

Introduction

The Dynamics of Capital Market Governance

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Efficiency and integrity in contemporary financial markets do not correlate without direct intervention. Notwithstanding the rhetorical power of the 'invisible hand' metaphor, the laissez-faire contractual account of governance it ordains is, at base, a political construct. What constitutes the optimal level of intervention is contingent on the variable interaction of material and ideational factors. These include the depth, liquidity and importance of capital markets, interest group organisational power, and international regulatory trends. The extent and direction of change are further affected by the environmental impact of professional norms and behavioural mores on the formal and informal nodes supporting the structural architecture.¹ A critical mediating factor is the ideational terms of reference set by the wider political firmament. The extent to which it internalises market-derived conceptions of utility helps determine risk profile and appetite. The complex interaction of these vectors determines who is given voice, authority and legitimacy within the complex network of organisational forms in the overarching regulatory matrix.²

¹ Neil Fligstein, *The Architecture of Markets: An Economic Sociology of Twenty-First Century Capitalist Societies* (2001); Steven Vogel, 'Why Freer Markets Need More Rules' in Marc Candy, Martin Levin and Martin Shapiro (eds), *Creating Competitive Markets* (2006) 25, 27.

² Leigh Hancher and Michael Moran, 'Organizing Regulatory Space' in Leigh Hancher and Michael Moran (eds), *Capitalism, Culture and Economic Regulation* (1989) 271; for conception of regulatory space as network, see Albert-Laszlo Barabasi, *Linked: The New Science of Networks* (2002) ('Real networks are not static ... there is a hierarchy of hubs

Key performance indicators for regulatory agencies ostensibly resolve the tension over the form and substance of market oversight.³ They delineate duties and responsibilities. They set expectations against which the delivery of specific regulatory objectives can be measured. They offer assurance to the regulated that accountability extends to the regulator. They act as homogenising agents of remarkable strength.⁴ Evaluating regulatory effectiveness through this lens can be, however, exceptionally problematic. As the 20th century's most celebrated mathematician recognised: 'not everything that counts can be counted, and not everything that can be counted counts.'⁵

Perception of what constitutes value differs among institutional actors in any given regulatory matrix. Relative ranking inevitably impacts on the design and authority of deployed indicators. Here it is important to differentiate between technical and value-driven indicators of performance. The first is relatively unproblematic. Technical improvements can — and should — ameliorate unnecessary duplication. Greater consultation can — and should — improve the cost–benefit analysis. Clearer governance and accountability structures can — and should — place the exercise of discretion within accepted and acceptable parameters. Furthermore, for the agency itself, careful design calibration can — and should — minimise the risk of privileging indicators designed for administrative convenience rather than analytic value.

The management of these conflicting imperatives becomes more difficult when accountability for maintenance of market probity requires

that keep these networks together, a heavily connected node closely followed by several less connected ones, trailed by dozens of even smaller nodes. No central node sits in the middle of the spider web, controlling and monitoring every link and every node. There is no single node a scale-free web is a web without a spider': at 221).

³ What constitutes performance has mutated from simplistic financial measurement to 'balanced scorecard' approaches, which in turn require multidimensional mechanisms to evaluate competing perspectives: for review see David Bryde, 'Methods for Managing Different Perspectives of Project Success' (2005) 16 *British Journal of Management* 119.

⁴ See, eg, Giandomenico Majone, 'Regulation in Comparative Perspective' (1999) 1 *Journal of Comparative Policy Analysis* 309. This process privileges self-regulation through nodal networks in which the state plays a diminished role. What is particularly striking is that the capacity of the state itself is circumscribed by acceptance of market-ordering terms of reference: see Clifford Shearing, 'A Constitutive Conception of Regulation' in John Braithwaite and Peter Grabosky (eds), *Business Regulation and Australia's Future* (1993) 67, 72; see also Cass Sunstein, *After the Rights Revolution: Re-Conceiving the Regulatory State* (1990) 42.

