'. In the view of CAI the content and the enforcement of regulation cannot be disconnected.

Secondly, the Grabosky/Braithwaite work did not make any attempt to consider the views of the 'client base' of the regulators they surveyed.

CAI initiatives on regulation

As the Grabosky/Braithwaite work points out, CAI in 1980 released a major study which put the issue and particularly the cost, of business regulation on the Australian political (and we would hope economic) agenda. CAI had undertaken a survey which indicated that annual costs to industry arising from regulation was in the vicinity of $3.7 billion per annum.

Grabosky and Braithwaite make a somewhat off-hand comment that the CAI study was of dubious methodology, but they provide no specific technical comments or suggested alternatives.

In subsequent years CAI and other industry groups became extremely pro-active in respect of encouraging self-regulatory initiatives, particularly in the area of Trade Practices, and to seek financial impact statements in respect of all new regulatory initiatives.

Despite positive rhetoric from the Commonwealth Government in the mid 1980s there was little substantial follow up in respect of impact statements. There has been considerable progress in respect of self-regulatory arrangements which can be a more cost-effective and practical way of achieving objectives and securing industry understanding and commitment.

Business attitudes to regulation and enforcement

Somewhat unfortunately, the topic of business regulation has become something of a stand-off, which at times has reflected a view by some in business that all controls in the marketplace are inappropriate, while representatives of some single interest groups regard government regulation and intervention as the only means to control what they appear to perceive as the unscrupulous and predatory corporate sector.

Business is most unfairly characterised, in this general way, by the groups who are in effect 'anti-business'. In fact, the overwhelming proportion of all businesses have a complete respect for a balanced regulatory regime and have stated philosophies that their staff must comply with both the spirit and letter of the laws. However these laws must be made to overcome some demonstrated problems and the cost to those being regulated should not exceed the benefit of such regulations.

The mainstream of respectable businesses believes it has a vital role to play in helping establish these laws, in terms of the 'public interest'.

Business in general strongly believes that laws should be enforced and those that are not enforced should be repealed. Unless enforcement occurs, the small minority of non-complying businesses get away with behaviour that is not only contrary to the public interest but secure an unfair competitive advantage in comparison to the rest of industry who do comply.

This general requirement of enforcement should not be confused with the more subtle choice of whether regulators should go 'by the book' or follow a 'reasonable regulation' goal to achieving compliance without invoking the formal legal process. Business would see this issue as a matter of 'horses for courses' and the challenge which regulators face in enforcing the regulatory process. It highlights the difficulty faced by Grabosky and Braithwaite in their categorisation of enforcement strategies of regulatory agencies. It raises the central issue of the quotation from

Robert Gardini at the beginning of the paper concerning the level of business understanding and acumen of regulators.

This should not be regarded as a lawyer bashing exercise. It is about integrating the regulatory process into the increasingly internationally competitive Australian economy, in a way that most efficiently meets the multiple economic and social objectives involved.

In a recent speech, the Chief Justice of the High Court Sir Anthony Mason praised the Deakin University's new law program which has been placed within the Commerce Department rather than in a separate law faculty. Sir Anthony saw great benefit in stimulating and maintaining interaction between lawyers, economists, accountants and other business and financial experts on a broad range of regulatory issues.

The Chief Justice said, 'the promotion of such a dialogue is essential not only to the solution of national problems but also to effective academic research and instructive teaching of students.' Business believes that this should be taken one stage further and that all those involved in the research and enforcement of regulation should gain practical experience in the working of industry and an understanding of our economic system.

Recent Developments in Regulation and Enforcement

Despite objectives to the contrary, business regulation has been growing throughout the 1980s and is now estimated to be in the vicinity of $8-10 billion per year in terms of cost of compliance to industry. Apart from the inherent tendency for government and bureaucrats, this is due to three factors:

- lack of application of financial assessments to new regulatory proposals and a failure to review existing provisions;
- a backlash to the 1980s corporate misconduct, partly in an attempt to show to the world that we are being well regulated, whereas it would be more appropriate to concentrate on proper enforcement of existing laws;
- special consumer and environmental interests have managed to increase the pressure on governments to increase legislative coverage. These interests have also established pivotal roles on advisory bodies connected with both regulatory policy and administration.

Commonwealth-state issues

There have been serious efforts towards better Commonwealth-state cooperation, with the National Companies Scheme and more recently the initiatives in relation to regulatory consistency and mutual recognition through the New Federalism program. Yet fragmentation remains a serious problem within and among all levels of government.

One costly outcome of Australia's federal system is that Commonwealth and states tend to enact overlapping and at times inconsistent legislation that breaks up an already small Australian market.

The inherent inefficiencies in the inconsistencies and duplications involved reinforce businesses cynicism about complying with regulations.

Appropriate role of government

Business responded positively during the 1980s to the acceptance by government of self-regulation. CAI played an important role in the development of a voluntary product recall code for business which resulted in legislation containing only reserve powers.

The other major development in the 1980s has been the move towards deregulation, particularly in areas of reform such as the financial sector and the airlines.

Although some degree of deregulation and privatisation has occurred, it has often not been supported by the application of competition laws in a manner that can overcome continuing elements of monopoly and shield of the crown, enjoyed by public business enterprises. Business considers there has been a considerable degree of hypocrisy in supposed moves to 'level the playing field' in this deregulatory process. There is little sign that the issues involved are going to be quickly resolved to allow true competition in the sectors concerned.

Specific Business Concerns about Regulation and Enforcement

The main concerns of business cover the following issues:

- involvement of enforcement bodies in policy making and their lack of attention to actually enforcing the laws that are in existence;
- insufficient emphasis on compliance programs;
- some aspects of self-regulatory arrangements and in particular, the implications of dual controls over business;
- selective enforcement by some agencies;
- abuse of enforcement powers;

- imposition of pecuniary penalties by non-judicial means.

In discussing these issues, examples are mainly drawn from recent business experience with the Trade Practice Commission, the Australian Securities Commission and the Australian Tax Office. Their significance however, relates to principles which apply equally to all regulatory bodies, if they are to gain the commitment and confidence of the private sector.

Extent of policy roles by some enforcement bodies

In a recent article in the Trade Practices *Bulletin*, Geoffrey Taperell, partner in Baker & McKenzie's Sydney office, provides an assessment of the Commission's enforcement of the Trade Practices Act. Mr Taperell comments

> . . . in many respects it is more important to ensure there is a high level of compliance with existing laws than to expand the scope of those laws. .. . the Commission should give higher priority to enforcing existing laws rather than changing them . . . (Taperell 1991).

Business has been most concerned over the past year over the extent to which the Commission has increased its attention to policy development, at the apparent cost of its role as investigator and enforcer of the law, particularly its activities in relation to the investigations of the Cooney Senate Inquiry into Mergers and Acquisitions (Australia 1991).

Similarly the Australian Securities Commission has paid particular attention to encouraging the extended coverage of companies and security laws rather than concentrating on more effective application of existing laws now that a truly national, adequately resourced enforcement agency is in place. Thus for instance, in connection with the role of the DPP in corporations law, the protection of self-incrimination is likely to be abolished for the administrative convenience of the administrators rather than for consistency with any underlying principles. This appears likely to create bad law. Double standards will result, as the treatment of those connected with enterprises goes in the opposite direction to the greater protection being afforded to individuals under the law.

Lack of attention to compliance

The greatest challenge involved in regulation is to secure business compliance. This is far too often seen as whether the regulator secures a 'scalp'. Not nearly enough emphasis has been placed on compliance programs by regulatory agencies. In other words the regulatory bodies should be far more clever in utilising the combination of

- the regulations themselves;
- the over-riding threat of enforcement;

and, more importantly,

- improving the understanding and commitment of the relevant section of the commercial sector to achieve an overall objective of appropriate commercial behaviour.

'Scalps' are more a sign that, at the margins, the overall regulatory program has failed rather than that it has succeeded. Unfortunately, the emphasis of this Conference seems to be toward investigation and prosecution to the neglect of the 'compliance' role of enforcement agencies.

The Trade Practices Commission (TPC) resources have gradually moved away from compliance by business, as reflected in activities such as the education program for business. In fact there are indications that the TPC has sought to have companies pay for 'compliance' promotion themselves. In a most recent development, the issuing by the TPC of the Environmental Marketing Guidelines, has had full business support. It is now of concern that even before the Guidelines were formally issued, the TPC were preparing for immediate policing, without allowing for any phase-in period.

In other words business believes that the regulatory agencies, in not emphasising the 'compliance' role, are diminishing what is probably the most important element of their activity in securing the cooperation of the business sector.

Self-regulation—a good idea but some regulators want it both ways

There are two problems here that have caused business to wonder whether self-regulation is really worthwhile.

Firstly, it appears that regulators have a distrust of self-regulation ever working and therefore demand dual control over business. The combination of self-regulation and mandatory regulations adds greatly to costs and uncertainties for business. In adopting this approach we believe that regulators have succumbed to pressure by consumer interests. Yet it is understood that leading thinkers on regulation such as John Braithwaite have backed away from views that dual controls are necessary and now admit that self-regulation can work.

A second and more complex issue is the actual mechanics of self-regulatory codes and that most sensitive of issues, the application of resources (that is who pays for it).

Geoff Taperell (1991), for instance, makes the point that the TPC have devoted too many resources to assisting in the development of self-regulatory or 'co-regulatory' codes in various industries. Taperell considers that by being so closely involved in developing and promoting any self-regulatory code the Commission puts itself in the position of 'having to adjudicate on its own proposals' (Taperell 1991). Taperell

suggests that as the competition watch-dog the Commission should be scrutinising the regulatory codes developed by others. We have great empathy for this view and agree with Taperell that the Commission's pro-active role should generally be limited to issuing guidelines as to the principles to be applied.

The TPC has put admirable effort into developing a 'code on codes' but this has so far proved to be elusive—probably reflecting the wide variety of issues and needs, depending upon the industries involved.

One would like to think that conspiracy theories are matters that are applicable in other countries, not in Australia. However, Bob Browning's (1990) book on the 'Network' certainly gives grounds for concern about the impact of the consumer and green movements including their politicisation of regulatory arrangements.

Without making too fine a point about this issue, there is a danger of business becoming cynical about the enforcement of the law, particularly as evidence presents itself about the increasing politicisation of the public service. The development of self-regulatory codes under the supervision of the TPC has clearly been a means for increasing consumer representation in these processes.

Consumer groups generally see themselves as having some type of democratic right of intervention.

Clearly business is having a close look at how the self-regulatory process may have been manipulated to 'democratic' ends. Business is naive enough to think that expressions of democracy should be limited to the ballot box. Business may have been better off saying to the regulators 'OK you regulate us'. This however, would be a cop-out. It is up to business itself, to put more resources and effort into the process of developing its own self-regulatory codes consistent with guidelines prepared by and in conjunction with the regulators.

We agree with Geoff Taperell that business as a whole has 'nothing to fear and much to gain' from an effective watch-dog. A high level of compliance with appropriate regulation has, in Taperell's (1991) words, great potential benefit to all businesses because it helps to ensure that their inputs of goods and services are as competitive as possible both in terms of quality and price.

Discretionary enforcement powers of some agencies

This problem arises most with regulatory agencies which appear to face some conflict among the objectives they are trying to meet. The best example is the Australian Tax Office (ATO) which has the dual and at times conflicting roles of ensuring tax efficiency and meeting revenue goals. The ATO has immense supporting powers to seize documents, obtain information and issue rulings with a quasi legal status which are at odds with the shift in the relationship between the ATO and the taxpayer as the system has moved to one of self-assessment.

Over the past couple of years, business representatives have been highly critical of this situation and the role played by the Tax Commissioner in a climate where the tax laws are extremely difficult to interpret. There is now an extreme wariness, even distrust, of the Tax Office among professionals in the tax field.

The Commissioner has powers which had originally been conferred when the taxpayer had only been responsible for providing relevant information so that the Commissioner could assess the taxpayer's liability. Now the taxpayer has to make the assessment and can be subject to considerable penalties for any errors.

Then there is the issue of selective enforcement by some agencies. For example, the Tax Office ignored the 1976 decision by the High Court in the Patcorp case (*Patcorp Investments Ltd v. Federal Commissioner of Taxation* (1976) 10 ALR 407-35) but selectively applied the decision to one well known corporation. The effect of this was to leave the corporation without a legal remedy.

Abuse of enforcement powers

There are also signs that enforcement powers are abused by regulatory agencies in a climate of intimidation and confusion. Examples of this include:

- harsh and oppressive interrogation of witnesses when written responses pursuant to statutory powers could achieve the same result;
- failure to warn witnesses of their right to legal representation during interrogations;
- failure to voluntarily provide transcripts to witnesses following interrogations;
- the commencement of legal proceedings by the TPC against the Service Station Association of NSW threatens the right of any trade association to assist its members. The TPC while closely involved with the oil industry in relation to structural problems did not discuss its concerns with the SSA of NSW before commencing legal proceedings.

Imposition of pecuniary penalties on corporations by non-judicial means

There is also concern about the use by the TPC of compliance deeds in administrative settlements. While such deeds may serve a useful role in achieving efficient compliance with the Trade Practices Act, there is a real danger that individual companies, not wishing to face a costly court battle

with the TPC, may be coerced into a harsh and oppressive compliance deed. CAI suggests that it should be mandatory for such deeds to be assessed by an independent third party and that the TPC be required to provide a detailed report to Parliament about each compliance deed entered into.

Business also has a major difficulty with Statements by Ministers which cause economic loss to companies, for example the media statement by the Minister for Consumer Affairs in December 1990 which stopped the sale of cosmetics and sunscreens containing an allegedly carcinogenic substance. The media statement was made despite advice that there were insufficient legal and medical grounds to support a legislative ban. The cosmetic industry had no legal recourse against the Minister as no decision was made under 'an enactment'.

More Efficient Approaches to Regulatory Enforcement

Given the national trend to cut-backs in the public sector, more efficient approaches to enforcement need to be considered.

It is the view of business that outcomes in many sectors can be achieved without recourse to enforcement of prescriptive laws by an administrative agency. A good example is the area of environmental controls. CAI and other peak business organisations have suggested the use of a new policy mix emphasising market-based solutions, taxation incentives and effective and accountable self-regulation.

Legislative controls exist throughout the states and at a federal level, via statutory authorities, to control the emission of pollution and the production, storage and disposal of chemicals, waste and hazardous substances. This is done principally through a system of prohibitions, licensing controls and works approvals and the imposition of penalties for breaches. Pollution control can also include direct prohibition of a particular form of polluting activity.

On the other hand, economic incentives to redress environmental damage are largely under-utilised in Australia. There is presently an abundance of sanctions to promote environmental compliance but not enough is being done to find less costly approaches based on market mechanisms.

Business believes that this view of a more market based approach to regulation could be applied more widely. The regulatory regime must be less remote and more integrated into the workings of the economy. Solutions will be different for different areas of regulation. However, we believe that by exploring these concepts, regulators will identify more constructive and acceptable ways of enforcing regulation.

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Chapter Thirteen

The Problems of Duplication and Inconsistency of Regulation in a Federal System

Roger Wilkins

I have been involved in the development of the model for mutual recognition here in Australia—which hopefully will come into force in early 1993. Also, I was a member of the group of officials who negotiated the Intergovernmental Agreement on the Environment which the Prime Minsiter and all Premiers signed in February 1992.

In developing these agreements and models we thought a lot about the problems of regulation in a system where power and resources are divided up among several governments. The result is some innovative or at least workable solutions. The proof will obviously have to await the concrete outcomes.

Two of the central problems of regulation in a federal system are first the problem of duplication mainly between the states and the Commonwealth and, second, the problem of consistent application of common standards across several jurisdictions.

Let us consider a couple of illustrations. In order to get approval for a major development, say a pulp mill, proponents have to run the gauntlet of both Commonwealth and state planning processes. The processes are not exactly the same, the factors to be taken into account and the standards are not the same although they are roughly similar and there is considerable overlap. The Commonwealth's interests by and large have to do with macro-economic policy, export and import implications, foreign investment and national environmental matters because of spillover effects.

Consider another case of duplication, which thankfully has now been obviated—meat inspection. There we used to have the ludicrous situation where the Commonwealth would inspect meat for export purposes and the states as a matter of course for health reasons. There is now a single inspection that does duty for both purposes.

There is horizontal duplication too—mainly to do with regulation of goods or services that are imported or exported across state boundaries. In some cases manufacturers of goods can be confronted with incompatible standards and requirements between states, as well as the need to have goods inspected or certified several times.

Apart from making the world an impossible place in which to do business, duplication also has a profound effect on the development of policy. Where there are strong ideological or political differences between the Commonwealth and the states, private individuals and companies can often find themselves as the 'meat in the sandwich'. This produces bad policy, legal uncertainty and entirely the wrong sort of regulatory infrastructure to encourage and facilitate business or to protect consumers, the environment or whatever.

One of the features of our system too is the paramountcy of Commonwealth law. So that means Commonwealth law nullifies inconsistent state law. Unfortunately, that sometimes happens accidentally and sometimes creates a climate of uncertainty. The original Commonwealth approach to Corporations Law is a good example of that. An even better example is the fiasco over vehicle emissions.

Another major problem is the consistent application of standards across all states and territories. Let me illustrate by reference to environmental standards. Heads of government agreed that there should be national ambient air and water standards. The thought was that it is unhealthy to have competition between states and territories setting lower standards to attract or retain industry or development. But national ambient standards are very general standards—and that is all they are. Once you set them, what guarantee do you have that they are being translated into practice consistently across Australia? The problem is not necessarily that some states will not take them seriously. The problem is that the states and territories have different (albeit similar) regulatory systems into which these new national standards have to be integrated. For example most of the other states and territories do not have sanctions as strong as the *Environmental Offences and Penalties Act 1989* in NSW.

This is a problem which we will have to solve in the coming months, because in the Intergovernmental Agreement on the Environment we have undertaken to set up a national Environment Protection Agency to set national standards, but state systems will be left the job of translating those standards into practice.

In Canada and Europe they have been grappling with the same problem. The European Commission makes considerable use of 'directives' issued to member states. For example the Commission has issued a number of directives to member countries on water quality, which must then be translated into law in the particular legal system of each member state. If the state fails to do so or fails to comply with the

standard, there is *some* scope for *individuals* to take the matter to the European Court or, more often, for the Commission itself to intervene.

But a cautionary note is needed here. It is possible to overstate the importance of uniformity. In some areas it simply does not matter or does not matter much. In other areas competition and differences between the states can be a positive good. The current obsession with uniform criminal laws and uniform laws of evidence is extremely puzzling. It is not as if there is a vast number of criminal acts that straddle state boundaries. There would be nothing wrong with uniform laws, but there are a lot of other areas where time and effort could be more profitably spent, for example on uniform trust laws.

There is, too, another problem which we might describe as the problem of internalising costs of decisions about standards. It is well illustrated by what could happen under a system of national environmental standards. A national body could set standards that have enormous cost implications for state agencies—both state environment protection agencies (EPAs) and state water boards and electricity commissions—but ultimately state consumers and taxpayers. This, of course, is not a problem peculiar to the regulatory system—cost shifting is a major political and bureaucratic game played in all sorts of areas and between all sorts of agencies. But it is exacerbated severely in a federal system, where one level of government can get another level to pay the costs of its decisions. This problem will not be discussed in detail here, except to note that in designing sensible regulatory systems in a federal system one has to be on guard against creating this sort of system of perverse incentives.

With these problems why not have just one regulatory regimen run out of Canberra or Ottawa as the case may be? Perhaps this is a very good reason to get the states out of it? The problems of duplication and inconsistency are undoubtedly one of the prices you pay for having a federal system. The pros and cons of a federal system will not be debated here, but it should be pointed out that the naive assumption and 'easy' argument that the system would be more rational and workable if it were all done from Canberra is flawed.

The Treaty of Rome implies what has become known in European law as the 'principle of subsidiarity' which encapsulates the idea that it is better as far as possible to push problem solving and service delivery to the most local level possible in the system—to devolve and localise government as much as you can. The onus should be on those who want to centralise power. In the European case, where there is not a federal system, the political appeal of this principle is obvious. But it should equally have some appeal for anyone interested in the dynamics of democracy and accountability.

At least one of the virtues of a federal system is that it acts as a brake on central power. But in terms of efficiency of delivery—it also means that

the clients and consumers have greater influence over decision making. Smaller and more localised governmental units are obviously more responsive to local needs and interests. Think about any sizeable company —you might get strategic policy made at the centre but you leave it up to your regional managers to implement the policy. You set clear outcomes you want to achieve, and you hold them accountable. Autonomy and accountability give you a much better incentive structure. And that is what the Intergovernmental Agreement on the Environment emphasises. The national body will eventually do two things:

- set standards saying what *outcomes* everyone agrees should be achieved;
- monitor the success of states and territories in delivering those outcomes; their compliance with standards.