⁵ The quotation was appended to a sign outside Albert Einstein's office at Princeton University.

ongoing credible commitments from those given delegated authority within fragmented or ‘decentred’ processes of self-regulation and co-regulation.⁶ None of the aforementioned performance indicators can deal adequately with the measurement of integrity within this wider architecture.⁷ Indeed, the focus on technocratic resolution exacerbates the problem, because associational imperatives can cut against personal integrity by situating ethics within narrowly defined legal parameters.⁸ This occurs because of cognitive dissonance between institutional actors over what constitutes integrity and who should shoulder responsibility for probity.

Those providing corporate advisory services have long adopted a range of ‘perfectly-legal’ strategies to transact around ‘soft’ compliance obligations, including adherence to internally devised and policed codes of conduct.⁹ This approach is often justified by reference to the corporate imperative to maximise profits within ‘the rules of the game’.¹⁰ To be effective across efficiency and integrity vectors, performance indicators

⁶ For an account of how the fragmentation of authority gives rise to competing legitimacy problems, see Julia Black, ‘Critical Reflections on Regulation’ (2002) 27 *Australian Journal of Legal Philosophy* 1; for self-regulation as a specific policy process, see Tony Porter and Karsten Ronit, ‘Self-Regulation as Policy Process: The Multiple and Criss-Crossing Stages of Private Rule-Making’ (2006) 39 *Policy Sciences* 41.

⁷ Integrity in an institutional sense refers to its completeness, wholeness or entirety. What constitutes integrity within a regulatory matrix is impacted by the interplay of associational, corporate, divisional and personal values: see Susan Babbitt, ‘Personal Integrity, Politics and Moral Imagination’ in Samantha Brennan et al (eds), *A Question of Values: New Canadian Perspectives on Ethics and Political Philosophy* (1997) 107, 118.

⁸ See Bronwen Morgan, ‘Technocratic v Convivial Accountability’ in Michael Dowdle (ed), *Public Accountability, Designs, Dilemma and Experiences* (2006) 243, 253 (situating regulatory reform processes associated with cost–benefit analysis within a ‘triadic logic’ that is itself informed by the need to present decisions on the basis of ‘ostensibly objective, relatively opaque, expert knowledge’: at 253. This process ‘mutes the discretionary, value-laden dimensions of those decisions’: at 257). Morgan argues instead for a conceptualisation based on inculcating ‘a particular *tenor* or *texture* of debate, a texture that transmits and generates implicit senses of community because of its capacity to defy routinization and the explicit codes of expert knowledge’: at 259 (emphasis in original). By acknowledging these assumptions, the debate takes on a more finely grained appreciation of underlying dynamics, which is central to an agonistic conception of political debate, see generally Chantal Mouffe, *On the Political* (2005) 18–25.

⁹ See Doreen McBarnet and Christopher Whelan, ‘The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control’ (1991) 54 *Modern Law Review* 848.

¹⁰ Milton Friedman, ‘The Social Responsibility of Business Is to Improve Its Profits’, *New York Times* (New York), 13 September 1970, 32–3, 122–6.

need to be amenable to both specific and holistic analysis. They must be capable of evaluation — in isolation and in combination — against the transformative potential of the *ex ante* and *ex post* regulatory mechanisms deployed by operational directorates and cross-cutting inter- and intra-agency taskforces. Moreover, they must be viewed in terms of how performance impacts on the goals of regulation, not simply the processes by which this was achieved. And this requires embedding accountability throughout the regulatory system, not just the regulatory agency itself.

Critics of attempts to broaden the debate on corporate governance and purpose from value to values suggest exceeding formal legal requirements diverts the corporation from its core purpose.¹¹ Furthermore, if new standards are to be introduced, what should the benchmark be? Who should set it? When core values conflict, which should be privileged and why? Should interpretation of (non-) compliance and censure rest with the corporation itself (through shareholder activism), the market (with variations in share price signalling displeasure), the gatekeeper professions (given delegated authority), the regulator (through enforcement strategies that transcend the existing legal core by mandating particular governance forms) or wider society (through a reinterpretation of the core responsibilities owed by the firm in return for the benefits of incorporation)? Can this be done in a piecemeal manner? Alternatively, does it require a more fundamental reconstruction: a re-imagining, as it were, of the societal purpose of the market? Mapping how ideational disputes directly influence the trajectory of public policy allows for a consideration of whether it is possible to instil order under the current system of control or whether, as with Sisyphus, we are caught in a laborious yet futile struggle.¹²

¹¹ See Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991); see also Michael Whincop, 'Another Side of Accountability: The Fiduciary Concept and Rent-Seeking in the Governance of Government Corporations' (2002) 25 *University of New South Wales Law Journal* 379.