That has the following advantages:

- there will be a very public and transparent accounting against outcomes—and 'bench marking' or comparison among states and regions;
- there will be an institution whose core function it is to worry about performance against outcomes.
- most importantly, because the emphasis is on the end result and not on the means of getting there, you will have maximised the freedom of different jurisdictions to choose the way in which to achieve those outcomes.

This last point is very important and not often appreciated. Cliff Walsh has referred in various fora to the benefits of 'competitive federalism'—using different and innovative techniques to solve the same problems. So some jurisdictions may choose to emphasise command and control techniques. Others may prefer to rely more on economic instruments, market based solutions, due diligence and so on. But the important thing is that there is an incentive of a major kind to experimentation and innovation.

Let me come back to the problems of consistency and duplication and say a little bit more about the types of solutions that are being developed. One sort of solution used in the Intergovernmental Agreement on the Environment has just been mentioned: you get agreement on *outcomes*. You then leave it up to the states to achieve those outcomes and make them account publicly against those outcomes. The national EPA is the classic case of that, although it is a technique that can be readily applied to other areas of Commonwealth-state relations, and was a model we first

suggested for dealing with tied grants at the very outset of the Special Premiers' Conference process.

But it is not always possible to say in advance what outcomes you want to achieve. Planning approvals are a good example of that. Here the outcome is not something you can prescribe in advance. A proponent comes forward with a proposal and then has to submit that proposal to a process of analysis and assessment. The end result is that it is approved or not, often with conditions and modifications. In this sort of case we focussed on the integrity of the process and not the outcome—the view being that if you get the process right then the outcome will be acceptable.

Under the Intergovernmental Agreement on the Environment we agreed that jurisdictions could 'accredit' each other's processes; particularly in the areas of land use and resource use decision making. What does 'accreditation' mean? Well it means that the Commonwealth, for example, will look at the NSW planning process from the perspective of Commonwealth interests. They might decide that it is perfectly adequate except it does not take into account impact on defence industries, or impact on balance of trade, but if it were modified it could do so. NSW could then agree to modify the process to take account of the Commonwealth's interests. Then the Commonwealth would *accredit* the process. The Intergovernmental Agreement on the Environment provides that once that happens the Commonwealth will give 'full faith and credit' to the outcomes of the process—and that is defined to mean that the Commonwealth will *accept and rely* on the outcomes of the process.

We have not yet got to the point where the agreement includes leaving the matter entirely to one jurisdiction. The Commonwealth and the state will still have to decide—there will still be *two* decisions but only one process. That is the idea. If that works well we may be able to get to the point where there is only *one* decision made as well.

One of the most important questions that came up in the context of thinking about regulatory reform was what sorts of standards and regulatory regimens needed to be uniform across Australia. Environmental standards is one case—because here there is the real chance that states will compete in setting lower standards and making concessions to get industry, development and employment. It was considered that where actions by one state have adverse effects on other states then the Commonwealth did have an interest in getting involved and the issue was not just a local state issue but a national or at least interstate issue. That is spelt out in the agreement.

Another criterion used, which had already been discussed in relation to the Australian Securities Commission, was the need to create and maintain a national market for goods, services and capital. The view was taken that Section 92 of the Australian Constitution had failed to do any more than cut down discriminatory laws. It had failed to eradicate all sorts of obstruction to the free flow of goods, labour and capital.

One of the best examples of this is the variation of standards in relation to goods from state to state. State laws can quite easily set different standards for goods without at all discriminating against interstate goods. But the fact is that because standards differ from one state to another, as a matter of fact they obstruct free trade and can indeed operate as non-tariff barriers to trade. For example: NSW labelling laws might require a manufacturer to supply different information than Victorian labelling laws. That means that manufacturers have to manufacture two different packaged products—one for Victoria and one for NSW.

The Europeans have already come to grips with this problem by developing a jurisprudence based initially on the Treaty of Rome that interprets the Treaty to require the mutual recognition by member states of each other's standards. In very simple terms, the European Court will not allow the sale of goods to be prevented in say, Germany, because of failure to conform with German law, if the goods have been manufactured and are capable of being sold in say France and hence comply with French standards. In the example just given of labelling laws—the fact that goods had been packaged and labelled in accordance with French law would be a defence to any prosecution for failure to comply with German law.

It represents a very simple, elegant and efficient solution to non-tariff barriers to trade perpetrated by the mere fact that different states have adopted different regulatory standards. It is much more efficient than trying to find a single uniform standard that can be agreed to by everyone. The quest for uniformity is flawed chiefly for two reasons—first, agreement is hard to get and often results in the lowest common denominator or unclear law; second, agreement on uniformity is very hard to maintain and adapt to changing circumstances.

There is now a draft law on mutual recognition of goods and occupations for Australia which is in very general terms. In relation to goods it says roughly this—if goods can be manufactured and sold in say NSW then they can be sold in say Victoria, notwithstanding that they contravene standards required under Victorian law. Where it is considered that standards need to be maintained for the purposes of health, safety or the environment then there is a mechanism agreed to by all Premiers and Chief Ministers that would allow a standard to be put in place if two thirds of the states and territories agree.

Moreover, to ensure that there is no deliberate or accidental 'backsliding' by states and territories, the Premiers and Chief Ministers were prepared to refer power to the Commonwealth to pass the Mutual Recognition Bill. In this way they could avail themselves of the paramount power of Commonwealth law under Section 109 of the Constitution. If a state tried to do something inconsistent with the Commonwealth Mutual Recognition Law it would be rendered ineffective by S. 109 of the Constitution.

This is very bold and innovative reform. It is amazing that it has received so little coverage in the media. It is a measure that exhibits all the best features of microeconomic reform and the Special Premiers' Conference process:

- it is the states and territories trusting each other—according faith and credit to each other's capacity to regulate sensibly and rationally;
- it is the states and territories prepared to cede power to the Commonwealth because it is critical to the development of a national market place that parochial state interests should concede;
- it is 'low maintenance' law. No one really has to administer it;
- it shifts the onus away from those who advocate free trade and requires those who wish to obstruct trade to justify their position;
- in fact it has and is acting as an incentive or stimulus to develop uniform standards. Far from being inimical to uniformity it has in fact provoked it (and it is not even law yet!);
- it also contains a quite remarkable move away from the requirement of consensus in decision making in Ministerial Councils, to a two thirds majority.

This is a good example of how to handle the problem of different and inconsistent standards that tends to be a feature of federal systems. As already noted it cannot be done for all standards—some need to be uniform. But most do not. Uniformity simply doesn't matter that much—to a large extent the quest for uniformity in such cases is gratuitous, particularly in a country like Australia with largely homogeneous interests and values.

In the case of occupations the model is a little different. The basic idea is the same—if you are good enough to be a doctor in Western Australia, then you are good enough to be a doctor in New South Wales. The Mutual Recognition Bill therefore requires registration boards and authorities to register people on the grounds that they are already registered to practise an equivalent occupation in another state or territory. By putting the onus on registration boards and authorities consumers are protected from having to know and make decisions about equivalent occupations—they can simply continue to rely on the fact of registration or authorisation.

These are some of the ways in which the problems of duplication and inconsistency can be overcome. But solutions also require imagination, a lot of hard work and most importantly, the commitment of all the

Premiers, Chief Ministers and the Prime Minister to look beyond their own parochial concerns, even in some cases to look beyond their own political interests.

Chapter Fourteen

Detecting, Investigating and Regulating Business Law-Breaking

Albert J. Reiss, Jr.

The introductory chapter to this volume declares that the major challenge facing this nation in the twenty-first century is '. . . to ensure Australian competitiveness in the world economy'. It admonishes that in this changing business climate, there is a need to develop innovative strategies for regulating business, preferably ones where self-regulation and government enforcement work together. That seems like a reasonable if not altogether feasible goal. Yet, as we ponder the problems of legal detection, investigation, and regulation of business enterprises in a competitive world economy[1] of the twenty-first century, it seems that this formulation of business regulation focuses our vision too narrowly. Perhaps we might even be misled in our thinking about their regulation.

The market regulates business enterprise in an economy but their legal regulation requires a polity. We may easily be misled into thinking that business enterprise in a world economy of the twenty-first century can be legally regulated principally by and within sovereign states like Australia and the United States. A major problem for sovereign states in the next century, however, is how to regulate business enterprises in a variety of transnational markets primarily through the exercise of their sovereign powers. Although there is merit in the regulatory goals of sovereign states, it is doubtful whether Australia or any other society has the capacity to achieve them in a world in which polities and their sovereignty, economies and their markets, and technologies and their organisation are changing rapidly.

[1]. Phrases like global economy and world economy are rarely defined in ways that are germane to normative, and specifically legal, regulation.

Changing Sovereign Powers

We shall turn first to consider the growing incapacity of sovereign states to control the behaviour of corporations (either 'domestic' or 'foreign') in transnational markets. Unwilling and unable to surrender their sovereign powers to transnational regulatory bodies or federations, they are increasingly impotent to regulate business transactions in transnational markets by exercising their sovereign regulatory powers.

The changing nature of national economies and their markets is a principal source of the decline in the power of sovereign states to regulate domestic and foreign business enterprise. National economies are being dismantled, transformed, and Balkanised into economic or trade communities. Some economies, like the former Soviet Union, are being dismantled. Others have been rapidly transformed into modern economies, such as the contemporary economy in the Republic of Korea. Still others are being Balkanised as trading communities, such as the EC, the North American trading community, and the emerging pan-Asian trade federation. Although most are made up of sovereign states, the EC is emerging as a polity that increasingly regulates business enterprise by setting standards for consumer products, the marketing of stocks, transport, environmental pollution, and human rights.

A major theme of this paper is that the growing complexity of commercial enterprise, the increasing versatility and complexity of technology, and the separation of production, assembly, and distribution of goods and services in separate economies and sovereign states is leading to an erosion of sovereign powers to regulate business enterprise within its jurisdiction and to control trading beyond its boundaries.

Let me begin by presenting two fairly recent cases that illustrate how the regulatory powers of a number of countries were circumvented, compromised, and otherwise severely undermined to serve as a basis for further discussion of the coming crisis in twenty-first century regulation of business enterprise.

BCCI COLLAPSE The first case was billed as the BCCI (Bank of Credit and Commerce) collapse, a case that is widely believed to carry lessons for the regulation of international banking. It is a complex case involving not only what is alleged to be the biggest fraud in banking history—perhaps as much as US $15 billion in losses (*The Wall Street Journal Europe*, 23 July 1991)—but because its branches also served other illegal activities such as money laundering for drug trafficking, the transfer of funds for covert intelligence operations, the transfer of public funds to private accounts, maintaining accounts for terrorist organisations, and covert share purchases to gain control of banks where sham deposits and loan accounts were recorded (*see* Wagner 1991, p. 4; *Sunday Times*, 21 July 1991; *The Wall Street Journal Europe*, 23 July 1991, p. 22). As

George Melloan of *The Wall Street Journal Europe* said waggishly: 'One might say that, with its money laundering capabilities and all, BCCI was a full service bank'.

BCCI SA was closed down by Bank of England regulators on 5 July 1991 (*The Financial Times*, 24 July 1991, p. 6) and liquidation of its assets begun. The Australian division, BCCI Australia, was placed in voluntary liquidation during the same week (*The Sunday Age* (Victoria), 14 July 1991) and there continue to be repercussions for branches or subsidiaries in other countries, such as the riot of Hong Kong depositors the last week of February 1992 and the early 1992 close-down of the Independence Bank in California in which BCCI had secretly bought an interest (not all of the BCCI group fell under control of receivers so that assets may have been transferred from those not in receivership, *The Financial Times*, 24 July 1991, p. 6). The pattern of fraud in BCCI is fairly clear. Faced with losses from bad investments and problem loans, it sought to cover these losses with a variety of fraudulent practices some of which resemble the practices of sophisticated embezzlers and others seem as crude as check-kiting. The devices used to conceal losses include (*see* Bray 1991a, p. 11; Lohr 1991; *The Wall Street Journal Europe*, 24 July 1991):

- booking corporate losses against client accounts;
- using funds owned or managed by a related company, usually a Cayman Islands based company, known as ICIC;
- drawdowns against fictitious loans and use of the funds drawn;
- unrecorded deposits;
- dealing in its own shares through nominees and using the profits from those transactions;
- secret agreements and unrecorded borrowing involving other banks and investment institutions;
- agreements with major customers by which BCCI indemnified the customers, who, in return confirmed balances to auditors; and,
- secretly gaining control of the Washington, DC-based First American Bankshares and in clandestine moves taking over the National Bank of Georgia and the Independence Bank of California (*The Daily Telegraph*, 25 July 1991) and then using their interest in these banks as security for further loans to nominees who confirmed sham transactions and balances (*see* Bray 1991b, p. 23).

To understand what went wrong in regulating BCCI, we must first understand something of its Byzantine structure—a regulatory agency's nightmare of webs joined in an hierarchical network. At the top of the hierarchical pyramid were Abu Dhabi shareholders who created BCCI Holdings, a Luxembourg-registered subsidiary. BCCI Holdings set-up directly held bank subsidiaries in various places, including, for example, Hong Kong, and the United Arab Emirates. It also created a Luxembourg Bank Subsidiary, BCCI Holdings SA, that had a London operating headquarters, subsequently moved to Dhabai, with operations in Britain and a number of other countries, mainly European. A second bank subsidiary, BCCI Overseas, Ltd. was registered in the Cayman Islands. It operated 62 branches in 28 countries, including Pakistan and other Asian and Middle East countries. The bank was clearly organised so that in effect it would be offshore everywhere and consequently hard to regulate. This, perhaps, is the first and most important regulatory lesson to be gleaned from the BCCI debacle: that it is difficult for any country to regulate a corporate holding company that is organised to operate beyond its sovereign domain or that of any other sovereign state.

Perhaps it will not seem surprising to those acquainted with regulation to learn that this was not the first time Britain and the European nations had learned this lesson. Previous experiences had led to the formation of an international collegium as a kind of international regulatory body (*see The Financial Times* 22 July 1991, p. 12). The starting point was the 1974 collapse of the German Herstatt Bank. This downfall led to the formation of the Basle Concordat in December 1975. That Concordat provided for the division of regulatory responsibility among national authorities. The central principle was that responsibility for the supervision of foreign banks should be the joint responsibility of the chartering and host countries.

The collapse of Banco Ambrosiano's Luxembourg subsidiary in 1982 highlighted the transparency of this concordat when both Italy and Luxembourg disclaimed responsibility for supervision of the Luxembourg holding company. There was a catch-22 situation. According to Luxembourg law Banco Ambrosiano was not a bank, but a holding company for banks (holding companies are common in contemporary US banking) The Basle Concordat did not apply to holding companies! Accordingly, the Basle Concordat was amended to include two additional regulatory principles. One was the so-called dual-key approach in which parent and host authorities assess one another's supervision. The second principle consolidated regulatory authority in the parent authority, holding it responsible for the supervision of all of a bank's worldwide operations, including foreign subsidiaries. When a host country concludes that the supervision of a parent authority is inadequate, it should discourage such offices or impose specific conditions for its operation; alternatively it may discourage the parent bank from continuing to operate in its jurisdiction.

These principles place an extraordinary burden on each national supervisory authority since it must satisfy itself that its banks' foreign operations are being conducted in jurisdictions with sound supervisory practices as well as that foreign banks operating within its jurisdiction are subject to adequate supervision in their parent jurisdiction. For these principles to be effective the national authorities in leading banking centres must be prepared to exclude foreign banks that are chartered in permissive jurisdictions such as the Cayman Islands and at the same time prevent their own banks from conducting international banking operations in those jurisdictions. BCCI provides convincing evidence that these principles were, at best, working poorly. How this form of supervision can operate effectively without far more regulatory authority and resources than any national regulatory authority for banking possesses is unclear after BCCI.

There is a further provision in the Basle Concordat that strikes at a fundamental tenet of domestic regulation of foreign corporations and most forms of international regulation such as the Basle Concordat. It holds that banking authorities cannot be satisfied that individual foreign banks operating within its domain are sound unless they can examine the totality of each bank's business wherever it is conducted. This necessarily means the right of the parent company, at least, to inquire into the individual bank transactions in every country. The principle, ignores of course the legal structure of banking in different countries and the obligation of corporations for full disclosure. The domestic legal structure of banking is precisely what was at issue in the Ambrosiano and BCCI cases for under Luxembourg law, a holding company is not a bank!

There was another structural weakness and an attempt was made to repair it. The weakness was that consolidated supervision was impossible when a holding company incorporated subsidiaries in different jurisdictions. BCCI was such a case, having incorporated subsidiaries in Luxembourg and in the Cayman Islands. To deal with that complexity, a College of Regulators was established in May, 1988. Initially, the College of Regulators for BCCI consisted of Luxembourg, the UK, Switzerland, and Spain; gradually France, the UAE, Hong Kong, and the Cayman Islands were added. This repair was obviously insufficient to ward off the BCCI collapse. Whether intended or not, the College of Regulators was structurally weak. Its members were not sovereign nations with the powers to sanction. As a body, it lacked sovereign legal authority, being at most a creature of sovereign organisations who retained their sanctioning powers. Consequently, the College was essentially powerless to formally regulate BCCI. It had few powers and resources for formal investigation and no powers of any kind to compel compliance or to deter by sanctioning violators (*see* Forman & Haggerty 1991), powers that ordinarily are rooted in legal authority. Legal authority, as we noted at the outset, is what characterises sovereign regulation.

We come then to a second major lesson from the fall of BCCI. Either the dispersal of regulatory responsibility to a collective authority with few guiding principles for selection of members and operations and lacking in sovereign legal regulatory authority or the dispersal of regulatory responsibility among many national authorities is insufficient to regulate multinational corporate structures and operations. To rush to the conclusion, as some have, that this requires an international body with someone in charge of detecting and sanctioning violations is to ignore fundamental questions of both the powers one has to investigate and sanction violations and of how one operationally can carry them out. The nature of these problems will be illustrated only briefly and will be referred to again after consideration of the second case.

The problem of detecting violations by holding companies of banks and investment houses operating in different countries is especially complicated. First of all, there is the matter of the powers and resources of regulatory bodies, particularly their proactive capability to detect violations and ensure their correction before shareholders and corporate entities are damaged severely. Because countries vary in size, they vary considerably in the resources they can allocate to regulating corporations that either are chartered within, or operate within, their national boundaries. Luxembourg, for example, has always maintained that it has insufficient resources to monitor effectively and made that claim in both the Ambrosiano and BCCI cases (*see* Forman & Haggerty 1991).

To rely upon private investigation, such as those of auditing firms, is also problematic. They frequently are compromised by the need to protect their market position, lest they lose a client. Some critics suggested after the BCCI debacle that:

> . . . Price Waterhouse was reluctant to antagonise a lucrative client that one former bank executive said paid audit fees of more than $3 million a year. But accounting experts reply that a $3 million fee would not have been too high for a bank with the sprawl and complexity of BCCI. The real issue, these experts say, may have been whether the fees were enough for Price Waterhouse to make a profit without cutting the corners on such a difficult audit (Lohr 1991).

The traditional auditing of records and transactions is limited by methods of accounting, the availability of information for audit, and the necessity to rely upon methods of verification that are independent of the group committing fraud. In the BCCI case, only one auditing firm was responsible for BCCI audit in the UK—Price Waterhouse. Price Waterhouse contended after the collapse of BCCI that the complex structure of BCCI made it difficult to detect and investigate irregularities in audit and that when irregularities were detected and reported to the Bank of England, the Bank was slow to respond because of concern that reporting irregularities or closing BCCI would have severe systemic repercussions. Indeed, Mr Robin Leigh-Pemberton, the Bank Governor,

in responding to MPs questioning as to why the Bank failed to act against BCCI more than one year earlier on the basis of information available to it acknowledged that:

> Up to then, no evidence of fraud on a scale to justify revocation existed . . . There was an indication that certain things were not well. Some transactions were false or deceitful but our view was that even if these transactions added up to individual acts of fraud, it did not add up to *systematic fraud* (emphasis added).

He went on to add:

> If we closed down a bank every time we had a fraud, we would have rather fewer banks than we have (Waters 1991, p. 6).

Moreover, he also defended the behaviour of Price Waterhouse:

> The bank has been involved in . . . a form of deception against which it is very difficult to guard and which is very difficult to discover. I must say that Price Waterhouse worked promptly and effectively throughout this whole matter (Waters 1991, p. 6).

Several things are easily overlooked in the Governor's response to the MPs. Perhaps most importantly is his presumption that some fraud is endemic in large capital institutions whether domestic or foreign. Because it is endemic, the regulator must decide when a threshold is reached that signals, in his terms, systematic fraud. The Bank and its auditors, one can be sure, have no clear and certain test of when fraud is systematic, except by an after-the-fact designation. What is usually left unsaid in all legal regulation is how does one evolve decision rules and under what circumstances does one apply them? The procedures of regulation and auditing are grounded, as are the procedures of the organisations being regulated, in a thin reed of discretionary decision making—decisions about when and what to investigate, what to make of evidence that signals wrongdoing, what actions are to be taken on the basis of that evidence, and so on.

The problem of investigating and detecting violations is affected also by the structures that link sovereign nations. Again the words of the Bank of England Governor are instructive. The MPs had become aware of the fact that earlier, New York State in the USA had refused to charter BCCI branch banking and moreover, that Mr Robert Morgenthau, the Manhattan District Attorney, had been investigating BCCI and had requested information of the Bank of England and BCCI in that connection. Mr Leigh-Pemberton acknowledged that the Bank and BCCI's auditors had deliberately withheld information from Mr Morgenthau stating that the Bank and Price Waterhouse had been constrained by the secrecy rules in the Banking Act. Clearly, each sovereign nation adopts laws and administrative rules that protect corporate information from disclosure to

other sovereign regulators and to competing market organisations. For market competitors, secrecy is a condition of survival. For the sovereign state it is also a condition for maintaining a competitive climate. For those who would regulate organisations operating in a global economy, secrecy is a barrier to effective regulation. What does seem clear to me is that in the twenty-first century sovereign states like Australia will have to surrender a great deal of the cloak of protective secrecy for its own corporations operating in foreign markets and that it will need to insist upon more openness from those that would operate within its domain. Effective regulation requires, at least, the penetration of corporate and state secrets. It requires the former for effective state control of domestic and foreign corporations and the latter because the state is not immune from corruption of its authority and powers to regulate. Just how much business enterprise is willing to give up its secrets to not only national but international regulatory bodies will no doubt be much debated. Secrecy has always been one of the great barriers to effective self-regulation by a business or industry. Protection of financial information, of corporate clients, and of internal management emasculates self-regulation by an industry or business community as well as governmental regulation. Self-regulation then tends to become synonymous with a corporate conscience akin to an individual's conscience, which we know requires considerable re-enforcement if it is to govern in the face of temptation.

It is axiomatic among authorities on the regulation of business enterprise that corporations intending to commit fraud or other illegal activities will gravitate to sovereign states that combine stringent secrecy laws with a weak regulatory environment. As Richard Dale concludes, there are no ready answers as to how to regulate under these circumstances but much more on-site examination may be required (*see The Financial Times*, 22 July 1991, p. 12). Clearly such examinations can be highly intrusive and it is not clear how easily examiners can penetrate corporate cloaks in a weak regulatory environment nor how willing are such states as the Cayman Islands or Luxembourg to permit these investigations. An alternative, for each state to preclude operation in any such country, may be unrealistic since the capacity to form and cloak operating subsidiaries is considerable. Moreover, competitive advantage in world markets, such as third world markets, may be in the interest of one's domestic corporations when it advantages the domestic economy without harming it. A Nestle Corporation advantages the Swiss economy while potentially harming infants in third world countries that are too weak to regulate in their long-run self-interest.

The economic and political structures emerging among sovereign states complicate questions of what, and how, to regulate. To choose but one example, under recent agreements among the European countries, banks incorporated in any country will be able to branch automatically into any other country. The UK, for example will have nothing to say about the

branch of a Luxembourg bank operating within its domain. Clearly what we face in the new economic and political unions of sovereign nations is a question of what kind of governing regulatory authority shall be given full powers of investigation and sanctioning for any corporation that operates outside its domain. Perhaps I need not remind you that in the absence of any supernational authority and/or express agreements between sovereign nations, any nation depends primarily upon the parent nation for insuring its corporate and capital integrity. The United States, for example, remains largely dependent upon Australian regulation to insure the integrity of Westpac in permitting it to operate within its domestic domain.

Facilitating Iraq's Nuclear Development

The second case requires only a brief exposition as it serves to raise additional issues about the regulation of business enterprises in a world economy. UN inspection teams sent to Iraq in the aftermath of the 1991 war soon uncovered evidence that Iraq was much closer to becoming a nuclear power than Western nations had assumed from their intelligence sources. Apart from calling into question the reliability of information based on covert intelligence operations, the investigation soon produced considerable evidence that Iraq had been able to purchase most of the technology required for the manufacture of nuclear weapons and their nuclear ingredients, such as centrifuges, high grade metals, and electronic missile components. Without going into detail about how Iraq was able to purchase the technological components essential for manufacturing nuclear materials and missiles, what soon became clear is that a number of western nations had knowingly sold essential components or parts. Sellers included some of the largest international corporations of western countries such as Du Pont in the United States as well as smaller high tech firms in the Federal Republic of Germany, Switzerland, The Netherlands and Sweden (incidentally, an irony of modern history is that Swedish companies also constructed the underground bunkers in which Saddam Hussein's household and cabinet were housed). All of these countries were committed to nonproliferation of nuclear power and, except for the United States, strongly opposed to possession of nuclear weapons. Yet the business enterprise of these and other countries provided component technologies.

The discovery probably was not surprising to the governments of these countries. Even when a country specifically enjoins businesses from exporting a given technology or technological component to given countries, it easily loses control over such sales. A vast network of sales agents and brokers exist in many countries for the express purpose of laundering technology. Trans-shipment of technologies and their components is common and it is difficult to hold sellers accountable for

prohibited sales to buyers in international markets. Indeed, typically a business enterprise has no way of independently verifying whether a buyer intends to use a technological product, modify it, or broker its sale. The requirement of an export licence is thus only a very crude instrument for nations to regulate sales of prohibited items. Moreover, what is a prohibited item for one country is permitted by others and legitimate covers exist for prohibited transactions. Western German corporations were linked to the building of toxic gas facilities in Gaddafi's Libya only to respond that they thought they were contributing to the construction of a pharmaceutical facility.

Without belabouring the point, it is difficult for any nation to control either the sale of technologies to prohibited consumers or the uses to which they will be put. The reason it is unable to do so inheres in the nature of both markets and technologies. Markets and technologies are both relatively indifferent to nonmarket ends. Moreover, because business enterprise increasingly consists of manufacturing component parts that can be assembled in quite different products in widely scattered locations, it is difficult to regulate either their sale or purchase.

The problem of regulating commercial sales in world markets looms as potentially one of the major problems in regulating global markets in the twenty-first century. The opportunities for fraud in marketing are considerable and may well lie beyond the preventive capabilities of either business enterprises or their governments; both will have to rely increasingly upon strategic interventions to control its consequences for profitability in competitive markets. Nowhere is this more apparent than in the growth of credit and transaction frauds. The recent disclosure of an air ticket and travellers cheque scam operating in Sydney and Melbourne is illustrative (*see The Daily Telegraph Mirror*, 15 February 1992, pp. 1, 4 and 5).

Credit and Transaction Fraud in the Travel Industry

Shortly after coming to Sydney from the UK via Germany, two Sri Lankan businessmen established two shelf companies, using family members and associates as directors. Then they applied to the International Association of Travel Agents (IATA) for a licence to operate travel agencies after posting a bond to the NSW Travel Compensation Fund. The first scam simply involved failing to pay six foreign airlines for advanced bookings; their losses are estimated at about A$1.3 million. The second defrauded passengers and airlines by falsifying coded airline and destination details on tickets. When the false entries were discovered, passengers often were forced to re-purchase tickets at the foreign destination.

To finance the travel racket, they printed more than 300,000 bogus National Australia Bank and American Express travellers cheques and sold bogus credit cards and Australian passports.

Money was transferred to Swiss and German bank accounts and, it is alleged, used to negotiate the purchase of weapons in Israel to support Tamil Tiger guerrillas in Sri Lanka.

The scam was first uncovered through the routine arrest of a man for credit card fraud carried out at major retail outlets in Sydney. During their investigation authorities uncovered information that led to a broadening of the probe. Eventually the following domestic agencies were involved: the NSW and Victoria police departments, the Australian Immigration Department, NSW Consumer Affairs, the NSW Travel Compensation Fund, the Australian International Travel Agency, the National Crime Authority, the National Australia Bank and other Australian banks. Foreign agencies in addition to the six Dutch, Malaysian, and American airline carriers included American Express, IATA, and Interpol.

This particular scam is repeated time and again in different countries but the capacity of modern technology to facilitate fraudulent conversion may well lag behind the adaptation of means of detection and investigation to prevent it.

The Future of Regulatory Control

Perhaps undue attention has been drawn to the myriad problems that confront the investigation, detection, and regulation of illegal markets and marketing in the twenty-first century. Foremost among these limitations would be the decline of sovereign powers to regulate business enterprise both domestic and foreign within and without its sovereign domain. The sovereign state as we have known it in the twentieth century is becoming more vulnerable to regulation by global markets and supranational polities. At the same time the prospects for either regulation by supranational bodies or by self-regulation are quite limited. Corporate secrecy and its sovereign protections when coupled with the self-interest of the market thwart preventive regulation. As resistance to proactive detection and investigation advances, governmental regulation is limited to reactive mobilisation.

The result need not be a continual loss of regulatory control both internally and externally. One alternative is to increasingly surrender national regulatory powers to supra regulatory agencies, accepting their right to lift the veil of internal secrecy and protection in the interest of effective regulation. It is likely that governments, particularly those emerging around economic communities will move in that direction, though business enterprises understandably will resist. For them, private

information is an asset in global markets and they will seek its protection from supranational regulators.

Another alternative is to sacrifice preventive and proactive regulatory intervention for reactive responses to detected violations. Although reactive strategies seem less effective because their specific and general deterrent effects are limited, there are possibilities to strengthen them. The current practice is for regulators to sharply limit investigations to the specific violations that drew their attention rather than to use those violations as symptomatic of more general problems in corporate enterprise. We need to broaden their horizons to examine the systemic nature of most problems.

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Chapter Fifteen

New Strategies for the Control of Illicit Money Laundering

Bill Coad and Pat McDonnell

General Background

The traditional approach to criminal law enforcement in Australia has been:

- to define a crime in law;
- to investigate and prove activity that might involve such a crime;
- to bring the perpetrators of that criminal activity to justice including sentencing—fines or gaol or both.

During the 1980s in Australia, there was a revision to this approach. That revision meant that, in appropriate cases, not only was there an attack on the crime and the perpetrators of the crime, but also an attempt to confiscate the proceeds of the crime where those proceeds were discovered as part of the investigation. Thus there have been a number of cases where, once criminal activity has been discovered, investigated and charged, there have been steps to take away the proceeds of that crime .

A further development of this 'revision' will add to the traditional 'after the event' attack on criminal activity, particularly activity that is associated with drug trafficking and other facets of organised crime. The end result will be a non-traditional attack—involving use of criminal laws, civil laws and taxation powers—to seek to disrupt the money flow from practices such as drug trafficking without always involving criminal charges. By taking this attack into real time there is potential to choke off funds that might be used for the next round of drug supply.

Australia is following the lead of the US in this non-traditional approach. It has already reached point two, 'the revision'; it is now developing systems that will enable it to go to point three, the non-traditional attack on money flows suspected of having been derived from activities such as drug trafficking.

Much has already been written about the change of focus towards the proceeds of crime and asset forfeiture. Much of the debate has centred on drug proceeds and on the flows of cash/money arising therefrom. The Stewart Royal Commission into Drug Trafficking, and the Williams Royal Commission before it, disclosed not only the brutal nature of Australia's drug syndicates but also their sophisticated organisation and international networks. Attention was drawn to the vast wealth amassed by those involved in the hierarchy of the drug trade. Justice Stewart's report recommended the introduction of wide-ranging proceeds of crime legislation, the creation of an offence of conducting commercial transactions in a false name and an extension of requirements for record retention by financial institutions coupled with the adoption of measures to facilitate their retrieval for law enforcement purposes.

These Commissions reinforced the inevitable conclusion that the scope of money laundering in Australia was vast, that law enforcement agencies were unable to follow the money trail because of the destruction of, or inability to locate, relevant records and that imprisonment, even for a long period, was inadequate as a deterrent to major criminal activity. There have now been several instances where offenders have pleaded guilty to drug importation offences and accepted heavy sentences (for example 23 years in the case of Bruce Cornwell), but who have appealed every stage of the proceedings to confiscate their profits (some $7 million in the Cornwell matter).

Even so, with the opening up of forfeiture and confiscation of assets as a methodology, law enforcement thinking in Australia has only recently started to go beyond what one might call a notion of 'extra retribution'. The prevailing wisdom has remained that forfeiture and confiscation is 'extra punishment' for those who have been engaged in drug trafficking. So one proves an offence—trafficking of marijuana or importation of heroin—and attaches to that offence claims of confiscation aimed at punishment for those crimes.

But the notion of confiscation can be taken further than that as is happening in the United States. The notion of confiscation can go to the disruption of cash and money flows; with disruption intended to interfere with future drug trafficking flows. Thus where a loose knit syndicate is regularly involved in drug trafficking—and there are a number of such groups in Australia—interference with their cash or money or wealth, so the argument goes, would affect their ability to engage in such trafficking. The disruption to money flows might aim to be partial or total; the latter may be hard to achieve.

Such an approach might well involve the use of taxation powers as well as traditional criminal law powers. This is the theme of this paper. This is the new strategy for the control of illicit money laundering. It applies particularly to drug trafficking but it also could be applied to other endemic criminal activities.

Legislative Background¾ Money Laundering and Confiscation Legislation in Australia

To examine the strategy one needs to consider the legislative background. At the Commonwealth level there are two different schemes for the confiscation of proceeds of crime. One is a non-conviction based scheme under the *Customs Act 1901* which relates to the proceeds of drug offences only. The other scheme is conviction based under the *Proceeds of Crime Act 1987* which applies to all indictable offences against Commonwealth and Territory law. At the state level in Australia, some laws are non-conviction based as well.

Money laundering

Money laundering is an offence under the Proceeds of Crime Act 1987—*see* 'Offences' later.

Customs Act—confiscation

The confiscation provisions of the *Customs Act* were enacted in 1979. They permit the restraining and confiscation, by means of a pecuniary penalty order, of the benefits derived by a person as a result of his/her engaging in a prescribed narcotics dealing. A prescribed narcotics dealing includes the import/export of narcotic goods or any other dealing in narcotic goods illegally imported into Australia.

Assets may be frozen by order of the court once an application for confiscation is made if it is satisfied that there are reasonable grounds for believing that the defendant engaged in a prescribed narcotics dealing and that s/he derived benefits from that dealing. Where the assets sought to be restrained are reasonably believed to be those of the defendant, the court may also order the Official Trustee to take custody and control of the property. The court may require the Commonwealth to give appropriate undertakings as to the payment of damages or costs arising from the making or operation of the restraining order.

Where the court is satisfied on the balance of probabilities (being a feeling of actual persuasion of the correctness of a particular view) that the defendant engaged in the prescribed narcotics dealing, it can make a pecuniary penalty order. The amount of the pecuniary penalty may equal the value of the benefit derived from the offence. The legislation assists in the assessment of that benefit by permitting the court to make betterment

assessments, that is the determination of value of assets before and after the offence with the increase presumed to be derived from the offence unless the defendant established a legitimate source. Benefit may also be assessed on the basis of expert evidence adduced on the street value of the drugs involved. Expenses and costs incurred in committing the offence cannot reduce the benefit derived but taxes paid on the income and fines, reparation or compensation paid in relation to the offence can reduce the amount of the order.

Commonwealth Proceeds of Crime Act—Confiscation

The Proceeds of Crime Act deals with the proceeds of all indictable offences against Commonwealth and Territory law, not just with drug offences. It requires that the offender be convicted of the offence before confiscation can occur. There are certain cases in which a person may be deemed to be convicted of an offence, for example where the offender has absconded. (In these cases, before confiscation can be ordered the court must be satisfied that the person absconded and that the person has either been committed for trial or having regard to all the evidence before the court, a reasonable jury properly instructed could lawfully find the person guilty of the offence.)

The Proceeds Act permits an offender's assets to be restrained, either under the control of the Official Trustee or in his own hands. Restraining orders can be obtained 48 hours before charge and, in certain circumstances, without notice to the offender. Generally restraining orders are granted (unless it can be shown not to be in the public interest) where the court is satisfied that there are reasonable grounds for believing that the property is tainted property in relation to the offence or that the defendant directly or indirectly derived a benefit from the offence. Provision can be made from restrained assets for the reasonable living and business expenses of the defendant and any dependants, the costs of defending the criminal charge and the payment of specified debts entered into in good faith. As with the Customs Act, assets can be restrained in the hands of the defendant, or all, or some assets placed under the control of the Official Trustee. The Court may require the Director of Public Prosecutions to give an undertaking on behalf of the Commonwealth as to the payment of damages or costs in relation to the making or operation of the order.

Where the offender has been convicted of a serious offence—defined to be a serious narcotics offence, organised fraud or money laundering of the proceeds of either of these offences—the legislation provides for forfeiture by operation of law of all property which is the subject of a restraining order six months after the person has been convicted of the serious offence. The legislation makes extensive provision for the protection of third parties with an innocently acquired interest in property liable to confiscation.

The legislation provides law enforcement with new tools to follow the money trail. These include new powers to search for property-tracking documents, production orders to obtain such information and, for serious offences, monitoring orders which enable law enforcement agencies to monitor the movement of funds through accounts almost as they occur. These tools can be used prior to any conviction.

Provision is made in both the Customs Act and the Proceeds of Crime Act to enable the court to lift the corporate veil to determine whether the defendant effectively controls property secreted through shareholdings, debentures, directorships, trusts and other relationships. Where property is effectively controlled by the defendant it can be restrained and is available to satisfy a pecuniary penalty order.

Confiscated assets are to be paid into a special trust fund which is being established, the bulk of which will be spent on drug education and rehabilitation and law enforcement projects.

Offences The Act creates two offences of money laundering. Under Australian law a person engages in money laundering if the person engages in a transaction involving the proceeds of crime or receives, possesses, conceals, disposes of or brings into Australia the proceeds of crime.

There are other offences under the *Cash Transaction Reports Act 1988* namely

- structuring transactions to avoid the reporting requirements of the Cash Transaction Reports Act (*see* later);
- failure to comply generally with those reporting requirements.

These offences may provide an (easier to prove) 'second string' in respect of activities that may constitute money laundering.

Proceeds of crime are the proceeds of an indictable offence or of a foreign drug-related offence. Before a person can be convicted of the more serious money laundering offence, which is punishable by 20 years imprisonment and a fine of $200,000, it must be shown that the person knew or ought reasonably to have known that the property the subject of the dealing was derived from some unlawful activity. There is a less serious offence which is punishable only by imprisonment for two years and a fine of $5,000 where it need only be shown that the property the subject of the dealing is reasonably suspected of being proceeds of crime. It is a defence to such a charge if the person can show that s/he had no grounds for suspecting that the property was unlawfully derived.

The Act also creates the offence of organised fraud which arises where a person engages in conduct which constitutes three or more public fraud offences from which s/he derives substantial benefit. Public fraud offences are defrauding or conspiring to defraud the Commonwealth and

certain *Crime (Taxation Offences) Act 1980* offences. The maximum penalty for this offence is 25 years imprisonment and a fine of $250,000 for a natural person or $750,000 for a corporation.

State and territory laws on proceeds of crime

All state and territories other than Tasmania have similar legislation for state offences. No state has an equivalent to the Commonwealth statutory forfeiture under Proceeds of Crime. Many states are about to amend their laws to bring them more into line with the Commonwealth Proceeds Act, particularly in the provision of money laundering offences. Further detail of state laws follows.

Queensland laws are the same as the Proceeds of Crime Act.

Western Australia's laws are the same as the Proceeds of Crime Act but do not include any money laundering offences.

Northern Territory has the Proceeds of Crime equivalent without monitoring orders and with only the less serious money laundering offence.

South Australia legislation is in a very different form to the Commonwealth Act. The differences in substance from the Proceeds of Crime Act are that there are no pecuniary penalty orders and no money laundering offences.

Victorian law differs from the Proceeds of Crime Act mainly in the investigatory tools. There are no production orders or monitoring orders available. There are no money laundering offences.

NSW *Confiscation of Profits Act* is the same as the Proceeds of Crime but only has the more serious money laundering offence and requires actual knowledge of the fact that the property was unlawfully derived before a person can be convicted. The NSW Drugs legislation which provides for civil (non-conviction based) confiscation is similar to the Customs Act. It provides for restraining orders, forfeiture orders, pecuniary penalties and the investigative tools available under proceeds.

Development of Investigative Tools for Chasing the Dollar

The traditional investigative methodologies used by police for criminal investigation work have equal application to money laundering investigations as well. Methods involve witnesses, informants, surveillance, under-cover operation, wire-tapping, document seizure, and the like.

Traditional police intelligence also has its place as an important investigative aid for money laundering investigations. Typically this service is operated by the Bureaux of Criminal Intelligence within the various police forces in Australia. Police tactical and target development units have an important role to play in these investigations.

The combination of information, intelligence and working marketplace investigative methodologies remain 'the real stuff' of police operations for criminal detection and bringing criminals to justice. This same combination equally applies to money laundering investigations.

To assist with the proceeds of crime and money laundering issues, new skills and tools have been added. The new laws referred to earlier have been put in place and significant police education and training has been undertaken.

There is now an added system of financial information and intelligence that is made available through the operation of the *Cash Transaction Reports Agency* (shortly to be known as 'AUSTRAC'—Australian Transaction Reports and Analysis Centre).