¹² Sisyphus is one of the great tragic figures in Greek mythology. His persona is often associated with deception and hubris. A renowned trader and negotiator, he deceived the Queen of the Dead, Persephone, and escaped the Underworld. When eventually returned, he was sentenced to an eternity of interminable labour for thinking that he could defy the Gods. This involved pushing a boulder to the top of a hill only for it to slip down, whereupon he was destined to repeat the process. The cruelty of the punishment was frustration.

The problem ceases to be an academic puzzle when the regulator sets — or is set — a policy objective of enhancing integrity within technocratic terms of reference that simultaneously require market promotion. On the one hand, regulators are charged with ensuring that markets operate in a fair, efficient and transparent manner, if necessary by adopting a coercive enforcement agenda. On the other, prevailing economic and political orthodoxy links robustness to increased costs, reduced choice and capital flight.¹³ The new dynamics of global financial capitalism raise a host of normative issues, which are made difficult to resolve because asymmetrical power relations produce restraining influences on national regulatory capabilities.¹⁴

This book advances an integrity-based approach to market regulation within a realist framework. The cardinal pillars of financial regulation, namely, market efficiency, contractual probity and financial stability, inform its conceptual parameters. Scholars and practitioners from across the social sciences and across the world outline the deficiencies associated with the current paradigm, and evaluate how to integrate more closely regulatory ‘mission’ or ‘purpose’ with the normative values posited by institutional actors, which are central to their own conceptions of what constitutes their professional ethos. The intention is to generate a synthesis that could reduce incommensurability problems. It will be argued that this approach offers a much more meaningful indicator of ultimate performance and has applicability beyond the narrow field examined in this study.

The aim is best illustrated through an extended example of the dynamics of a specific regulatory environment. The remainder of the chapter is structured as follows. First, the regulatory architecture in Australia is examined to assess how conceptions of ‘best-practice’ are arrived at and legitimated. As with other developed capital markets, a nexus of exogenous forces is buffeting the Australian market, not least of which is the rapid expansion of private equity. Second, the difficulties of enrolling professional groupings in the surveillance apparatus is presented and critiqued. Third, the contours of an alternative approach are delineated based on the interlocking relationship between ethics and

¹³ McKinsey Report, *Sustaining New York's and the US' Global Financial Services Leadership* (2007); Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* (2006).

¹⁴ For perceptive analysis, see Martin Wolff, ‘New Revolution as Unfettered Finance Reshapes the Global Economy’, *The Australian* (Sydney), 25 June 2007, 33.

compliance. The chapter serves as an introduction to the ideas in the collection, which has been conceived as a deliberative approach to regulatory design, with a focus on how to secure agonistic acceptance of an integrated suite of high-level principles capable of transcending formal legal compliance.

I THE AUSTRALIAN REGULATORY ARCHITECTURE

The capital markets in Australia are regulated through a 'twin peaks' model of oversight.¹⁵ The model is situated within a wide-ranging Corporate Law Economic Reform Program.¹⁶ The framework is designed to promote confidence that fair, orderly, and transparent processes govern the market.¹⁷ Within this rubric, the Australian Prudential Regulation Authority ('APRA') has responsibility for ensuring capital adequacy, banking regulation and the superannuation industry. Market integrity issues, including continuous disclosure, the regulation of directorial conduct and fiduciary obligations imposed on intermediating professions, fall within the ambit of the Australian Securities and Investments Commission ('ASIC'). The peak regulatory agencies

¹⁵ For early references to the structure, see Ian Johnston, 'The New Financial Services Reform Disclosure Regime, Likely Impacts on our Industry' (Speech delivered at the Financial Planning Association Conference, Gold Coast, 10 May 2002); David Knott, 'Changing Dynamics of the Superannuation Industry' (Speech delivered at the Association of Superannuation Funds of Australia Ltd Luncheon, Sydney, 25 September 2002).