The Cash Transaction Reports Act 1988 draws heavily on the legislative framework of the US so-called bank secrecy legislation (which in fact removes rather than preserves secrecy), although the implementation and operation of the legislation is very different in the two countries. The Act creates a money trail that can be followed by law enforcement in the conduct of an ongoing investigation into an offence or proceeds of crime. The information also assists in identifying potential targets for revenue and law enforcement agencies. This arises both directly through the reporting of suspect transactions and indirectly through the creation of a data base which is analysed to highlight any anomalous financial activity warranting close examination. To achieve these objectives the Cash Transaction Reports Act places certain obligations on financial institutions, namely:

- the reporting of transactions suspected of relating to tax evasion, offences against Commonwealth law or the enforcement of the Proceeds of Crime Act (suspect transactions);
- the reporting of cash transactions involving $10,000 or more (significant cash transactions);
- to identify all signatories to accounts according to statutory procedures; and
- the Act also creates offences of opening, or operating, accounts in false names.

Individuals are required to report the sending or carrying of currency in excess of $5,000 into or out of Australia.

The existing provisions of the Cash Transactions Report Act will, in about nine months time, be supplemented by information from banks and other cash dealers in relation to international transfers of funds by telegraphic means.

Thus, AUSTRAC will have available to law enforcement agencies:

- information on suspicious financial transactions;
- information on major cash movements; and
- information on international telegraphic transfers.

This provides a significant store of information for the purposes of chasing the money trail in a way that is developed herein.

The provision of this data is, of course, underpinned by the Commonwealth's taxation objectives. The Act is expected to provide the Australian Taxation Office with useful information in respect of persons or organisations likely to be evading tax by operating in the cash economy or by moving their funds offshore. The ambition of AUSTRAC is to serve such revenue raising by the Australian Taxation Office so as to at least cover the whole cost of providing this financial information/intelligence to law enforcement. In that way, law enforcement agencies who want to follow the money trail in respect of criminal activities are hopefully to have 'a freebie'.

The objective of such tools is to allow the process that has been developed in the US to take place. Put simply, in the US, they follow the money trail both ways. They follow it to its ultimate source and to its ultimate disposition. Both ends of the transaction can lead investigators to hidden sources of income, hidden assets previously unwitnessed and to other principals.

The system will facilitate investigators in Australia to analyse both 'cash records' and 'bank records'.

Bank records are probably the most important source of leads towards assets. Such records include account transactions, non-account transactions, wire transfers, safe-deposit box transactions, records concerning the cashing of cheques and straight cash dealings.

The records now retained by the Cash Transaction Reports Agency, and soon to be retained within the total aegis of AUSTRAC, add to the bank records already held to provide:

- a cash trail for persons operating in cash;
- an aggregation of international transfers by particular persons (by the end of 1992); and
- a bank's suspicions in relation to a particular person or organisation.

CTR records coupled with proper access to existing bank records provides a very useful way to assist law enforcement, both with starting

points and with points of development of investigations in relation to financial matters.

Analysis of the CTRA holdings may be intelligence driven or at large. CTRA is now undertaking analysis projects based on:

- screening through its data using criminal intelligence as a starting point;
- screening through its data at large and checking out, with the assistance of other agencies, unusual cash activity.

Criminals have often been shown to operate in cash. Many of their products start as cash sale products at the street level. They have difficulties in laundering that cash because large amounts of it are logistically difficult to handle and transport. Large stashes of cash are liable to discovery, theft or loss. Large amounts of cash are suspicious and draw attention to the holders. Some assets cannot be purchased for cash without explanation as to source.

Thus, the cash operators have problems and the CTR system provides a basis for pointing to them. The trick of course is going to be to cull through that data and not 'swamp' the police.

Those who launder funds within business (non-cash) transactions have problems as well. In most businesses there are records of transactions and tax must be paid on reported revenues. Every transaction has a source and destination which, when discovered, can lead authorities to criminal activity. Business records are the subject of review by regulatory authorities. Falsification of company records is a criminal act. New tools such as that proposed in relation to international telegraphic transfers will aggregate records and provide starting points and leads in for investigators. Thus there are new ways of getting behind record systems to assist in the discovery of illicit flows of funds associated with criminal activities.

The AUSTRAC system, both in relation to cash data, suspect transaction data and the proposed international telegraphic transfer data, provides a number of ways in which both single access or data aggregation can be employed by investigators to initiate and advance investigation probes, enquiries and field work.

In relation to particular cases, tactical analysis of the data, starting with the examination of material in relation to one person or organisation, and leading out from there to related groups and areas of interest, can be built up throughout the ongoing enquiries. This facility is being provided now. Analysis by a characteristic may also be utilised, again based on areas or known association, to widen the scope of the analysis being undertaken in relation to particular matters. This may be related to an existing case or may be utilised as a case initiation tool. And finally, macro analyses

utilising broad cash flow or money flow analysis have been developed to facilitate the targeting of areas of major money flows that might call for an explanation.

Tactical analysis is driven by direct inquiry on the data base by authorised law enforcement officers or by CTRA officers, or by both working in partnership. Tactical analysis might be simple or complex, depending on the nature of the matter being examined. The characteristic and macro analysis products are available through special reporting to clients by the CTRA using tailored software having a very sharp focus as identified by particular law enforcement agencies.

A Change of Thinking in Australia ¾ Law, Investigative Methods

The authors of this paper should not be taken as suggesting that one should set about to take away people's money from them without good reason. Rather what is suggested is that the notion implied in the various laws reflected upon earlier ought to be followed. That is, for serious drug offences, particularly those carried out by organised crime, where on the balance of probabilities the money flows have derived from the sale of narcotics, then that is an appropriate case for work to be done to have those monies, one way or another, put into the hands of the appropriate authorities. That might involve the use of whatever legal powers are available.

The notion of taking away money without there being conviction for a directly related serious offence is something that may not gel with the thinking of some lawyers. Clearly it is the notion that is developing in some of these laws. There are now Court decisions heading in this general direction. A very recent case in the District Court of New South Wales, Shadbolt J., is of relevance (*Regina v. Michael Farrugia*). The judge convicted Farrugia in that he did not report to Customs that he was taking $44,500 in cash out of Australia (CTR Act requirement); the judge went on to confiscate the money on the basis of that conviction plus the satisfaction that the money was to be used for either the purchase of drugs or some other nefarious purpose. No actual drug charges were brought.

The authors believe that they, along with other law enforcement officers, should have a strong conviction to follow this notion—that is, disrupt the money flow which may be associated with drug trafficking or other serious crime.

Many police have been brought up to think in another way. Training has led them to a tradition which focuses on the product or the crime, not the money. The approach is not simply one of dogma. Police and criminologists say it is a reflection of: the experience and training (police are trained to apprehend and charge); a fear of the detail of financial analysis (often the fear is unnecessary and unfounded and perhaps a

mystique has been created by some of those who want to see specialty develop); the short times allocated to jobs as part of a prioritisation system; the difficulties in proving new and what some see as complicated charges; the difficulty in supporting a request for special operations such as phone taps in respect of these new and untried areas; it is easier and more common to pursue charges such as possession and cultivation of marijuana; the greater ease of having a Court accept charges on the physical evidence (drugs) and thus a greater likelihood of success.

In many ways, all of this is true. Any work in law enforcement that is avant-garde is going to have its difficulties. It is easy to understand why police would prefer to follow the traditional investigation route which will lead to professional success and may well lead to particular officers being seen in a more favourable promotion light.

Experience on matters identified by CTRA in the first year of its operations for investigation by police have somewhat reflected that line of thinking.

Case One

A person was reported under the CTR system as having large cash deposits and withdrawals in a short period of time inconsistent with income.

The police investigator checked relevant police data bases; there were no direct references to this person, but drug related activities known to have been associated with the family. The investigator checked with financial and gambling institutions to ascertain if there were other places from where the money might have come from other than a possible drug involvement. Nothing showed. Surveillance and other associated investigatory methods were used but these were directed at obtaining evidence of possible drug charges.

It was determined in the investigation that there was some association with a real estate agent and a financial house, possibly involving significant amounts of money. However, this was not pursued because it did not appear to have a relationship to the drug charges. It also would have involved significant resource commitment.

At the end of the investigation, charges were laid in relation to drug supply. The issues concerning money flows were not further examined largely because the chances of success were not perceived as high and significant resource commitment would have been needed. The traditional approach to drug trafficking was followed in this investigation.

In this case, the CTRA financial information became a piece of evidence that was important to the commencement of, and the general evidentiary position of, the drug matter.

Case Two

This was a much bigger operation. A number of agencies were involved. Their coordinated activity was triggered by CTRA reports. Investigative techniques included surveillance, examination of telephone records, examination of police intelligence holdings, seizure of records, witnesses statements, administrative hearings, use of financial data bases (CTRA) and searching of bank records.

In this case, the money trail was part of a methodology to identify people, to determine events, and then to charge breaches of relevant laws. Much of the investigation focused on the product involved although revenue matters were reserved for issue of relevant assessments within the ordinary taxation system (that is, a post hoc revenue assessment).

The focus in this case was more on the money trail than in Case One because of the revenue implications, but the traditional approach of 'chasing the product' remained a strong flavour because of the experience of success that investigators have had in taking that approach.

The authors have noted in the three-year period in which they have been with the CTRA that there are is an emerging group of law enforcement officers who see real value in chasing the money trail. Not all of them have yet been put into an environment where this type of thinking is able to be put to work. Some of the newer agencies such as the NSW Crime Commission and the Criminal Justice Commission of Queensland are clearly trying to cultivate that approach. Some of the major police forces as well are making room for this type of approach, particularly the Australian Federal Police. There will always be some resistance to chasing the money trail. We have heard it said 'we've seized the product and therefore we've got the future money (proceeds) from the product, why do we need to chase the money?'

In some cases that may well be correct but it tends to ignore a number of factors. It particularly tends to ignore that they will not always have all the product. There is a continuum of drugs flowing through the Australian marketplace being sold in a multiplicity of places. If the product can be interdicted at a point of 'head supply', it certainly may be correct to say that that is the end of the matter. But success in that 'head supply' area is not often achievable.

It must be remembered that the cash is much harder to hide than the drugs. For example, A$1 million in A$100 banknotes is about the same size as an ordinary briefcase and weighs 11 kg. However, A$1 million in heroin is about the same size as a small paperback book and weighs 1 kg.

If one attacks the cash at the point where there is a stash—and, in the case of organised crime, there will be a stash for a period of time somewhere—it indeed might prove easier to find than the drug itself.

Thus the attack on the money might start at the bottom of the heap.

Bottom of the heap—the cash flows

The dirty end of street crime, such as narcotic trafficking, is the hand over of cash for drugs. It starts with small quantities of both. The dirty cash is then aggregated, 'placed' inside the financial system and eventually ends up as useable wealth for those higher up the pile. Money laundering investigative techniques must penetrate that long chain or cycle and attempt to connect the evil beginnings of the money to the owners of the wealth, either those at an intermediate stage or those at the end of the line.

For the organised trade of street crime, such as organised drug trafficking, the flows of cash (or other money) are like the flows of a stream arising from contaminated hills. Trickles of dirty cash link together into polluted ponds which aggregate into fast flowing streams. Eventually these polluted streams enter the clear waters of the mainstream of the financial system. The trick is to be able to identify the contaminated cash flows prior to their entry into that mainstream; to 'tag' them if possible and to follow them downstream to see who claims ownership. Starting in the mainstream is almost impossible; the best point of identification of the dirty cash is close to the original street crime. Not only is it easier to see the separate cash flows but linking it to the crime may become an important part of the remedy (charges and seizures for money laundering).

The traditional approach to, say, drug trafficking has been to investigate a supply flow of narcotics, to seize a delivery of narcotics (including any money proceeds on hand) and to charge those concerned with drug trafficking.

Investigation of money laundering from the cash end adds a new dimension. It starts at the point of sale of narcotics (for cash). It follows the cash forward through the flows and aggregations. It tries to 'tag' the cash flows as they are converted into non-cash monies and eventually into useable wealth; and it tries to pinpoint (and implicate) all those involved. Investigation of money laundering is an art form of its own; just as investigation of drug trafficking is and will remain so.

There is an added bonus to pursuing the 'cash end' new dimension technique of conducting enquiries. In money trail investigations there can be a focus on a continuum of real time activity, namely the stream of tainted money which is flowing continuously or almost continuously. This provides investigators with a number of windows of opportunity to conduct their enquiries. By way of contrast the traditional investigative approach has a very narrow window of opportunity which is reliant upon 'spot the drug when it moves'.

It is useful to recognise at least two stages in the process of money laundering investigation:

- the cash flow;
- beyond the cash flow.

The investigative methods and legal tools available are somewhat different between these stages. They can, in appropriate cases, be complimentary. With some types of crime there may of course, be no cash flow.

Generalisation permits the following summary of the many investigative tools available; the examples cited before, indicate that these tools would be used whether the chase was in respect of the drugs or the cash.

Marketplace investigation

- informants, witnesses
- surveillance
- undercover operation
- other infiltration (such as the provision of store front money laundering services)
- wire tapping

Information and Intelligence

- criminal intelligence
- financial information and intelligence (including holdings of the CTRA)
- information from public data bases (car registration and so on.)
- information from seized records

Financial records

- seized records
- records held by banks
- telegraphic funds transfers

It is necessary to establish cash flow investigative aims. Again generalisation permits distillation of two alternatives:

- what might be termed the 'search and destroy' mission—identify the 'cash stash' and take it out;

- the 'win the war' approach; trying to trace the polluted money to its ultimate recipient and take out the whole 'box of dice', top to bottom.

Theory suggests that the second may be the sound approach. Practice (mainly based on US experience) indicates that constant disruption by 'search and destroy' process might often be more achievable. Clearly the 'win the war' approach is a desirable aim; but the authors of this paper have sometimes gained the impression that the exponents spend a lifetime planning the war, with not a shot ever fired in anger. There are, however, fine examples of this approach (Pinner 1991).

'Search and destroy' in the cash phase of laundering

Cash flows associated with drug trafficking (and other street crime) start on the street and will finish up being deposited in the financial system either within Australia or overseas. In the process the cash will be aggregated and may pass through various intermediate points (the 'polluted ponds').

Some of these intermediate points have been seen to be (US experience mainly) apparently legitimate businesses (pizza parlours and so on) and dealers in precious metals and jewellery.

At a more rudimentary level is the 'stash house'; literally a house full of cash.

Once in these 'polluted ponds', depositing the cash into the financial system calls for ingenuity; not surprisingly it is there. In the case of the apparently legitimate business it may be banked as takings; likewise for the metals and jewellery dealers. The stash house operator may break up the kitty into chunks and:

- 'smurf' it; using couriers to deposit amounts under the $10,000 currency reporting requirement;
- deposit it with the help of corrupt bank officials, who do not report the significant cash amounts;
- use professional cash laundries—accountants and lawyers who themselves disguise the cash and deposit it as some business related nominee;
- use the expertise of a professional money launderer who services clients operating in the black economy;
- take the physical cash offshore for depositing in overseas banks, in countries that do not really care what happens in the banking system.

Investigative techniques focus on identification of the fundamentals of that cash flow; all of it may not be clear and indeed may never be identified. The starting point of the investigative penetration of the cash flow may be 'at its beginning', 'in the middle' or 'at the end'; for present purposes 'the end' is where the cash enters the bank.

'At the end' (where the cash enters the bank) identification of the suspect cash flow comes from:

- the reporting of suspect transactions by the bank;
- analysis of significant cash transaction reports by an agency (such as the CTRA in Australia or FINCEN in the USA) to identify:
- unusual cash flows in the banks or business areas suspected to be concerned;
- linked transactions or accounts suspected to relate to already identified polluted cash flows.

Typically these identification systems will suggest persons and organisations with too much cash when regard is given to their business circumstances, and persons and organisations who are structuring transactions or using other devices such as false name accounts to disguise the cash.

This analysis is not a one time matter; agencies like CTRA or the banks themselves can be used to monitor aspects such as:

- the continuing cash flows;
- where the money goes once it is in the bank; or
- other simple facts such as the days on which the deposits are made (and thus provide surveillance opportunities for the investigative agency).

'In the middle' and 'at the beginning' of the cash flow penetration will likely come from informants, infiltration, store front undercover laundering operations, telephone tapping and traditional investigative enquiries.

With the cash flow penetrated by the investigation team, the traditional law enforcement methodologies may be applied: use of data bases to track individuals and their activities; conduct of surveillance operations and other field work. In short, traditional evidence gathering techniques will be deployed (but in real time) except that the product focus is money.

The difficult part is then deciding what to do. The 'win the war' approach would have it that you stake out this cash flow process, continue to monitor it and move on into the bank records, up the tree

towards the heavies at the top. If ultimate success in that direction seems remote, disruption of the cash flow through 'search and destroy' may take the front seat.

Assuming the latter to be the case, the options are still numerous but the following have been utilised. If, for example, some sort of 'stash house' is likely involved and the cash flow has been identified at its entry into the bank, the location of the house is pinpointed by surveillance of those involved in the cash flow; the house may be watched or telephone tapped and, at an appropriate time, it may be raided and the cash seized. The power for seizure may need to relate to the money laundering or proceeds of crime offence; but the authors feel that taxation powers are also well to be kept in mind.

If, for example, the cash is co-mingled into apparently legitimate businesses, the disruption process might better focus on use of the tax power; to put it in very plain and short words: allow the taxation authorities to take out the 'polluted' cash. That is not to say that the money laundering or proceeds of crime route should not be used here; but the difficulties of all the required evidentiary connections must be recognised and the cost/benefit of that taken into account. If the objective is to disrupt the potential wealth arising from drug trafficking, the tax solution can be quick and effective in nabbing the cash in cases like this.

Between 'search and destroy' and 'win the war' approaches there is a third alternative of 'win the battle'. The technique to be deployed here is to disrupt the money flow for that time span which will produce disharmony within the group by those whose money supply ceases. The deprived members of the group are likely to apply their own brand of justice on their colleagues. Their actions will add visibility to the group and may be of even more positive assistance to law enforcement.

The exporting of polluted cash from Australia to deposit it in overseas institutions provides a real challenge. The extent of the problem is not yet known although early analysis indicates it may be significant. Much of the offshore transportation could also involve tax evasion and not criminal activity such as drug trafficking. Some investigative methods that may be considered to penetrate the cash flow include targeted searching of outgoing aircraft and passengers. These methods are utilised in the United States as part of money laundering enquiries. That includes both the use of x-rays of baggage and the searching of certain outbound passengers. Again the purpose is to penetrate the cash flows.

Win the war

Just as winning a war might be expected to require all elements of defence forces, in the arena of money laundering multi-agency financial operation forces have often been used in facilitating this approach in matters such as total money laundering enquiries in respect of the Colombian cocaine cartels. In major matters like that, most of what has already been said

about investigation of the cash phase would have occurred; whether cash flow 'disruptions' had been effected or, on the other hand, the system allowed to run its course until something bigger was achieved, is a matter for the particular strategy. The further development of a money trail investigation focuses on getting into the bank records, tracing financial instructions back to the source (through telephone tapping or document examination), confidential informants (accountants are of note) and undercover work. The use of bank documentation and other financial data is referred to in a later part of this paper; in short, it requires tracing forward through accounts, the observation of markings on cheques and money orders, searches of telegraphic funds transfers and the like. This will likely require work both within and outside Australia. The objective becomes one of tracing the flow to the ultimate destination of the money; starting as what we have termed 'polluted cash' then becoming 'tainted money' and ultimately wealth. It is truly the long, hard road. US experience is that this course can be very effective but it requires dedicated long-term effort by a very cooperative team.

Financial analysis In the 'win the war' approach, financial analysis will come into play. Here we are trying to follow the trail forward (or in some cases reconstructing it backwards!) from a cash phase to its ultimate destination. We are assuming that we are beyond the cash phase and we are tracing the money from the point where the deposit has been made in the bank.

Methods used here vary from case to case but some common aspects have been noted in work done by one of the authors (McDonnell) and also in papers written by other financial investigators in Australia. We have also observed similar work in the US in this area.

Bank records, obtained on proper legal order, might be searched to determine the accounts operated by the particular parties, any asset and liability statements provided to the bank by those parties, loan applications made by those parties, documentation in respect of fixed or term deposits and the like, documentation relating to safe deposit facilities and credit card facilities, requests for international credit card facilities, overseas bank drafts and the like.

Copies of relevant documents would be obtained including the following:

- signature cards;
- loan application forms;
- term or fixed deposit forms;
- asset and liability statements;

- bank manager diary entries and memoranda relevant to the flow of funds;

- bank statements for those accounts which are of interest for the particular period.

And later it may be necessary to obtain from the bank particular vouchers (deposit slips and processed cheques). The main purpose of tracking through these records is to trace the ownership line of the proceeds of crime or the money being laundered as a result of criminal activity.

Having to go through all of this financial documentation plus those that might have been seized from the alleged criminal perpetrators themselves, may, by some investigators, be seen as 'boffin' work. That need not be the case. In a very useful paper, a Senior Financial Analyst of the Queensland Criminal Justice Commission set out how his Commission went about tracing certain matters concerning property ownership in a case in Queensland (McGrath 1991). This case was (in relative terms) not of an overly complex type but the work done was clever and very logical. In essence, it was a case of 'following your nose' and that is not something which is foreign to investigators. McGrath, in seeking to trace certain properties (backwards) to illegal beginnings:

- examined all seized documents from the particular persons;

- carried out searches of records such as those maintained in the Land Titles Office;

- issued compulsory notices on financial institutions (and on some individuals) for records concerning sources of funds to purchase certain properties;

- examined cheques and supporting documents relating to the purchase of those properties;

- examined deposit documents obtained from banks relating to the deposits of those cheques;

- examined applications for the bank cheques concerned;

- took statements from relevant tellers in relation to dealings by the persons involved in respect of those cheques.

It can be seen that a trail was being followed (in this case from the property backwards) through a series of documents. That is an investigator's work and, in this case, appears to have been done with care and done successfully.

Similar 'follow the trail' steps were taken in a recent case involving the importation of several tonnes of cannabis. As described to the authors by Detective Sergeant Perry Hume of the Australian Federal Police a mix of land titles searches, motor vehicle registration searches, and seized documents from defendants' premises, gave leads to money, real estate and bank accounts. Affidavits required by law pointed towards share dealings as well. All of this was done largely within Australia in an environment where tracking of such documents is on familiar turf and using financial institutions and other information sources that are basically 'friendly' to the investigation process.

A greater challenge in relation to chasing the money trail in this fashion occurs outside of Australia. Assuming that funds have been telegraphically transferred (or carried out) to other places, the problems of tracking the polluted monies (by now non-cash) increases immensely. There are difficulties which arise because of attitudes of some foreign governments to the provision of information; there are obvious cultural and language difficulties to be traversed. The documentation involved will look different and be different.

Ken Goodchild (1991), Director (Financial Investigations) of the National Crime Authority, notes some of the difficulties outside Australia. But even so, the National Crime Authority and other law enforcement agencies have sometimes been successful in chasing that money trail offshore. But it is clear that difficulties such as where to look and what to look for are enhanced immensely in offshore matters, and the cost of looking for that information escalates very quickly indeed.

Putting aside those difficulties, the general tenor of what is to be done is similar to what was indicated earlier and examined in the McGrath paper. It may be, however, that if the logistic problems of going offshore are too large, this might be one reason why one would resort to a 'search and destroy' or 'win the battle' missions at the cash phase of money laundering. It becomes a matter of general strategic objectives and a need for realistic assessment of the ability to achieve those objectives. Detailed strategies can be prepared once those general objectives have been decided upon.

The Application of Legal Powers

Much of the investigative and case work done today on confiscation type issues has been of the 'traditional' nature. That is a crime is proved and confiscation is attached to that crime. The proceeds that were derived from that crime were identified and confiscated by relevant court orders. The investigative approach is exemplified by the earlier work of Mr McGrath mentioned herein. The Australian Taxation Office's powers to extract taxation, by virtue of seizing assets, have been a useful 'back-stop'.

There have been a number of cases involving many millions of dollars in assets seized at both the Commonwealth and State levels in Australia using this type of approach. Very few of the cases have involved money laundering charges. There have been confiscations based on particular proven criminal activities.

In terms of examining money laundering in relation to the continuing behaviour of particular organised crime syndicates, there has been very little work done to date. This is likely to change in the near future.

Money laundering as a phenomenon in its own right has now been the subject of intensive scrutiny by the National Crime Authority whose 1992 report will become useful for those working in this field. And, as described within this paper, new intelligence systems have been established to assist in the work of investigators who have to apply themselves to detecting and bringing to an end money laundering of criminal funds.

Recent field research in the US by the CTRA, particularly some discussions with the US Justice Department, indicate some ideas of how the new laws might be applied. US Justice saw the CTR reporting legislation as a front line law that might be used in relation to the 'search and destroy', 'disruption' approach earlier identified. Thus, offences such as structuring transactions to avoid the reporting requirements and failing to report transactions to the CTRA may become part of the armoury that is used in cases where the cash end of the money laundering channel is to be the subject of legal attack in its own right. In the traditional proceeds type approach, the CTR Act is more likely to only be used as an additional tool to identify assets for seizure.

Examples of how the CTR Act might be used in the 'disruption' approach then come to mind:

- if, for example, the Australian Customs Service were to identify a large quantity of cash being transported from Australia without reporting under the CTR provisions, this might provide the basis for seizing the cash (*see* earlier reference to the Farrugia case);

- if for example, in a particular case, a person was engaging in a course of conduct over a long period to structure transactions to avoid the reporting of cash requirements, this, if proven, is a criminal offence and could provide a basis for confiscation of the cash concerned.

Other examples might indicate the need to utilise the powers of the Australian Taxation Office. If for example, a retail shop was laundering cash as part of co-mingled takings, it is unlikely that tax would have been paid on the total cash amounts involved in those takings and thus the Australian Taxation Office might have grounds to 'take out the cash'.

The authors think that much of the work on disruption of the cash phase will need to be done as a matter of surprise. A long, heavy involvement involving seized documents and the like is very likely to see the cash truly gone by the time the ultimate law enforcement strike is made. Thus, at the cash phase, the element of surprise might mean that powers such as the Taxation powers or the simple offences under the CTR Act might achieve that surprise result.

The US Justice Department has told us that the money laundering offences were written into the US laws to turn the light onto the 'high level folks'. Thus it was made a crime to conduct a transaction with the knowledge that the money is dirty and with the intent to use the money to commit a further crime. This attracts criminal forfeiture with heavy penalties including confiscation.

The money laundering laws tend to be used in the US in the 'win the war' approach to investigations whereas the CTR Reporting laws (in the US, the Bank Secrecy Legislation) are used in the 'stash house' side. That is a generalisation, not a rule.

Thus, we have gained the impression that typically one might see the following:

Cash Trail	**Money Trail**
• tip-offs or CTR data	all cash trail tools are utilised
• surveillance (re: structuring, failure to report etc.)	PLUS
• find the cash stash or the cash laundering vehicle	• wire-tapping of instructions between principals and 'lower down players'
• use intelligence	• confidential informants
• use powers available for quick action	• infiltration and under-cover work
	• financial intelligence etc.
	• document seizure and the like

None of these ideas are ironclad. Rather they are generalisations that enable some analysis of new strategies.

What is clear, however, is the need for a coordinated approach to any new strategies for the control of illicit money laundering.

Some Ideas About the Third Dimension

The third dimension is money; the first and second dimensions are the product (such as drugs) and the crooks. Our observance of operations arising from the reporting of suspect transactions, suggests that at least in respect of major matters, there is a good case for coordinated activity between various law enforcement agencies to avoid tramping over each others ground in examining particular matters.

The CTRA noted in its 1991 *Annual Report* (para 5.10) as follows:

> The NSW Crime Commission has raised the issue that in Sydney (mirrored to an extent in Melbourne as well) there is a lack of coordination in dealing with suspect transaction reports. In some places, such as in Perth, there is good coordination to try to avoid duplication of work arising from particular suspect transaction reports. In the major cities, this coordination is less evident. Discussions are taking place at senior levels to try and improve the degree of coordination in this respect.

The discussions referred to have resulted in the establishment of a joint analysis unit involving various Federal authorities, with the CTRA looking after the State interests as well. This means that in respect of major matters raised by the reporting of suspect transactions and also in respect of similar matters that are derived by CTRA analysis procedures, there will be some preliminary work done to best determine how a matter may be handled. Experience has shown that there is also a need to channel very minor matters away from investigative resources that are best reserved for more important issues. There was a National Crime Authority task force that carried out this type of activity in the early days, but problems in that task force led to it going into abeyance. This type of coordinated activities have now been resurrected.

Beyond this preliminary filtering stage, one then gets into the examination of more complex matters—money laundering by organised crime. There is then an even stronger case for cooperative and coordinated activity. In one task force that the CTRA has participated in to date (which was a fairly extensive matter), there was quite good cooperation and coordination organised by the National Crime Authority. Even so, there were slip-ups where the full utility of certain documents were not exploited, but the coordinated approach worked very well and in that case we expect it will ultimately lead to a significant result. There will always be slip-ups even with the best will in the world, but a degree of coordination is much better than none at all.

At the very least, there needs to be management strategies to bring about effective results without everyone stomping on each other's ground. We observed a case in the US where a particular 'stake out' involving a

fairly complex money laundering matter was interfered with because the 'stake out' place happened to be the place where the local police had lunch. It doesn't help trying to do something complicated like that when evidence is impeded by the presence of others. But perhaps it adds a touch of reality! In a similar incident we observed in the US there were retail premises under surveillance for money laundering activities when a local drug dealer made his presence known by offering product, not money. The undercover agents concerned with the money laundering matter made no attempt to deal with that, rather they called in their cooperative agents involved in the 'product' and the matter proceeded from there. So goodwill and cooperation will provide a necessary backdrop if there are to be police or other investigators concentrating on the money on the one hand and other investigators on the product (drugs) on the other hand. At the grassroots level there is already a great deal of such cooperation in Australia.

'Tainting' of the money is required to prove an offence under the money laundering laws. Thus to some degree those investigators who are chasing the drugs and those who are chasing the money must have the benefit of the work of each other. It might be that those chasing the money may discover a line of commerce that might lead the others to the head supply of the product.

The work that we have observed in FINCEN (the Financial Crimes Enforcement Network) in Washington USA indicates to us that a proper combination of traditional police intelligence, financial intelligence such as the CTRA system and normal investigative work would provide the best tactical mix in the money laundering investigative process. The intelligence systems must be readily available and capable of being used in several possible streams (chasing the product, disrupting the cash, winning the war) and by different operatives, depending on the total game play. Furthermore, and importantly, there must be cooperation so that someone can decide what to target in particular cases.

It may be possible to 'chunk up' the exercise so that Group A would take part of the game play for 'disruption' of the cash supply; Group B, say Customs, might have a chunk of the play to disrupt outbound cash flows associated with certain classes of individual; Group C might chase the paper trail.

How to bring these together is the question. There might need to be some big picture 'boss'. Australia, however, has no such figure in the money laundering area. Indeed, the coordinated approach is only a fairly recent phenomenon in the US, and it has not always been there. In many ways, it is still fairly loose and sometimes rather shaky.

Some police rightly observe that it is sometimes easy to get lost in the grand strategies at the preliminary stage and then nothing ever happens. Equally so other police point to cooperative work in particular areas. It seems to us that it is very much a matter of common sense rather than

overburdened formality, a little less patch consciousness and a fair degree of goodwill and cooperation, that is needed.

Teamwork

What is implied above is the need for some form of teamwork, certainly for 'win the war' or 'win the battle' strategies. The idea of a 'task force' is often not welcome in police forces. It can mean a long-term commitment of resources to someone else's control and that in turn leads to endless debates about who pays, who is responsible and the like.

In addition to that the shift of responsibility to a task force can lead to patch consciousness and a degree of formality which may work against the chances of the task force operations being successful. Some of the less positive experiences in relation to the National Crime Authority, in matters of resourcing and responsibilities, are indicative of the point.

And yet there is a need for cooperative work if chasing the money trail is to be a central plank in the areas such as the attack on drug trafficking. Chasing the money trail requires proper resourcing and the work on money laundering is not just an adjunct to chasing drugs or fraud. The investigative people may well be different but they need to be able to work with the general team.

We believe that there should be a search for some way of coordinating the work on money laundering without the problems of formality and resourcing which attach to the creation of formal task forces. We are looking for at least a loose form of teamwork.

Dreaming or Achievable

Law enforcement strategies in relation to the type of attack on money laundering that we have discussed in this paper can be slow in coming. There are many reasons.

There is a natural tendency amongst some law enforcers to see this type of approach as a bit 'off the beaten track'. Many in law enforcement will seek to stick with traditional methods of attacking fraud, drug trafficking and other crime. This is not a criticism; rather, it is a recognition of reality.

Such traditional views are enhanced by the practical difficulties that are properly perceived with an attack on money laundering or the difficulties that can be perceived with following the money trail. Law enforcement focus on money laundering goes fairly readily onto the resource intensive 'win the war approach', which can be very difficult. Money trail work can prove frustrating and that sense of frustration is nowhere better exemplified than the journalists' views in an article entitled 'Missing Millions' in the *Sydney Morning Herald*, 11 January 1992. Apart from the

investigative difficulties, there is then the well known conservatism of the prosecution process.

So it is perceived as a difficult investigative road to follow and as earlier noted, one can expect judicial difficulties in terms of what happens in the Courts. These are new laws and new ideas that need to be put into the judicial setting.

Another reason why such strategies can be slow coming is that there are unfortunately some people in law enforcement strategic intelligence who overlay their work with their own ideas and debate what really are issues for political judgment in relation to subjects such as drug trafficking. Some prosecutors do this too. Thus the focus on enforcement strategy tends to be derogated by ideas and feelings about, for example, how serious the drug problem is in Australia; whether resources would be better concentrated on other issues such as tobacco advertising and alcohol advertising. Argument about the facts themselves adds 'grist to the mill'—in one week you can read an article in one newspaper that says the cocaine is not a problem in Australia and then later that there are 'floods of cocaine' at the Gold Coast. Some have personal views about, for example, legalising the sale of marijuana, and see chasing the money trail in respect of that product as not being terribly relevant to the whole issue of control of drug trafficking and drug abuse.

There is also a tendency among some to mix concepts; (detailed) tactical intelligence is not distinguished from (broader) strategic intelligence; thus the focus on tactic means that strategies may never emerge. This all adds time and endless debate.

We have a less complicated view. In respect of drugs for example, what is clear to the authors is that the drug problem in Australia is not as bad as the United States from where the concept of chasing the drug monies has derived. But it is as equally clear that there is very significant narcotics trafficking in Australia and that there are fairly well known criminal groups that are associated with that trafficking and that they are deriving cash and money from that trade. Why not start there?

No doubt some would say that view is too simple. But we believe that it is not for us and indeed it is not for most law enforcement officers to get too embroiled in the political debate about the best overall social strategies on drugs or indeed on other criminal activities. And we believe that there is enough information to commence broad strategies in the main areas. We have been given a new raft of money laundering legislation; there are strong statements that have been made by many of our political leaders as to the intent of that legislation and therefore we should try and see it applied in this novel way and after that stand back and make an assessment as to how effective it is.

Both of us have worked in 'new' legal areas in the past and both of us have experienced a tendency in Australia to talk about what might not be achieved in legal administration before any real attempt has been made to

step out and try to achieve it. Our point of view is that one should look retrospectively and see success and failures rather than speculate too far out front what might or might not be achieved. It really is a matter for our political leaders to do the latter. Having said that, we recognise that we must look for realism in strategic approaches. It is no use setting out to conquer the world if that is not feasible. It is not a case of 'dreaming' it is trying to achieve something that is realistic. Strategies in this area can easily be side tracked by arguments and difficulties, but we do not perceive the need for that if one takes a modest but achievable approach.

That modest approach might, in respect of the money trail, focus on:

- teamwork;
- avoiding too much formality;
- simple strategies based on some of the ideas in this paper; and
- the recognition of the need to use 'horses for courses'; in these strategies.

Teamwork and horses for courses might in a particular case mean for example, that the Australian Taxation Office would audit businesses suspected of co-mingling proceeds of crime; that the Australian Customs Service would monitor and check the exit of certain types of persons who are suspected of taking cash off shore for laundering in foreign banks; that the Australian Federal Police might seek to follow the cash trail from the drug selling point to the 'stash house' and then make decisions about 'taking out' the cash; that the National Crime Authority might, in the important case where it is difficult to track funds off shore, coordinate what is done utilising all of the law enforcement resources and treaty agreements to secure a practical result; and that a body like the National Crime Authority might coordinate the teamwork where all of these steps were important to success.

We do not think those are radical ideas and we do not think that operating in that way would be unattainable. We have seen work in some cases along these lines and it is showing good results. In many ways it is not new. It is the sort of teamwork that has operated down the line in many police forces for a long time. It is just that the product, money, is new.

Nor do we underestimate the difficulties. If one is going to take out ten million dollars in cash from some house there are certainly going to be teams of lawyers who are going to try and get it back. But our own law enforcement experience suggests that a first strike is best. It put smart lawyers on the back foot if a merger was stopped by the Trade Practices Commission before it occurred. The alternative, after the event legal disentanglement, was difficult as experience has shown; teams of lawyers

driven with the essence of delay—a hope that time would see the issue die. But if the prize is already in custody, time is on the side of the custodian. Real time law enforcement is a good aim—even here; but we do not delude ourselves that it is always going to be easy.

Conclusion

The discussion in this paper has been very much oriented towards drugs and cash, but not exclusively. That is because we started there. The Cash Transaction Reports Agency is concerned with cash crime (mainly drugs) and the cash economy more generally. The theme of the paper is to give some emphasis to the 'cash chase' and to see it as something a little different from 'old time asset forfeiture'. By the end of this year we will have a good grasp of international funds transfer data; we may have to adapt our analytical and investigative approaches in that light. That area will be a new experience as there is no precedent, not even in the United States.

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Chapter Sixteen

Risk Management on a Market Segmented Basis

Trevor Boucher

We all practise risk management nearly everyday, maybe without realising it. For example, by making the choice to insure your car, you reduce the chance of incurring a significant financial loss by passing the risk on to the insurance company through the signing of a contract and the payment of a premium. For you the size of the risk can be measured in terms of the dollar value of the car. The real management of risk is that of the insurance company which constructs its contract with you on the basis of broad claims experience, attributes of your car type and even of your class of driver, locality, repair and restoration costs and earnings from investment of premium moneys.

In the Australian Tax Office (ATO) we are primarily concerned with the amount of the revenue that is at risk. For the 1990-91 financial year the ATO collected around $77 billion. By identifying those areas where the revenue is at risk and implementing some sort of mechanism in relation to those areas, the Tax Office better protects the tax that the community is entitled to receive.

Risk management is not new in fundamental concepts but as a specialist management technique it is still developing. It has become increasingly preferred by organisations in the late eighties and early nineties, to enable organisations to combat ever increasing exposures resulting from developments such as automation, computerisation and the use of increasingly sophisticated and complex products.

Managing risks to the revenue is very high on the ATO's agenda with the Australian taxation system having been always based on voluntary compliance and, as a more recent formal expression of that, on self-assessment notions.

Risk management strategies are being developed having regard to our employment of a more systematic approach to categorising taxpayers into broad market segments. The ATO is developing an appropriate service, enforcement, systems and collection mix for each of these markets.

This paper describes the management of revenue risk in the ATO and the reasons for our approach. Firstly, it will be useful to review some background and show the direction in which the ATO is heading.

If you were to go back and analyse a dim and distant past, the way we used to do things was based on the assumption that people cannot be relied on to get their tax right, so therefore we must check everyone in detail. It may just have been OK in a dramatically less complex world. Even if we wanted to, we would not be able to do things this way today without a whole army of assessors and additional powers of access to information to check on accuracy, and, incidentally, only with levels of intrusion that the community could not tolerate. Prior to our formal adoption of self-assessment we were kidding ourselves that we were really checking, when in fact we were simply wasting valuable technical resources on what had effectively and necessarily become a processing function.

In today's self-assessment environment we assume that given the right environment, systems, processes, information and service, most people will try to get their tax right and will succeed. Sound risk management will allow us to identify and correct those who do not, perhaps either through ignorance or because they are willing to try one on. You see parallels of this on the roads—the vast majority of road users drive at or about the speed limit and policing can probably be conducted around that central core.

With a tax system based on self-assessment, the role of the Tax Office and how it is seen by the community changes. Self-assessment has meant different assumptions than previously about matters on which administration of the tax system is based. As mentioned earlier, long gone are the days when there was a large portion of our resources devoted to effective manual checking of taxpayer details and information.

Instead, and reflecting the existence of a generally compliant community and the existence of supporting systems, we ask for less information. We rely more heavily on matching taxpayer details with externally and internally generated income, deduction and rebate entitlement information.

We are improving our service and education programs with the objective of improving voluntary compliance with the tax laws. A key part of our service philosophy is to trust taxpayers and help them to get their details right, preferably the first time.

What we have not changed is the mission of the Tax Office—what we are about is still the same—that is to collect revenue properly payable under the law, while minimising the cost of collection. Our formal **Mission** statement puts it:

> The ATO exists to ensure that the revenue payable under the laws administered by the Commissioner of Taxation (including as Child Support Registrar) is collected in a way that is both cost effective and consistent with the policy objectives of those laws.

> We believe the most effective way of doing that is to maximise voluntary compliance in a self-assessment environment through the right balance of help and enforcement based on an understanding of our clients and achieved through the skills and commitment of our people.

Minimising the cost of collections means minimising costs to the community and also implies minimising inconvenience to the community. Risk management is the management methodology chosen by the ATO to achieve this.