¹⁶ See *Corporate Law Economic Reform Program* (1998) Commonwealth of Australia <<http://www.treasury.gov.au/documents/264/PDF/clerp.pdf>>. The CLERP process, which is now in its ninth incarnation, retains as a core objective 'the need to encourage free enterprise for the benefit of all Australians': at iv. This process has been accompanied by a similarly wide ranging review of regulatory policy: see Taskforce on Reducing Regulatory Burdens on Business, Parliament of Australia, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (January 2006) ('Banks Report'); Australian Government, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business: Australian Government's Interim Response* (April 2006); Australian Government, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business: Australian Government's Response* (August 2006). See also Gary Banks, 'Reducing the Regulatory Burden: The Way Ahead' (Speech delivered at the Monash Centre for Regulatory Studies, Melbourne, 17 May 2006).

¹⁷ As such, the reform process cannot be dismissed as a knee-jerk response to scandal, see Jennifer Hill, 'Evolving "Rules of the Game" in Corporate Governance Reform', in this book.

interdict with Treasury and specialist organisations, including the Reserve Bank of Australia (on macro-economic stability), the Australian Taxation Office (on the tax impact of financial engineering), the Australian Consumer and Competition Commission (on trade practices) and the Takeovers Panel (as the primary adjudicator of contractual disputes during merger and acquisition process).

This hybrid architecture contrasts with the unitary approach to market governance adopted by the Financial Services Authority ('FSA') in London.¹⁸ In contradistinction with the multiplicity of organisational forms given authority in the United States,¹⁹ the formal separation of prudential and disclosure regulation is conceptually neat and intellectually cogent. The separation allows for the simultaneous adoption of coercive and less intrusive forms of market surveillance within an integrated principles-driven framework.²⁰ However, unlike its counterparts in London and Washington, ASIC does not have the capacity to set rules. While discretion is limited to interpretation of legislative intent within public values, this is not an insubstantial power.²¹ Independence is further circumscribed by specific policy guidelines, which are framed within a process explicitly

¹⁸ Iain MacNeil, 'Enforcement of Capital Markets Regulation: The United Kingdom and Its International Markets', in this book.

¹⁹ The Securities and Exchange Commission has oversight for the capital markets but regulation of banks fall within the Federal Reserve and the Office of the Comptroller of the Currency. In addition, state regulators have formal delegated authority and state Attorneys-General have emerged as increasingly important autonomous actors, see Justin O'Brien, 'Securing Corporate Accountability: The Efficacy and Pitfalls of Pre-Trial Diversion' (2006) 19 *Australian Journal of Corporate Law* 161.

²⁰ The formal separation has not been trouble-free: see, eg, Commonwealth of Australia, HIH Royal Commission, *The Failure of HIH Insurance* (2003). Commissioner Justice Owen observes that APRA 'was aware of its lack of general insurance experience, [yet] there was no evidence that any steps were put in place to monitor the progress of the individuals who had the front-line jobs supervising this industry': at 24.1.6. This systemic problem was exacerbated by the 'light and non-obtrusive supervisory methodologies adopted': at 24.1.7. He concludes: APRA did not give sufficient consideration to the consequences of reform and full integration. In this context, it did not give adequate consideration to creating systems to ensure it would meet its regulatory responsibilities. This resulted in systemic weakness in APRA's supervisory regime': at 24.1.12. Both agencies have worked hard to dispel the criticism through an ongoing series of civil prosecutions and banning orders.

²¹ See ASIC, *Working for Australia: ASIC Annual Report 2005–06* (2006) 44 (requiring decision-making informed by impartiality, honesty, diligence and service); all ASIC staff are also subject to wider statutory-imposed values and codes of conduct: *Public Service Act 1999* (Cth) ss 10(1), 13.

predicated on the need to minimise transactional costs. All major policy revisions require an accompanying Regulatory Impact Statement ('RIS').²² The RIS is a standard public policy response that defines the problem, sets out objectives, delineates options, evaluates cost and benefit, includes a consultation and recommendation statement, and outlines the strategy for implementation.²³