Risk management need not be complicated and neither is the availability of masses of data a prerequisite for an effective program. Risk management is a matter of commonsense, judgment and willingness to operate a disciplined approach to one of the most critical features of any business enterprise, that is, the risks that are entailed in it.

Through the exposure to a wide range of risks it is inevitable that some financial loss (revenue in the ATO's case) will occur sooner or later in particular cases. The degree of severity will vary according to circumstances, but that some such form of loss will occur is beyond doubt. A prudent manager, recognising this fundamental truth, will identify practical ways of measuring his exposure. Having done so, he will decide how best to reduce it to an acceptable level in the most cost effective manner available to him.

The risk management process provides the necessary mechanism and the process adopted for ATO purposes is illustrated here. We -

- **Identify where the revenue is at risk**

  Seven broad areas of risk have been identified:

  - failure to enter the system;
  - dropping out of the system;
  - deliberate underpayment of tax;
  - inadvertent under/over payment of tax;
  - use of tax planning arrangements;
  - failure to pay tax; and
  - failure to withhold tax.

- **Analyse the risk**

  - broad look by senior management at the level of risk for each market segment for each identified area of risk; and

  - in-depth research and information gathering coordinated, market by market, for each of those sub-areas identified as medium to high risk.

- **Quantify the risk**

  - likelihood of it continuing or is it a one-off risk;
  - severity, that is, amount of revenue at risk; and
  - prioritise on the basis of likelihood and severity.

- **Manage the risk**

  - develop strategies to reduce or eliminate the risk;
  - this includes:

    law reform;
    education initiatives;
    service initiatives;
    systematic approaches;
    changing attitudes;
    changing behaviours; and
    enforcement action.

- **Evaluate**

  - effectiveness of management of risk (ongoing).

The ATO found at an early stage of what is still a developing process that groups of taxpayers had varying needs, which meant that in order to achieve compliance and minimise costs of collection, in other words to effectively manage risk, then it was necessary to make arrangements to deal with the groups on a market segmented basis. This was going to take some adjustment given that the ATO is structured along functional lines—the one taxpayer's affairs are managed by separate groups within the office—Revenue Collection (returns processing and debt collection), Taxpayer Assistance, Taxpayer Audit, and Appeals and Review. Approaches are therefore still at a somewhat developmental stage.

The ATO is working on identifying key areas of risk for each segment and in determining priorities for management of identified risks. We have defined three broad segments as follows:

Large/Medium Market—Business having receipts >$5m.

As appropriate, entities/individuals directly associated with large businesses would also fall within the ambit of this segment where it is evident that equally complex arrangements are involved.

Small Business Market—business having total receipts <$5m.

Non-Business Individuals Market—taxpayers who do not return any business income (either profit or loss) in their tax returns.

> Business income includes partnership and trust distributions, primary production income, non-primary production income and income or contract payments that have amounts deducted through the Prescribed Payments System.

The ATO has looked at the different types of risk within each segment, the different classes of risk needing to be considered being:

> **Realised Risks**—These are those which to some extent are already resulting, or in future will result, in lost revenue. In general, they are the combined result of the existing legislation, taxpayer behaviour, ATO procedures and functional programs.
>
> **Potential $ Risks**—Here we have those dollar risks not currently being realised but which to some extent will be in the future if certain conditions and circumstances arise.
>
> **Direct and Indirect Risks**—Direct Risks can be measured in terms of the loss that will arise if a specified course of action is taken. Indirect risks are much more difficult to measure. For example, if the ATO were to remove the Taxpayer Audit program then the direct risk could be estimated based on the loss of revenue that has been collected from that program. By contrast, the indirect risk would involve the estimated adverse impact on the revenue due to a decline in the level of voluntary compliance in the absence of an audit program, that is, without the messages that an audit program sends to the whole community and sectors of it. Due to the patent difficulty of estimating indirect risks, it would seem appropriate to focus measurement attention, initially at least, on the direct risks.
>
> **Qualitative Risks**—This approach recognises that different types of risk to the revenue, other than dollar risks, attract differing levels of interest from the Parliament, the Australian National Audit Office, the media and academics. As a result there may well be merit in considering low dollar but high public impact risks. Adverse publicity can be very damaging and very expensive.

As indicated previously, the Tax Office identified seven broad areas of risk. The next step was to look at the classes of risk associated with each of the seven identified areas.

As an essential part of the risk management process we needed to know if a particular process or situation is in control—that is, whether it is within a particular range. The magnitude of risk in the ATO is usually equated with the expected amount of revenue foregone or likely to be lost. Therefore we have analysed information available to determine the severity of the risk and then to prioritise the risks accordingly.

Work plans have been developed by those responsible for detailing strategies and business plans to manage the identified risks.

Some of the findings from our research and details of our strategies and work plans are included here. Each market segment is dealt with separately.

Large/Medium Segment

Here we have identified six areas of risk:

- tax planning industry;
- foreign controlled corporations;
- corporate groups;
- key individuals;
- superannuation funds;
- other corporations and trusts

Although the large entities are only a couple of thousand in number they account for over half of total tax paid and remitted. Pareto's Law—or the 80/20 rule where 20 per cent of cases account for 80 per cent of the risk—holds well with the large segment.

Despite the success of the Large Case Program, corporate groups do remain a high risk to the revenue. This is due to the amount of potential tax revenue generated by these clients, combined with a commercial approach to tax compliance. Understandably enough, the bottom line is important to them.

You may have seen that we have recently had conducted an external formal evaluation of the Large Case Program. The report indicates that, though only partially complete, it has significantly exceeded revenue goals, with coverage, duration and cost objectives being broadly achieved. A major success noted has been in the area of increased ATO organisational effectiveness.

As to the increased revenue outcome, it has been said publicly that those companies that have come under the Large Case Program have resigned themselves to settling to pay an amount of tax claimed by the ATO to be owed but which the companies do not believe is the amount properly payable under the tax law. This is on the basis that they are being squeezed so hard by the Tax Office that it is better to give up ground rather than pursue the figure they believe is payable. Perhaps they themselves are engaging in risk management.

These public comments strain credulity. A shareholder of any company that argued that it paid more company tax than was required under the tax law because of pressure by the Tax Office or the Tax Office taking advantage of unclear areas of the law would have plenty of questions to ask at, say, the annual general meeting.

A challenging question coming out of the evaluation is whether the Large Case Program has contributed to increased voluntary compliance by our major companies. The reviewers put it this way:

> Large corporate taxpayers and the ATO define voluntary compliance, and thus tax due, differently. Most corporations desire and make substantial efforts to comply with the taxation law, while at the same time practising varying degrees of active tax planning in their goal to maximise returns to shareholders. The ATO's view of compliance, on the other hand, is influenced by a conservative view of the law and the need to protect the tax base. With many grey areas of the taxation law, different perceptions of tax due on the part of corporations and the ATO are inevitable. In fact, these grey areas account for more than half of all debits collected by the program, while the remainder is mostly attributable to legitimate disputes of fact or errors where the law is not in question.
>
> Given these different perceptions, the term 'voluntary compliance' for this taxpayer group may be somewhat misleading. For other taxpayer segments, 'voluntary compliance' describes the readiness of the taxpayers to do the right thing—to accurately report their income and expenses and pay the tax due. On this definition, the largest corporations (the top 100) can be said to be highly compliant, as this taxpayer base, with rare exceptions, is not intending to evade tax. In fact, only one instance of tax evasion have (sic) been prosecuted for the LCP. Nonetheless, corporations still have a large motivation to minimise tax, which occurs most fruitfully in areas where the law is unclear. In this taxpayer group, the degree of 'non-compliance' is more a function of a lack of clarity in the tax law than inappropriate taxpayer behaviour. The key, therefore, to increased voluntary compliance by the ATO definition is to narrow the gap between the ATO's and corporate taxpayers' interpretations of the law.

Three ways of narrowing that gap are offered. Firstly, there is the audit process itself, with its attendant publicity. Secondly, there is improvement of the law through litigation and better legislation. This means a lower degree of case finalisation through settlement. The recent well publicised decision of a company that is in the mainstream of the largest companies to contest one of our audit adjustments is an example of this approach in action.

The third approach, which is put as being the most effective, is use of audits and other insights towards production of a greater range and number of formal ATO rulings. We are acting to adopt that approach, but it is not being pursued as an abstract thing. As the reviewers have said, its purpose is to increase voluntary compliance. That is, and speaking in the generality, the expanded rulings process can be expected to lead to more revenue dollars being paid as rulings establish the correct point of compliance in that grey area between an 'ATO view' and a company's 'maximise returns to shareholders' view.

Before leaving the Large Case area it should also be noted, as a further illustration of risk management techniques, that the large corporate group, to be expanded in coverage from 100 to 600, itself warrants internal segmentation, leading to the companies being placed across a spectrum of perceived revenue risk. This will lead, at one extreme, to a continuous

ATO audit presence for a small number of low complying corporations and at the other to much shorter attention to those where the risk is seen to be lower. Included in the selection factors could be the known tax propensities of those who are the guiding minds of a company or group.

Taking another perspective, the ATO is progressively using key accounts to manage the larger accounts. Key account management involves the management of one or a group of accounts by one officer. That officer acts as the prime point of contact, ensures that our understanding of the operations of the firm or group are current, notes major developments, identifies whether action is necessary and liaises both with the appropriate functional areas within the ATO and key stakeholders external to the ATO.

Key account management can be applied in any segment. It is based on the notion that an entity or group of entities within a segment are sufficiently important to warrant some form of special attention. Key accounts within a segment may vary over time depending on circumstances. It is more likely that most members of the large segment will justify being treated as key accounts, either on a national or a branch office basis. Some members of the medium segment may also become key accounts but this will depend partially on the national and branch office revenue impact in addition to the special considerations mentioned. It is interesting to note that the ATO collected $75.5b from 10.7m taxpayers in 1989-90. Of this, the large/medium market segment represented collections of $52.1b involving 43,801 taxpayers.

Small Business Segment

Four categories of particular interest have been identified in this segment:

- new businesses;
- known areas of non-compliance;
- areas where compliance costs are relatively high;
- areas where compliance is considered to be relatively good.

A set of standard perspectives or 'sub-sets' can be applied to each sub-segment to provide a comprehensive framework for information and identification of compliance issues. These include:

- industry type and nature;
- revenue significance;
- taxpayer type;
- geographic location;
- cash/non-cash business; and
- tax agent/no tax agent.

Historical and research information available indicates that some of the least compliant taxpayers and clients are in this segment. The sheer size of it prevents the ATO from looking at all those in it. So risk management techniques become increasingly important when we look at this segment in terms of entities, revenue at risk and resources available to control the segment, that is, to manage the risk effectively.

Research and information available enables the ATO to build industry profiles and look at compliance levels. Over the last few years we have been publishing a list of those industries that we are building profiles on in the annual business plan of the Taxpayer Audit Group. However, this does not mean that they are the only industries where we will look at compliance behaviour. We have already established industry profiles for some and there are also other industries where we know enough to reasonably conclude that their level of voluntary compliance must be tested out.

Project based audit (PBA) activity, which is where we focus our attention on selected industries, has been very successful in providing additional information to determine levels of compliance in particular industries. Where research and information indicates that there are or are likely to be low levels of compliance, we conduct audits on a carefully selected sample. Again, we have to act according to perceived priorities.

We have identified a number of criteria which provide a guide to the types of industries we should rank highly when we select our program for the coming year. These include:

- the relative size of the industry measured in terms of turnover;
- from data we have collected from our previous audit activity:
    - the level of compliance;
    - the coverage of each industry by the audit program;
    - the average omitted income for audit cases in each
    - industry; and
    - the productivity of audit activity in each industry.

These criteria are given weightings and the industries are compared against each other to obtain a ranking of suitable industries for project based audits.

The criteria chosen means that not only are we taking account of risks to the revenue but we are also ensuring there is equity in our treatment between taxpayers. We achieve this by specifically making allowance for the relative audit coverage of each taxpayer group in our selection process.

To be successful, project based audits must be approached with an open mind about the likely causes of and remedies for non-compliance. We believe it is quite appropriate to tell taxpayers that selection of their

industry does not imply any pre-judgment that the level of compliance is low.

Reflecting this, our internal guidelines make it quite clear that a follow-up to the initial sampling stage of a project need not necessarily involve more audits. In many cases we can expect to gain much better 'leverage' through education and other strategies. Where follow up audits are the most appropriate way of dealing with non-compliance detected in project based audits, resource constraints dictate that innovative audit techniques be developed to reach as many non-compliant taxpayers as possible. These techniques are likely to be significantly less intrusive than traditional techniques.

We recently looked at the fish processing industry. Large amounts of cash were involved, which usually indicates that the quality of business records kept, if any, would be poor. This in fact was the case. As a result of the audits we found that a lot of transactions involved cash and went unrecorded. Also, there were poor financial controls in the businesses that we looked at. Prosecution action was taken where income had not been returned, and also for not maintaining adequate business records. Simply by persuading members of the industry that more accurate records could be maintained simply through the use of cheques instead of cash, we knew that a positive step towards raising the level of compliance in this industry had been taken. With the appropriate mix of service and enforcement throughout the fish processing industry the levels of compliance have been raised.

In one of our branches a project based audit was conducted in the metal fabricators industry. Letters were sent to all those in the industry who were not included in the sample. There was a 70 per cent response to the letters and voluntary disclosures were made.

Another branch discovered a compliance problem in the retail photocopying industry because of the use of interposed entities by the salespersons. The industry is a growth one and it was decided to identify all the sales persons in the state and write individually to each of them. Omitted income of around $2 million will now be taxed and it is intended to extend the exercise nationally.

Alternatives to the impossible and undesirable option of trying to audit every taxpayer need not be sophisticated. One of our early project based audits involved one of our branches looking at the legal profession and, in particular, barristers. Details of barristers' income streams were easy to obtain as payments are made through barristers' clerks. It was simply a case of matching the income details we had obtained with income disclosed in the returns. Where there was a discrepancy between the two figures, audit action followed. Further, by building up a profile of the profession we were able to establish a reliable profit ratio enabling the detection of excess expenditure claims. A number of non-lodgers were also detected. The profession is now back on the straight and narrow

using a mix of full audits, requests sent out to review previous returns and voluntary compliance.

Here the ATO has been able to achieve the maximum coverage of a particular industry without having to resort to the costly method of full audits of all those in the industry.

In many cases, and a couple of the examples above bear this out, taxpayers in the small business segment do not meet what is required of them because of poor bookkeeping and inadequate accounts. There is room here through education and training, and perhaps in some re-focussing of accountancy services, to contribute to a solution. Harking back to the larger business area, hopefully, in the light of our experiences of the 1980s, upgrading of accountancy standards and of their application is pursued.

Non-Business Individuals Segment

For the 1989-90 year around 10.7 million taxpayers lodged tax returns, of which 7.8 million fall within this segment. There is also an unknown number that have failed to enter the system or dropped out of the system.

The greatest number of non-business taxpayers will be people whose income is mainly salary or wages. Outside that group, there will be others whose major source of income is a pension, rental income, dividends or interest.

Having approached the matter on the basis of the seven areas of risks identified by senior management, we consider that we already have substantial mechanisms in place to monitor and to achieve compliance within this segment. These include:

- the Pay as You Earn System under which tax is deducted at source and matching information supplied to the Tax Office;
- the general Income Matching System, which compares income information with details supplied in tax returns;
- Employment Declaration processing which enables the ATO to verify the validity of employee information provided to employers and ensures that details supplied on group certificates at a later date (including tax file numbers) are accurate; and
- the general Tax File Number (TFN) System.

Going further into it, there is an important distinction to be made between compliance for 'salary and wage earners' as people, and for salary and wages as an income stream. If we define salary and wage earners as those not receiving any type of business income, and look at the salary and wages stream, then the available information suggests that

compliance here is in the high nineties. The PAYE system, TFN and Income Matching are major factors here. So audit activities can be framed accordingly, with prime attention being given to seeing that at the payer end things are done as they ought to be.

In other words, the generality is that available approaches of a 'systems' kind give us high levels of assurance that salary and wage income is brought to account. For employees in more risk-prone industries, Employment Declaration processing will increasingly help to narrow the gap and, incidentally but importantly, assist in bringing to book those who are seeking to escape their child support responsibilities.

Viewing it from the angle of salary and wage earners as a group, the compliance issue moves more to that of work-related expenses. They are running at a high level, despite substantiation requirements, but it is pleasing to observe that claims for such expenses in last year's returns are somewhat below what we had anticipated. This may be due to the 'steady on' messages we were sending in the middle of last calendar year.

Obviously, our capacity to audit the millions of people in this category is limited, and as a further illustration of the breadth of possible risk management approaches, we will be asking taxpayers when they fill in returns for the current income year to itemise their work-related expenditure. Thus they will have to give more serious consideration to their claims—is it deductible, is the quantum correct, do they have substantiation?

With some qualifications, the broad picture emerging from available information is that we have just about reached an acceptable level of compliance in this market segment. This does not mean that we can relax our attention. We are proceeding with risk analysis and risk assessment and we will have a more complete picture when the process is finished.

There are of course other issues and areas that cover all segments and do not fit comfortably into one segment. These include fringe benefits tax, capital gains tax (CGT) and Group Employers. These issues will be dealt with in the segment that the entity falls within.

Just one reference should be made to capital gains tax. Some projects undertaken on real estate transactions in a number of states and on share transactions in one state, led us to conclude that an important obstacle to full compliance lay in taxpayers not keeping adequate records and in not knowing enough of what is expected of them. A response has been the preparation and release of a self-explanatory booklet/booklets on capital gains tax and the setting up of a specialist CGT cell which is releasing CGT 'determinations' (rulings) at a very fast and effective rate.

Again to illustrate the range of available risk management techniques, we have used our auditors to give service to a well-defined group of taxpayers, macadamia and other nut growers in one area of the country. We started off testing the viability of 'current year' audits—audits carried out before returns are lodged—but soon found that a key issue was that the producers were unaware that they fell within the trading stock

provisions. Similarly, they were operating on a cash rather than an accruals basis. So the project changed gear to respond, in a service way, to those issues.

Last year we commenced project based audits on group employers involved in the clothing industry. Information available suggested that this was not a very compliant industry so we decided to test this with a sample of project based audits across Australia. We were able to identify massive non-compliance in this industry. From this scoping exercise we were able to make estimates of the amount of revenue at risk in the clothing industry and we determined that entities from all market segments are involved.

Rather than to take the approach of auditing everyone in the industry, all functional areas in the office have become involved in looking at why there was the degree of non-compliance and how it could best be dealt with. We are in course of developing strategies to raise the level of compliance, through an appropriate balance of service and enforcement actions.

There is one group in the community, not yet covered, which will be of interest. It includes:

- those persons engaged in criminal business pursuits which generate assessable income;
- high profile persons who for various reasons attract the interest of law enforcement agencies; and
- those who because of their status and possible criminal business connections merit particular attention.

Our compliance research is able to tell us that this group within the community is the least compliant of all—which is no real surprise. It is not hard to imagine that persons engaged in illegal business activities, and thus in breach of general or criminal laws, are even less likely to be attentive to their tax responsibilities.

For this group we are not able to use usual compliance information available to us within the ATO—instead we must rely on other intelligence so that we can target the high risk areas. We rely quite heavily on the flow of information from sources external to the ATO and the continuing development of close liaison with other law enforcement agencies. Also, it is important that we are able to access other law enforcement intelligence databases so that we can better identify the areas of greatest risk to the revenue.

The entities and individuals in this group do not fall neatly into one segment. There are such varying degrees of severity of risk to the revenue, ranging from petty criminal activity to the larger more organised element. Accordingly, they are dealt with by the appropriate segment and appropriately trained staff.

Conclusion

There is a lot happening in the Tax Office now as we take a market segmented/risk management approach to doing our business. However, the ATO has by no means completed research into the client base and finalised definitive market segments. In fact, some of ATO's further research is showing that we may need to slightly rearrange along the lines of **Large and International Business, Domestic Business** and **Individuals**. These are only preliminary findings and the ATO still has a long way to go before we have an adequately clear picture of our client base.

Market segmentation and risk analysis is an iterative, dynamic and organic process. It does not have a defined finishing line that we can cross. To switch metaphors, the goal posts keep moving.

Chapter Seventeen

Prosecuting Regulatory Offenders

Michael Rozenes Q.C. and Graeme Davidson

At the time of writing this paper, I had been the Director of Public Prosecutions for little over a month. That time has been spent in an intense learning exercise attempting to come to grips with the issues and problems involved in prosecuting those charged with offences against Commonwealth law.

My experience prior to becoming DPP was on both ends of the bar table either as prosecutor or as defence counsel, although it is fair to say that by far the bulk of my work was for the defence. However, it is only now that I appreciate some of the issues and difficulties encountered by the DPP when deciding to institute prosecutions for Commonwealth offences.