Despite these restrictions, an independent taskforce charged with evaluating effectiveness has identified signs of 'regulatory creep' across the institutional framework.²⁴ According to its report, 'risk aversion' imperatives were particularly present in the financial sector.²⁵ Significantly, the Banks Report ruminated that enforcement strategies were in part to blame for reinforcing sensible commercial opportunities, thus having a detrimental impact on the 'overall efficiency and dynamism of the economy'.²⁶

As noted above, the debate on what constitutes the optimum level of enforcement is predicated on what regulatory priorities are set, and how they are ranked and implemented. Even if these priorities have demonstrable 'whole of organisation' value, absent wider market professional buy-in to the concept, active enforcement is reduced to symbolic and potentially counterproductive intervention, as the case taken by ASIC against Citigroup in the Federal Court of Australia graphically demonstrates.

²² Office of Best Practice Regulation, *Best Practice Regulation Handbook* (2006). It expresses a clear policy preference for time-limited intervention, for example through sunset clauses: at [4.7.6].

²³ See Melvin J Dubnick, 'Sarbanes-Oxley and the Search for Accountable Corporate Governance', in this book.

²⁴ [Taskforce on Reducing Regulatory Burdens on Business] *Rethinking Regulation*, above n 16, 14–15 (citing increased 'risk aversion' as a primary cause for increasing the burden and dysfunctional incentives facilitating its growth, for example, the lack of integration between cost and benefit, policy silos and heavy-handed and legalistic approach to enforcement).

²⁵ *Ibid* 89–90 (recommending development of performance indicators that speak directly to the need to enhance 'efficiency and reduce business costs': at 90).

²⁶ *Ibid* 90 (Recommendation 5.3). In addition, the Taskforce included a provocative statement from the Association of Australian Permanent Building Societies on guidance material emanating from APRA and ASIC: 'their observance has become almost mandatory and those that treat them as non-binding do so at their own peril. They are now in effect de facto law': at 91. The Taskforce implicitly agreed with this formulation in its demand that regulators refrain from overly prescriptive measures: at 91. It also appeared to reject any use of enforceable undertaking that imposes obligations to a higher standard of compliance than that mandated by law: at 93.

It is, of course, perfectly understandable that enforcement is one of the most widely used indicators of regulatory performance. It represents a visible and easily quantifiable metric. It also offers a means to delineate at surface level between form and substance of regulatory agendas.²⁷ Conversely, viewed in isolation, it skews policy direction, budgetary priorities, operational capacity and overarching effectiveness. More problematically, inculcating a punitive deterrence model can have a deleterious impact on agonistic engagement.²⁸ Undue emphasis on enforcement proclivity is, therefore, a flawed and potentially misleading indicator of performance but not necessarily for the reasons outlined by the Banks Report.

While a critical regulatory tool, enforcement is best viewed as a mezzanine-failure of specific market actors to understand or accept the value of self-restraint. Effective self-restraint requires the internalisation of a common conception of what constitutes ethical practice, which in turn requires thinking beyond technical compliance. What is particularly evident in the Australian context is the exceptionally narrow conception of regulatory purpose informing the Taskforce on Reducing Regulatory Burdens on Business.²⁹ The conflation between the means of regulation and the ultimate goals inevitably privileges minimalist intervention, designed only to correct ‘market failure’.³⁰ This is exacerbated by an emphasis on the need to curtail direct costs rather than extend embedded value.³¹ It is in this context that the need to evaluate ideational pressures comes into clear focus.

²⁷ See John Coffee, ‘Law and Enforcement’ (Paper delivered at the Dynamics of Capital Market Governance Forum, Australian National University, 14 March 2007).

²⁸ Robert Baldwin, ‘The New Punitive Regulation’ (2004) 67 *Modern Law Review* 351; see also Justin O’Brien, *Redesigning Financial Regulation: The Politics of Enforcement* (2007).

²⁹ George Gilligan, ‘The Significance of Relative Autonomy in How Regulation of the Financial Services Sector Evolves’, in this book.

³⁰ See Tony Prosser, ‘Regulation and Social Solidarity’ (2006) 33 *Journal of Law and Society* 364 (suggesting many of the conflicts centre on values rather than technicalities: at 372); for a practitioner’s perspective, see William McDonough, ‘Accountability in the Age of Global Markets’, in Justin O’Brien (ed), *Governing the Corporation: Regulation and Corporate Governance in an Age of Scandal and Global Markets* (2005) 47.

³¹ In this, the Australian framework mirrors the UK Treasury’s SMART regime: see HM Treasury, *The Green Book: Appraisal and Evaluation in Central Government* (2007). ‘SMART’ is an acronym for ‘specific, measurable, achievable, relevant and time-bound’: at 13. If no market value can easily be adduced, values should be calculated based on tabulating ‘willingness to pay’ against willingness to accept: at 23.

As Lauren Edelman remarks, 'corporate governance is not only the subject of legal regulation; it is also constitutive of legal regulation.'³² For Edelman, the governance of capital markets must be seen in the context of 'overlapping fields' of authority and 'multiple logics' through which law and regulation become infused with managerial values and assumptions. This nuanced conception contrasts starkly with the linear approach to regulatory design adopted by the Banks Report. The emasculating nature of the latter becomes evident when one examines guidelines for public agencies. The Australian Handbook on Regulatory Best Practice is instructive of the inhibiting logic. It mandates, absent compelling arguments, extensive consultation throughout the policy-making process.³³ This introduces multiple veto points to reform based on managerial conceptions of what constitutes intervention risk, including moral hazard, compliance costs, impact on competition and capital flight.³⁴

Contrary to the formulation adopted in the Banks Report that 'government alone makes regulation',³⁵ the state is best described as a 'structural effect'.³⁶ Regulatory capacity is determined, in part, by the alignment of political opinion. In a recent speech the shadow Treasurer, Wayne Swan, noted that regulation was simply 'an unavoidable reality of

³² Lauren B Edelman, 'Overlapping Fields and Constructed Legalities: The Endogeneity of Law', in this book.

³³ Office of Best Practice Regulation, above n 22, [2.4]. This approach dovetails that adopted by the FSA in the United Kingdom, see Harry McVea, 'Financial Services Regulation under the Financial Services Authority: A Reassertion of the Market Failure Thesis' (2005) 64 *Cambridge Law Journal* 413, 428.

³⁴ McVea, above n 33, 424 ('cost-benefit analysis reinforces the idea of markets as a naturally preferred form of social organisation and helps in providing a yardstick for limiting unwarranted state action': at 425).

³⁵ Banks, above n 16 ('Regulation is *made* by government, and most examples of inappropriate regulation can be sheeted home to deficiencies in the processes and institutions whereby governments respond to these demands': at 11 (emphasis in original)).

³⁶ See, eg, Timothy Mitchell, 'The Limits of the State: Beyond Statist Approaches and Their Critics' (1991) 85 *American Political Science Review* 77, 90, 94; for definitive treatment of 'structuration' theory, see Anthony Giddens, *The Constitution of Society: Outline of the Theory of Structuration* (1984); see also George Gilligan, 'The Significance of Relative Autonomy in How Regulation of the Financial Services Sector Evolves' in this book. For how this 'steers' policy through agenda setting, see Porter and Ronit, above n 6, 48–9.

modern markets' rather than a positive normative choice.³⁷ This reduction of purpose fails to deal with the externality costs incurred by privileging such emasculated conceptions of corporate and professional responsibility. Swan held out the possibility of ending the bifurcated model in favour of the FSA approach. More controversially, in the interim, both agencies were urged to set as an explicit goal the promotion of the financial services sector. No reference was made to how precisely the regulator should mediate its determination of promotion in the presence of conflict or how globalisation and the privileging of transactional imperatives over relational ones impacts negatively on the efficacy of professional norms.³⁸ These problems are magnified when the regulatory agency has responsibility for oversight of the professions as well as of the corporations to whom they provide advice, which is precisely the case in Australia.

II THE CONFLICTING ROLE OF THE PROFESSIONS

A critical component for longer-term market stability is the projection and maintenance of probity. The complexity of contemporary markets creates enormous oversight problems that can only be addressed through the formal enrolment of financial intermediaries into the surveillance apparatus. This is far from unproblematic.³⁹ By facilitating access to both products and markets, the professions act as 'gatekeepers' to an inherently conflicted space. The capacity of these communities of professionals to engage in self-dealing detrimental to the interests of individual clients or, by extension, the integrity of the wider market system, is central to the articulation of fiduciary obligation.⁴⁰ In common

³⁷ Wayne Swan, 'Speech to ASFA: Building Prosperity for the Next Decade' (Speech delivered at the Association of Superannuation Funds Australia Ltd Lunch, Westin Hotel, Sydney, 15 March 2007).