The DPP's office was established by the *Director of Public Prosecutions Act 1983*, with the office beginning operations in 1984. Perhaps the most important principle underlying the creation of the Office was to separate the role of prosecutor and investigator and give the prosecutor independence from the political process. This has had the effect of injecting a degree of objectivity in the prosecution process. The severance of the investigating function and the prosecuting function can create tensions, which will be discussed later; however, the essential merit of a separate and independent prosecutor should not be overlooked. The interests of justice require that there be an independent prosecutor to ensure that only appropriate cases are brought to court and thus serve the community at large.

I have some difficulty with the idea that the offenders can be described as regulatory or otherwise. In a sense all legislation is designed to regulate behaviour whether it be in the area of corporate conduct, the importation of narcotics or Social Security.

Perhaps those who formulated this topic, sought to draw a distinction between those offences which are to be found in either the Cooperative Scheme laws or the Corporations Law and other more general offences such as arise under the Crimes Act. I do not hold with this distinction.

Above all it is vital that the appropriate charge be laid in respect of the questioned conduct. If this conduct can appropriately be categorised as an offence falling within either the Cooperative Scheme laws or the Corporations Law then charges should be laid under the appropriate section. On the other hand, if the criminality of the particular conduct is appropriately reflected in a state Crimes Act offence then that must be the charge laid. In the end, the distinction—if there is one—between corporate offences on the one hand and more general state Crimes Act offences does not matter all that greatly. Difficulties encountered in prosecuting these types of offences can arise irrespective of whether Cooperative Scheme or Corporations Law offences are charged or state Crimes Act offences are charged.

It is recognised that some of the most important work in the DPP's office is the prosecution of corporate offenders. You only have to open a newspaper or turn on the television to see references to Royal Commission Reports, reports of the Australian Securities Commission (ASC), current prosecutions and civil actions arising from questionable corporate practices to appreciate the public interest in such matters. The issue of corporate prosecutions is topical and highly newsworthy in all forms of mass media.

Expressions such as the 'excesses of the eighties', following as it does upon the 'halcyon days of the seventies', can quickly become hackneyed and perhaps misleading. The excessive bank lending that eventually led to spectacular corporate collapses has been well documented. However, these expressions may not capture what was the mentality and practice of many persons at that time. These practices included back to back loans, transactions entered into prior to balance date in order to give a distorted view of company finances, channelling of loans through companies associated with entrepreneurs and various forms of market manipulation. In many cases corporate entrepreneurs appear to have treated the company's money and/or the company's assets as their own, intermingling funds or simply using them for purposes other than those of the company. These practices were at least questionable if not criminal. The effect on our domestic economy and international reputation cannot be over-estimated. The Australian economy has suffered as a result of these practices and will continue to suffer until there is a change both in the perception and reality of corporate regulation in Australia.

For the first time since Federation, Australia has a national regulator capable of administering corporate legislation in an effective manner. The ASC does not have the funding problems that plagued the National Companies and Securities Commission (NCSC). The ASC is an organisation that is committed to reform of corporate practices and promotion of corporate ethics. It has the opportunity and means to redefine Australia's corporate practice.

The ASC's predecessor, the NCSC, was not prosecution orientated. While it had legislative power to bring prosecutions, by ministerial direction it was required to delegate that power to State corporate affairs offices. Those corporate affairs offices could bring prosecutions in the NCSC's name. However, the NCSC could not direct the corporate affairs office to bring the prosecution. The ultimate prosecutorial discretion rested with the corporate affairs office and, in some cases, the State Director of Public Prosecutions or their predecessors. This factor, combined with lack of funds, led the NCSC to adopt a practice of commercial settlement. Faced with the reality that its resources would not permit it to run large prosecution cases, the NCSC attempted by commercial pressure and the threat of publicity to rectify what it saw as deficiencies or possible contraventions of the law. The outcome of those commercial settlements remains obscure. In some cases they appear to have involved the payment of money in return for an undertaking that a prosecution would not be instituted. Of course, it was never certain that the NCSC could cause a prosecution to begin. However, the threat of prosecution and the attendant publicity was usually sufficient to bring the corporation and its directors to the negotiating table.

Indeed the NCSC's funding was so limited that even its investigatory function was curtailed. Investigations would often be short-lived and ineffective simply because there were insufficient funds to enable the appointed investigator to properly inquire into the matter.

The criminal prosecution process was perceived to be too long and too expensive. It was also perceived as inherently fallible, for there was always the risk that the case would be too complex for a jury to understand. Further, as the central issue in a criminal trial is the defendant's knowledge that his or her actions were wrong, the difficulty in showing a fraudulent intent as distinct from sharp commercial practice may have often led to the decision not to prosecute. As a result, these difficulties led to the concentration of prosecution resources on minor more clear cut contraventions of the law.

Unfortunately, this approach did nothing to instil confidence in the criminal justice system or to raise the standards of the corporate community. Indeed, if anything it has undermined Australia's reputation as a place for investment and, given our businessmen the reputation of 'corporate cowboys'. Of course, for the vast majority of Australian businessmen this epithet was undeserved. Their conduct was and still is honest and honourable. However, others regarded the risk of a fine or perhaps disgorging any unlawfully made profits as a necessary incident of business life. On a risk analysis assessment, the factors were heavily in favour of the corporate criminal. Against the possibility of being caught there was a strong possibility that the corporate criminal would be dealt with by way of secret deal. These factors provided no disincentive to

engage in the particular conduct. Sadly, it also brought the criminal prosecution process into disrepute.

The important point that must be made is that civil action cannot, in cases of fraud or dishonesty, be an adequate and effective deterrent. It is sometimes said that the thing most feared by the white-collar criminal is the prospect that he or she will be stripped naked of their ill-gotten gains. My experience is that the thing that most scares white-collar criminals is the thought of incarceration.

There must be a real deterrent in the form of a criminal prosecution with appropriate penalties for those convicted. It is appropriate that the ASC has devoted its resources to cleaning up the mess of the 1980s and is committed to ongoing prosecution of corporate offenders.

Recently in NSW the Court of Criminal Appeal upheld an appeal by the prosecution against sentence imposed upon Naji Halabi. Halabi had been sentenced to 18 months weekend detention for his part in conspiring with two others to defraud Westpac Banking Corp Ltd. The Court increased the sentence to one of 18 months in custody. The Court was heavily influenced by the fact that the crime involved a breach of trust by an employee. In delivering the majority judgment, Loveday J said, 'Ordinarily, lengthy custodial sentences are to be expected for those guilty of serious white-collar crimes.' (*Halabi*, Court of Criminal Appeal, Unreported, 17 February 1992).

Prosecution action can of course be extremely frustrating to those unused to the criminal justice system. The time involved to properly investigate and prosecute major corporate fraud is often measured in years. No doubt advances can be made to streamline the prosecution of these sorts of cases—but at the end of the day the offender must have his guilt proved to the criminal standard. The frustrations that some feel as a result of such long lead times must not lead to the conclusion that the criminal process is inappropriate. Those who contravene the law must know that ultimately they will be brought to book. It has been said that a regulatory strategy without a credible threat of prosecution is simply no strategy at all. Such a strategy would be self-defeating, ineffectual and inappropriate.

There can be no admission on the part of the criminal justice system that cases are to difficult to prosecute. The consequence of such an admission is to acknowledge that those who can conceal their criminal conduct behind sophisticated corporate procedures so as to make it extremely difficult for the prosecutor to proceed walk free, whilst the less sophisticated and usually poorer criminal receives no such benefit. Such a course must inevitably bring our system of criminal justice into disrepute and erode public confidence in the rule of law.

When the prosecution process is seen to be cumbersome, time consuming and expensive there is an understandable temptation to seek to prefer other venues. One such venue is the substitution of civil remedies

for criminal process. It is said that the civil route is quicker and more efficient; that the standard of proof is lower; the remedy is commercially effective; and the impugned conduct is rectified by declaratory relief. The victim, be it the corporation, its shareholders or some third party are compensated and the wrongdoer is stripped of his or her profit. It cannot be the case that the ultimate sanction for the corporate wrongdoer is the mere restoration of the status quo.

That is not to say that civil remedies play no part in the prosecution of the corporate offender. On the contrary, civil remedies form an important weapon in the fight against corporate crime. But it must be understood that the only real and effective deterrent for the corporate crook is the certainty of detection followed by the certainty of punishment. To advocate otherwise is to simply encourage corporate wrongdoers to factor into the cost of doing business the risk of having to pay back ill-gotten gains. Such an approach will only ensure that assets are well hidden and that otherwise the risk is accepted.

The Government regards prosecution as a crucial element in its enforcement program. Naturally the ASC, when investigating these matters, tends to look to either the cooperative scheme codes or the Corporations Law for the appropriate offence. Often the particular activity will fit within one of those offences. However, the DPP has a wider focus. If the activity more appropriately falls within a more general state Crimes Act provision, we will recommend to the ASC that such an offence be charged, perhaps in conjunction with the cooperative scheme or Corporations Law offences.

As mentioned earlier, it is vital that the offences charged adequately reflect the alleged criminality. In some cases it will simply be the case that a charge of defrauding or even conspiracy to defraud will be the most appropriate charge. While we are sensitive to the views of the ASC and the desire to lay charges under a particular piece of legislation, there is a wider community interest that charges laid should adequately reflect the criminality disclosed by the available evidence. If such charges are not laid then any sentence handed down will not in turn, reflect the criminality and not be a true deterrent. In these circumstances, the whole object of the exercise may be lost.

This issue exposes one of the great difficulties for the ASC and the DPP. The ASC, while a national regulator, is working with uniform state legislation that applies federal law. But, in this area, the new corporate legislation is not a code as to criminal conduct. The provisions of the state Crimes Act complement the offence provisions of the corporate legislation. If, in order to show the true criminality, both state Crimes Act and company law offences should be laid, then that must be done. The ASC should have no difficulty with that; nor should it have any difficulty with those cases where only state Crimes Act offences are charged.

The DPP is working closely with the ASC in relation to corporate prosecutions. Current statistics indicate that since the ASC's inception 144 separate matters involving possible breaches of the law have either been referred to the DPP or the question of prosecution has been discussed with the DPP. Of those 144 cases the DPP has advised that 19 should not go further. Charges have been laid in approximately 60 of the matters with the remaining cases either with the ASC for further investigation or with the DPP for further consideration.

In relation to the cases referred to the DPP, all have been and are being dealt with promptly in an efficient and professional manner. Some of the cases being considered are potentially the largest this country has seen. They involve thousands of documents and deal with complicated corporate structures and transactions. Some require the consideration of multi-disciplinary teams—lawyers, accountants, financial analysts and experienced investigators. These cases are not easy. What has taken one or more years to investigate cannot be disposed of in a week. It takes time to properly consider and appreciate these legal cases and the DPP may see the focus of the case differently from the ASC. The point is, however, that the DPP has an objective role to play and we are concerned that we fulfil that role in a proper and responsible manner.

Of course, the statistics do not tell the whole story. The ASC is committed to investigating and referring matters to the DPP in a timely fashion. In many cases the DPP is involved in advising the ASC during the course of the investigation, as to possible areas of criminality. Ultimately, the ASC must refer a brief of evidence to the DPP before we can take action. Once the brief is received, the DPP conducts an objective, reasoned analysis of the case and evaluates the strengths and weaknesses of any evidence. The DPP may point out further areas where investigation is required. Accordingly, as with any case, there will be a process of interaction between the DPP and ASC in order that the case may be put in a way that complies with the principles of justice and the considerations set out in the Commonwealth's Prosecution Policy. Such a relationship is bound, on occasions, to cause some tension although fortunately on the whole relationships between ASC investigators and DPP prosecutors are good.

There is a need to resist the public pressure for quick convictions or 'runs on the board'. That expression is unfortunate but marginally better than 'scalps on the wall'. That there is a public expectation that corporate criminals face the court and be dealt with is understandable. Nevertheless, we must be careful to ensure that the prosecution response is an adequate and proper one. Among other things, this means that charges must not be laid prematurely in the hope that any gaps in the evidence can be closed as the case proceeds to trial. That is a tendency which must be avoided. Indeed to bring charges which must then be withdrawn because of evidentiary difficulties would, in my mind, be counterproductive if not

irresponsible. It is vital that the ASC and DPP work closely together in this regard. Short-term frustration because of a perceived lack of action will never be an adequate justification for premature action. As with any prosecution we conduct, the interests of justice and fairness must be paramount.

The ASC's current approach to offences that have occurred post 1 January 1991 are well known. The ASC is, understandably, concerned to institute civil proceedings at the earliest possible opportunity in order to protect shareholders or creditors or the rights of the company itself. Following such intervention the ASC will then consider the question of criminal prosecution. A tension can arise between the two sets of proceedings. While this paper is not a treatise on the law, it should be stated that doctrines such as contempt, stay of proceedings and abuse of process all have the potential to impact upon the situation where both criminal and civil proceedings are brought at the one time in respect of the same actions. The ASC have an understandable concern that should criminal proceedings be instituted in respect of the same actions where civil proceedings are on foot, those civil proceedings may be stayed by a court to prevent any unfair prejudice to the defendant. Of course whether such prejudice will be caused will depend upon the facts of each case and it is not possible to predicate with any certainty what the outcome will be. However, while the fact that the criminal proceedings are on foot has the potential to disrupt those civil proceedings, this should not be a reason to delay criminal proceedings until the civil proceedings are finalised. In many cases the two sets of proceedings may be able to run together. Further, the DPP is not adverse to civil proceedings in that it may be expected that if civil proceedings run their course they may result in material which is of use in a prosecution. For example, discovery or affidavits may provide the prosecution with an inclination of likely defences to criminal charges or may lock potential defendants into a story from which it will be difficult to extricate themselves.

Obviously the area is extremely sensitive and needs a cautious approach. The DPP takes the view that this issue must be examined critically and that as a general principle it is not correct to say that the institution of criminal proceedings will prejudice or stop the civil proceedings. Ideally we would like such actions to be closely coordinated so that injunctive relief or action for restitution can take place at the same time as the criminal proceeding. While this may not be possible in all cases, the importance of the criminal proceedings can not be underestimated. Further, if the institution of those criminal proceedings is delayed pending the outcome of the civil proceedings there is a potential for abuse of process arguments to be advanced on behalf of defendants.

In the end, any particular problem will probably be resolved by negotiation with the ASC. The DPP is a receptive agency in many ways. We rely upon other agencies to do the investigative work and refer the

brief of evidence. However, that does not mean that we sit back passively if we believe that certain areas need investigation and that those areas ought to be investigated. We are concerned that the system will ensure that conduct of a criminal nature will be investigated and briefs referred to the DPP. If the system does not have that result then we will complain long and loud.

The ASC is of course concerned to administer both the Corporations Law and the Cooperative Scheme Law where applicable. It is reluctant to devote scarce investigative resources to what is perceived to be purely state Crimes Act offences such as fraud or misappropriation of moneys. Most commonly this will involve criminal activity with the involvement of a company merely the means by which the fraud has been perpetrated. When exposed in this way the activity is seen as a matter for state police forces. In these circumstances in some cases, the National Crime Authority (NCA) might step into the breach to conduct an investigation where it is authorised to do so. There is, however, the potential that matters requiring investigation fall outside the NCA's area of operation and the state police force is unwilling or unable to take that matter on. In these cases we would agitate that the ASC take up the investigation either solely or in conjunction with another agency. It is simply unacceptable that such breaches not be investigated and prosecuted. This area as much as any other has the potential to result in injustice and frustration with the law.

Of course joint investigations have their own difficulties and it is beyond this paper to examine them. There needs to be careful coordination of investigative activity to ensure that the investigation proceeds in the right direction examining the most relevant areas of criminality. Further, the respective roles of each organisation must be clearly defined at the outset so that there is coordinated activity. The ASC and NCA have agreed guidelines in particular matters where a joint investigation has been instituted. No doubt as our experience expands and these sorts of investigations become more commonplace the respective roles of the investigating agencies will be determined. In this process we see the DPP as being able to assist and coordinate where appropriate.

It is appropriate to note a sound of warning. We must be careful to ensure that the errors of the 1980s are never repeated. It would be unacceptable to sit back after those cases have been completed and believe that the work has been done. It is vital that there be an ongoing and thorough commitment to prosecuting corporate fraud and corporate crime. No one believes that as at 1 January 1991 corporate crime ceased to exist. There will always be those ready to use the system and play it to their own advantage and at the expense of others. There is a need to clarify the law to ensure that such activities are adequately and quickly dealt with and those responsible prosecuted to its fullest extent. It is only by taking these steps that confidence will return to the investing public

both within and outside Australia. That must be both an immediate and long-term aim for both the DPP and ASC.

Chapter Eighteen

Rethinking Criminal Responsibility in a Corporate Society: an Accountability Model

Brent Fisse

Responsibility for Corporate Crime?

The present law in Australian as in foreign jurisdictions provides for both individual and corporate liability for corporate crime but there is little or no guarantee of a well-balanced mix; the balance in fact achieved depends on prosecutorial discretion where the high ideal of targeting individual personnel tends to break down when confronted with corporate lack of cooperation.

It should be noted that in this context 'crime' is taken to mean a criminal offence or penalty-carrying violation under existing law, and 'corporate crime' which is legally attributable to a corporate entity or any individual persons acting on its behalf. We are not concerned here with the problem, formidable as it is, of fraudulent corporate enterprises where the main concern is not so much the balance to be struck between corporate and individual responsibility but rather the difficulty of taking timely and effective action against the entrepreneurs behind the scams.

Two major problems of accountability thereby arise. First, there is an undermining of individual accountability at the level of public enforcement measures, with corporations rather than individual personnel typically being the prime target of prosecution (Fisse & Braithwaite 1988). Prosecutors are able to take the short-cut of proceeding against corporations rather than against their more elusive personnel and so individual accountability is frequently displaced by corporate liability, which now serves as a rough-and-ready catch-all device. (There is, however, the possibility of individual responsibility being enforced through civil action; *see further* Ming 1983, p. 271, Coffee 1977, pp. 1157-246, Pennington 1987, ch. 8). Secondly, where corporations are

sanctioned for offences, in theory they are supposed to react by using their internal disciplinary systems to sheet home individual accountability (Elzinga & Breit 1976, pp. 132-8; Posner 1985, pp. 1227-9; Kraakman 1984), but the law now makes little or no attempt to ensure that such a reaction occurs (Coffee 1980, pp. 458-60). The impact of enforcement can easily stop with a corporate pay-out of a fine or monetary penalty, not because of any socially justified departure from the traditional value of individual accountability, but rather because that is the cheapest or most self-protective course for a corporate defendant to adopt.

For some years now, John Braithwaite and I have been engaged in writing a book which explores possible ways of resolving the basic problems identified above. One step that we have taken is to set out the desiderata that seem to be critical when rethinking legislative efforts and enforcement strategies for getting accountability for corporate crime (*see* the next section). Another step is to formulate a model for the allocation of responsibility. The Accountability Model is described and an illustration of the intended application of that model is given in this paper.

Desiderata for the Enforcement of Responsibility for Corporate Crime

1. A strategy for allocating responsibility for corporate crime should reflect the received wisdom that individual responsibility is a pillar of social control in Western societies. The slide away from individual responsibility in our corporate law enforcement must be remedied.

2. A strategy for allocating responsibility for corporate crime should also accept that corporate action is not merely the sum of individual actions and that it can be just and effective to hold corporations responsible as corporations.

3. A strategy for allocating responsibility for corporate crime should seek to maximise the allocation of responsibility to all who are responsible, be they individuals, subunits of corporations, corporations, parent corporations, industry associations, gatekeepers such as accountants and indeed regulatory agencies themselves.

4. The maximisation of the allocation of responsibility to all who are responsible should be pursued cost-efficiently, and in a way that does not place unrealistic burdens either on corporations or on the public purse.

5. The maximisation of the allocation of responsibility should be pursued justly in such a way as to safeguard the interests of individuals. Rights of suspects must be respected. Procedural justice must not be sacrificed on the altar of substantive justice.

6. Those who are responsible for equal wrongs should be treated equally.

7. A strategy for allocating individual responsibility should remedy the scapegoating that has been endemic when individual accountability for corporate wrongdoing has been pursued.

8. A strategy for sanctioning the responsible should minimise spillovers of the effects of sanctions onto actors who bear no responsibility for the wrongdoing.

9. A means must be devised to escape the deterrence trap—the situation where the only way to make it rational to comply with the law is to set penalties so high as to jeopardise the economic viability of corporations that are the lifeblood of the economy.

10. A strategy for sanctioning the responsible must recognise that actors are motivationally complex. Profit maximisation is an important motivation for many private corporate actors, but the maintenance of individual and corporate repute, dignity, self-image and the desire to be responsible citizens are also important in many contexts, as are various more idiosyncratic motivations. A good strategy will not be motivationally myopic.

11. A strategy for sanctioning the responsible should also avoid myopia about what agents will dispense sanctioning of the responsible with the greatest justice and effectiveness. Often, it will be enforcement agents of the state who will do the best job. Yet we should not privilege the state as the only law-enforcer that matters. In particular, corporate internal disciplinary systems must be taken seriously as legal orders with realised and unrealised potential for justice and effectiveness.

12. Special care must be taken to ensure that the state does not cause private justice systems to become organised against the state justice system. The state should have enforcement policies that avert the formation of organised business cultures of resistance to regulatory law.

13. A strategy for sanctioning the responsible should also avoid myopia about the aims of the criminal justice system. Narrowly focused utilitarianism or retributivism is a prescription for disastrous

corporate criminal enforcement policies. Criminal liability is not merely a matter of paying a price for crime but has a prohibitory function which is reflected by the denunciatory emphasis of the criminal process. Nor should criminal liability be viewed simply as a matter of retribution. The harms protected against by corporate criminal law are too serious for us to indulge retribution at the cost of increasing corporate harm-doing.

14. A strategy for allocating responsibility should be in harmony with the varieties of structures, cultures, decision making and accountability principles in large and small organisations.

15. A strategy for allocating responsibility should be capable of nuanced response to the likelihood that the same corporate action can be usefully understood in many different ways. Our mechanisms for allocating responsibility should not be so calibrated that the ambiguous and paradoxical nature of corporate action eludes us. In other words, we should be able to avoid the traps of narrowness of vision through institutions that are able to imagine corporate action in multiple ways. Our methodology for allocating responsibility should foster a dialogue that brings these multiple interpretations of responsibility into the open.

16. A strategy for allocating responsibility in a complex corporate world where the motivations of actors are multiple and where no single model of corporate action grasps the whole story should be based on redundancy. That is, if the intervention fails for one reason, there should be other features of the intervention that might enable it to succeed. Redundancy should be built into interventions, while the inefficiencies of costly redundancies are avoided.

17. A strategy for allocating responsibility should ensure that the law does not straightjacket management systems into conformity with legal principles.

18. A strategy for allocating responsibility should operate with a conception of fault that is not time-bound, but copes with the dynamic nature of corporate action.

19. A strategy for allocating responsibility should not be bound by a national jurisdiction; it should be capable of responding to the increasingly international nature of corporate action.

20. A strategy for allocating responsibility should be workable in the context of public as well as private organisations.

An Accountability Model

The Accountability Model we advocate is based most fundamentally on the following rule of action:

> **seek to publicly identify all who are responsible and hold them responsible, whether the responsible actors are individuals, corporations, corporate subunits, gatekeepers, industry associations or regulatory agencies.**

This rule of action, which could be implemented by refining existing legislative and common law controls against corporate crime, suggests the need for a legal package containing the following essential elements:

- pyramidal enforcement whereby the legal response to non-compliance can be escalated progressively if necessary;
- guidelines which indicate the circumstances under which corporations and/or individuals are to be prosecuted for offences;
- accountability agreements, orders and assurances under which disciplinary and other duties are to be performed by a corporate defendant and relevant personnel;
- specification of the threshold requirements for accountability agreements, orders or assurances;
- designation in advance of the individuals and collectivities primarily responsible for ensuring responsibility with an accountability agreement, order, or assurance;
- provision for supervising and monitoring of accountability agreements, orders or assurances should such steps be required; and
- safeguards against scapegoating and other unjust practices by organisations subjected to accountability agreements, orders, or assurances.

The basic regulatory framework of the Accountability Model is pyramidal enforcement (Braithwaite 1985; Ayres & Braithwaite 1992), with informal methods of control at the base of the pyramid and severe forms of criminal liability at the apex. One commendable pyramid of enforcement, working up from the base, is this:

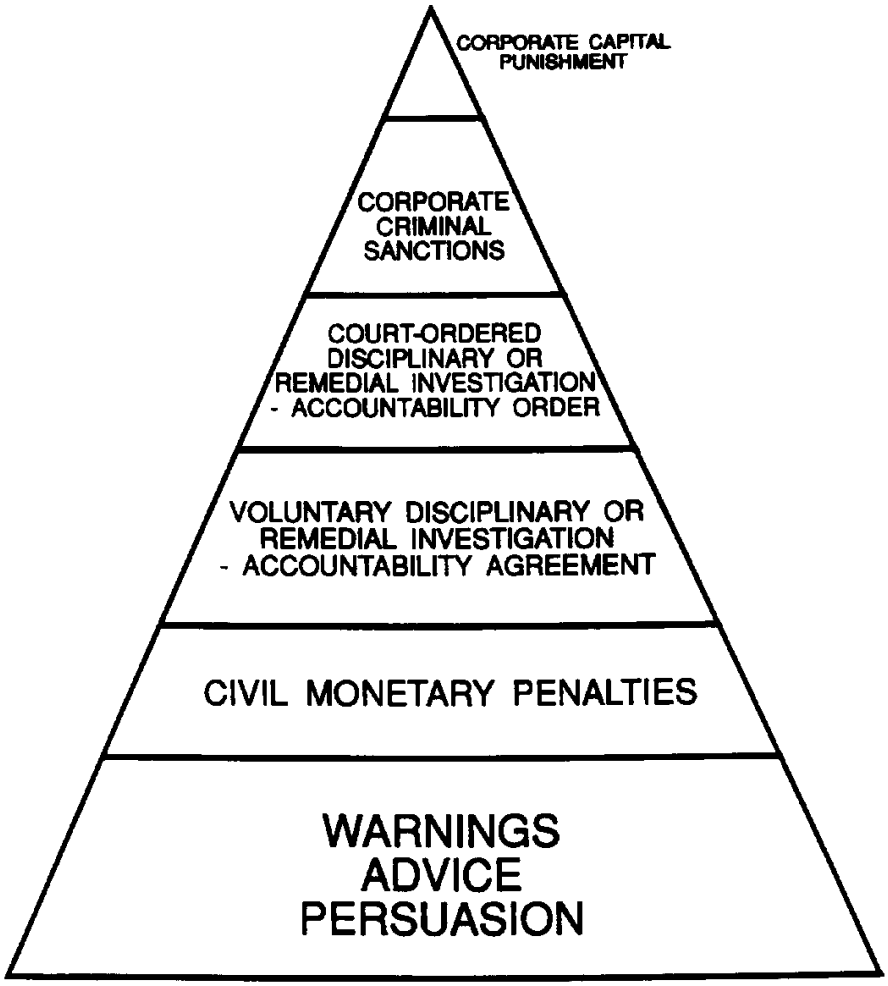
- persuasion, advice, warnings, and other informal methods of promoting compliance;

- civil damages and injunctions (corporate and individual);
- civil monetary penalties (corporate and individual);
- disciplinary or remedial investigation undertaken upon agreement with enforcement agency (accountability agreements) and court-approved assurance of an effective program of disciplinary or remedial action (accountability assurances), coupled with publication of an accountability report;
- court-ordered disciplinary or remedial investigation (accountability orders) and court-approved assurance of an effective program of disciplinary or remedial action (accountability assurances), coupled with publication of an accountability report;
- criminal liability (individual and corporate), with community service, fines and probation authorised for individual offenders, and adverse publicity orders, community service, fines and probation for corporate offenders.
- escalated criminal liability (individual and corporate), with gaol authorised for individual offenders, and liquidation (corporate capital punishment), punitive injunctions, and adverse publicity orders for corporate offenders.

Figure 1 presents the corporate version of this pyramid. When regulatory persuasion and advice fail, warnings escalate to civil monetary penalty, to negotiation of voluntary accountability agreements, to accountability orders mandated by the courts to corporate criminal sanctions escalating from fines to community service to punitive injunctions and corporate capital punishment (such as licence revocation).

The exact form of the pyramid may well vary from jurisdiction to jurisdiction, depending on such factors as the particular modes of regulation to which locals are accustomed, and the extent to which lawmakers are prepared to exercise their imagination. The options indicated above, however, are representative of those available in many jurisdictions. What matters for the purpose of the Accountability Model is not the infinitely various detail into which one might be tempted to descend but the strategy behind pyramidal enforcement and the implications which this strategy holds for the legal ordering of sanctions and remedies against corporate wrongdoing.

Figure 1: Pyramid of disciplinary and remedial interventions against corporate offenders



A central idea behind pyramidal enforcement is the game theoretic postulate that actors, individual or corporate, are most likely to comply if they know that enforcement is backed by sanctions which can be escalated in response to any given level of non-compliance, whether minor or egregious. The pyramid proposed is tall rather than squat, the theory being that the taller the enforcement pyramid, the more the levels of possible escalation and the greater the pressure that can be exerted to motivate 'voluntary' compliance at the base of the pyramid (Ayres & Braithwaite 1992). Compliance is thus taken to be a dynamic enforcement game where enforcers try to get commitment from corporations to comply with the law and can back up their negotiations with credible threats about the dangers faced by defendants if they choose to go down the path of non-compliance.

A key part of getting commitment from corporations to comply with the law is instilling and maintaining a sense of responsibility, corporate and individual, within the relevant organisation. To that end, the pyramid outlined is intended to give enforcers the leverage they need to persuade corporations to impose individual responsibility as a matter of internal discipline.

Where the violation is minor, the level of response warranted may be no more than a warning, a prohibitory injunction or civil damages order, or a civil penalty. At the next possible tier, an enforcement agency may need to insist on a formalised accountability agreement under which the corporation and designated personnel would agree to undertake an internal disciplinary inquiry and, at a specified later date, to provide an assurance, to be approved by a court, that certain disciplinary action had been taken or was about to be taken. A variety of business regulatory statutes already empower regulatory agencies to enter into and enforce such agreements. See, for example, Fair Trading Act (UK); Trade Practices Act (BC), s. 17. In Neilson's (1981) study of 90 formal trade penalties compliance agreements in three Canadian provinces, the use made of these tools was uneven and lacked a clear underling strategy: 'enforcement is carried out too often in an atmosphere of stealth and anonymity in which generalities abound, names disappear and enforcement priorities let alone activities, only infrequently come into sharp focus'.

In cases where the defendant is less trustworthy, application could be made to a court for an accountability order under which a corporate defendant and designated personnel would be required to make a disciplinary inquiry, to report back, and to give a satisfactory assurance about the disciplinary measures taken or planned. Note that the distinction between an agreement and an assurance is that an assurance is given to a court while an agreement is entered into with a regulatory agency only. The difference between an order and an assurance is that the order is mandated by the court whereas an assurance, like an agreement, is voluntarily given by the defendant organisation.

Accountability orders or assurances might also incorporate a variety of supervisory and monitoring mechanisms, depending on the severity of the offence and the compliance record of the defendant. For serious offences, including non-compliance with accountability agreements, orders, or assurances, the corporation and individuals implicated in the offence would be subject to criminal liability. For very serious offences, including repeated non-compliance with accountability agreements, orders, or assurances, the corporation and individuals implicated in the offence would be subject to criminal liability at an escalated level.

The range of sanctions in the pyramid for individuals is entirely conventional: gaol, community service, probation, fines, civil penalties, damages, injunctions, reprimands and warnings. The range of sanctions

for corporations, however, would need to be wider than the array of sentencing options that are currently available (United States Sentencing Commission 1991 1989 1988; Australia, Law Reform Commission 1988; SA Criminal Law and Penal Methods Reform Committee 1977, pp. 357-64; American Bar Association 1980; Geraghty 1979; Coffee 1981; Gruner 1988). Thus, we envisage corporate capital punishment as the most severe form of sentence available against corporations. This suggestion, hardly novel,[1] is advanced not out of misguided vindictiveness but simply on the basis that a drastic form of punishment may occasionally be needed to deal with the most extreme forms of corporate intransigence. Another option, is the punitive injunction, a hard-hitting and yet remedial form of punishment that would be appropriate in cases where liquidation would be unwarranted and yet where the record of non-compliance is such as to call for more than merely a probationary sentence or a fine (*see* Fisse forthcoming). Another option again would be court-ordered adverse publicity, a sanction designed to play on corporate sensitivity about prestige. The less drastic options would include community service orders, probation, fines, civil monetary penalties, damages, injunctions, and informal browbeating and cajoling.

The strategy of pyramidal enforcement is consistent with the more central desiderata which we have pinned down as critical to the just and effective allocation of responsibility for corporate crime. Pyramidal enforcement gives practical expression to the importance of individual responsibility as a pillar of social control in Western societies (Desideratum 1): accountability agreements, orders, and assurances are vehicles for achieving individual responsibility at the level of internal corporate discipline systems, which are activated by threatening corporations and their officers with escalating sanctions should they fail to ensure that internal discipline takes place. Pyramidal enforcement also reflects the ideal that all who are responsible should be held responsible (Desideratum 3): by inducing internal disciplinary action, it is possible to sheet home responsibility across a much broader front than could ever be achieved by reliance on the criminal justice system alone.

The strategy is also consistent with less central desiderata, including avoidance of the deterrence trap (D 9); heading motivational complexity (D 10); minimising the risk of cultures of resistance (D 12); reflecting the aims of the criminal justice system (D 13); redundancy (D 16); and taking account of the dynamic nature of corporate behaviour (D 18).

Cost-efficiency is a further feature of pyramidal enforcement. Emphasis is placed on stimulating self-regulatory mechanisms for achieving accountability: who would deny that internal investigative and

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1. In more recent times, for instance, it has been widely discussed as a sanction for banks which commit money laundering offences under US law.

sanctioning mechanisms are less costly to administer than the external criminal law method of dealing with corporate crime?

The Model Illustrated

Suppose that an illegal act of pollution, an injury through non-compliance with an occupational health and safety law, an antitrust offence, or an understatement of taxable income has occurred at one of the factories of the Sloppysops Corporation. The factory is in Texas, but it is the top management of Sloppysops in New York who are dragged into court. Sloppysops has had civil monetary penalties imposed for previous offences of this type and has not been a very cooperative company. The regulatory agency therefore decides to move up its enforcement pyramid, by-passing the voluntary accountability agreement option, taking the alleged offence to court with an eye to the accountability assurance/order option.

A civil enforcement action is taken against the company. The court finds, on the balance of probability, that the actus reus of the offence was perpetrated at the Texas factory, but stops short of enquiring into whether the offence was intentionally or negligently perpetrated, into whether any senior managers at Texas or New York knew of the offence or into who was responsible at any level.

Thus, what might otherwise involve a long criminal trial would initially be dealt with expediently in a civil proceeding; the evidence that a legally prohibited level of pollution was emitted from the Texas factory would be put to the court and the issue whether the actus reus had been committed would be determined by the court on the civil standard of proof with the enforcement agency bearing the persuasive burden of proof. Assuming that the actus reus was proven against Sloppysops, the judge would then invite the corporation to conduct an internal enquiry into the reasons for the failure of compliance. Should it wish to do so, and on the strength of its investigations and any suggestions made by the court, the company may choose to:

- prepare a report on the persons or entities responsible and file that report with the court;
- take disciplinary action against those responsible;
- voluntarily compensate those who were injured or suffered loss because of the offence; and
- commence a program of managerial reform, and revision of policies and procedures so as effectively to guard against repetition of the type of conduct proven against the company; and

- commence a program of compliance education within the firm and perhaps through the industry association as well.

The court will give Sloppysops a short time to decide whether it wishes to accept the opportunity to undertake the enquiry and to make a submission on how long the enquiry would take to complete. If the court is persuaded that the company's proposed time frame is genuine and realistic, then it will adjourn until the agreed date when Sloppysops will bring forward the report on its work. If the company does not take up the offer to provide an accountability assurance, or proposes only a perfunctory investigation which does not satisfy the court, then the enforcement agency will be invited to make a submission on how long they need to prepare a case for an accountability order against Sloppysops and/or individual officers within it, and a date will be set for the resumption of the proceedings against the corporation.

Note that the initial response of the court is not to order the corporation to conduct the enquiry. Nor is it suggested that the court should instruct the corporation how to undertake the enquiry, though it might make suggestions which the corporation would be foolish to ignore if it were keen to persuade the court. Indeed, the judge might also invite the enforcement agency to make suggestions, which the defendant would be equally free to take up or ignore. The assumption underlying this voluntarism is that a self-investigation which is compelled is less likely to incorporate the thoroughness and commitment to satisfy the court than is an internal enquiry which is freely chosen, planned and executed by the corporation. The other assumption is that corporations will mostly find the offer of self-investigation an attractive one because, while it will be expensive, the corporation in any case would be spending money on enquiring internally into what went wrong, and the costs might well be less than protracted litigation. More importantly, the corporation will usually take up the offer to enhance its self-image as a responsible corporate citizen and to present itself to the court, the regulatory authorities and the community at large as a responsible self-regulating organisation. Also the desire to avoid criminal liability by doing the job properly will be a factor, as will the desire to avoid a poorly conceived court-imposed management restructuring order which might reduce the productivity of the organisation. There may also be some less principled reasons for cooperating, such as the fear that an extended period of governmental investigation may unearth other skeletons in the organisation, or prompt employees to blow the whistle on other matters.

As it neared the completion of its investigation, a prudent Sloppysops would tell the judge, the prosecutor and the regulatory authority what it had done so far and whether they had any suggestions for other matters which should be further pursued internally. On the day the hearing of the

case resumed, it would then be in a position to present an accountability report which it believed to be acceptable to the court.

The court would review what the corporation put forward in its accountability report. Depending on the adequacy or otherwise of the action taken by the corporation, the court would then discharge the defendant, ask for a further assurance that additional action be taken, make an accountability order requiring further steps to be taken, or subject the corporation and the personnel specified in the assurance to liability for contempt of court. Thus a discharge would be appropriate where the accountability report persuasively showed that:

- the responsibility lay with a range of individuals and subunits within Sloppysops organisation and that appropriate disciplinary action had been taken against all parties implicated;

- the defective operating procedures and technologies that had contributed to the commission of the actus reus of the offence had been reviewed and adequately revised; and

- the corporation had been exposed to the adverse publicity of a self-condemnatory report and had voluntarily borne the costs of compensation.

Even in these circumstances, however, the court would normally order copies of the accountability report, and the court's findings in relation to it, to be sent to a long list of media outlets. This is predicated on the need to communicate an educative and deterrent message to other corporations, and on the empirical evidence that adverse publicity is the stuff of effective informal community control over corporate crime (Fisse & Braithwaite 1983).

If Sloppysops failed to hand up an accountability report or failed to comply with some term in the accountability assurance given to the court, the court could proceed to make an accountability order, with specific provision for supervision and monitoring by an officer of the court at the expense of the company. If breach of the assurance occurred, the corporation would also be liable to punishment for contempt of court. The range of punishments would include a punitive injunction directing that extraordinary action be taken by the company on an emergency basis, and an adverse publicity order requiring that the company's pigheadedness be exposed in the news media. The directors and managers charged in the assurance with responsibility for compliance would also be subject to liability for contempt. The range of sanctions for them would include community service, fines and probation.

In the event that Sloppysops failed to comply with the terms of the accountability order or punitive injunction it would again be liable for contempt of court. On this occasion, however, the punishment would

escalate. Thus, a more intrusive punitive injunction might well be appropriate. For instance, the board of directors could be required to dedicate itself to the task of compliance for a month and to report daily to an officer of the court on the progress being made. In an extreme case, Sloppysops would be sentenced to capital punishment by placing it in liquidation. The directors and staff members nominated in the accountability order or punitive injunction as the individuals responsible for ensuring compliance would also be subject to liability to contempt. Here too the sanctions would escalate, gaol being one possibility.

Alternatively, Sloppysops might well provide an exemplary accountability report. Nonetheless, Sloppysops' initial conduct in committing the actus reus of the offence could have been outrageous. In that case it would be necessary for stronger deterrent or condemnatory steps to be taken by launching a criminal prosecution against the company and/or particular officers or personnel. The court would have the power to so recommend. In recommending prosecution, the court would be informed by the guidelines on corporate and individual criminal liability published by the prosecutor's office as well as by the information revealed in the accountability report or from questioning conducted during the civil accountability proceedings.

Sloppysops' encounter with the Accountability Model might ultimately lead to the conviction of both the company and its key officers or managers. Such an outcome would depend on whether all of these parties were sufficiently at fault to satisfy the prosecutor's guidelines and, in the event of trial, the legal principles requiring corporate blameworthiness for corporate criminal liability, and individual blameworthiness for individual criminal liability. If convictions ensued, the pyramid of enforcement would provide an escalated range of sanctions for egregious offences, and a lower range of punishments for less serious offences. Thus, if the offence were monstrous then, assuming that Sloppysops was pervasively infected with the disease of sloppiness and utterly beyond redemption, the sanction would be liquidation. On the other hand, a lesser offence and a greater degree of corporate tractability could well result in a punitive injunction or a term of corporate probation.

Conclusion: Responsibility or Buck-Passing?

An Accountability Model for the control of corporate crime in modern society has been outlined. The underlying desiderata warrant full explanation and a number of obvious concerns, including the risk of employees being scapegoated by their superiors, call for detailed examination. Nonetheless, it seems worth pursuing the idea that the law can and should try to embody the commonplace principle that all who are responsible should be held responsible, whether by means of criminal or

civil liability or through the internal disciplinary systems of organisations. Unless there is such a change in direction, buck-passing almost certainly will continue to flourish as a freeway to evasion, in mockery of law and as a fundamental negation of the very idea of social control.

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