³⁸ See Porter and Kronit, above n 6, 59–61.

³⁹ See McBarnet, 'Compliance, Ethics and Responsibility: Emergent Governance Strategies in the US and UK' in this book; Cocking, 'Professional Norms' in this book; for a United States perspective, see John C Coffee, *Gatekeepers: The Professions and Corporate Governance* (2006).

⁴⁰ The fiduciary obligation originates in trust, see *Meinhard v Salmon* (1928) 164 NE 545, 546: 'A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive is the standard of behavior'. In its most absolutist form, the fiduciary must render her own interests

with compliance, however, fiduciary obligation is itself a remarkably elastic proposition.⁴¹ The relationship requires interlocking determinants: the binding (or perceived binding) obligation to act in the interests of another, without intermediating contractual provisions limiting the fiduciary's independence to act.⁴² These overrides make it exceptionally differentiate a breach from manifestation of standard (if sharp) industry practice.⁴³

The requirement that lawyers act as officers of the court, for example, can be deflected by reliance on fiduciary duty to justify a professional obligation to serve the client. Using claims of privilege to thwart regulatory investigations is an integral component of successful practice in the adversarial legal method, which in turn generates enormous transaction costs.⁴⁴ Recent legislative changes in Australia to the governance of the legal and accounting profession further stretch definitional limits. The expansion of Incorporated Legal Practices from New South Wales to the entire country generates new and complex ethical problems for the legal profession and its regulators, rendered more so by the historic public listing of Slater & Gordon in May 2007. By extending the benefits (and problems) of incorporation to the legal profession, another potential conflict emerges. The legal practitioner is not only an officer of the court and gatekeeper for wider market values; he or she is also now a representative of a corporate entity. This structural change exerts further potentially conflicting obligations and loyalties. In the presence of conflict, how does (or should) the individual lawyer or corporate entity order commitments and responsibilities?⁴⁵

subservient to those of her client unless provided for by informed consent, see *Bristol & West Building Society v Mothew* [1998] Ch 1, 18 (Millett LJ).

⁴¹ Paul Finn, *Fiduciary Obligations* (1977) 1.

⁴² *Ibid* 9–13.

⁴³ See Kenneth B Davis, 'Judicial Review of Fiduciary Decision-Making — Some Theoretical Perspectives' (1985) 80 *Northwestern University Law Review* 1.

⁴⁴ Robert Kagan, *Adversarial Legalism: The American Way of Law* (2003); Jeremy P Carver, 'The Role of the Lawyers: Hired Guns or Public Servants' in Justin O'Brien (ed), *Governing the Corporation: Regulation and Corporate Governance in an Age Of Scandal and Global Markets* (2005) 223. For an account that emphasises the technical nature of compliance across the professions, see Doreen McBarnet, 'After Enron: "Will Whiter than White Collar Crime" Still Wash' (2006) 46 *British Journal of Criminology* 1091. For its application in relation to private equity, see Douglas Cumming and Sofia Johan, 'Is It the Law or the Lawyers? Investment Covenants around the World' (2006) 12 *European Financial Management* 535.

⁴⁵ Slater & Gordon state explicitly that duties to the court will always trump short-term

The auditing profession faces structural problems of a similar and, arguably, more pressing, magnitude. The audit regulation framework in Australia is notable for the multiplicity of actors involved. This is exacerbated by ambiguity over the application and limits of requisite duties and responsibilities of each actor within the matrix. Responsibility for ensuring compliance with professional and ethical practice rests primarily with the audit firm itself through the Code of Ethics for Professional Accountants. External adjudication of effectiveness rests primarily (but not solely) within the disciplinary processes of the Accounting Professional and Ethical Standards Board, an industry-designed and controlled initiative. It lacks formal delegated authority, however, to ensure that the audit process is undertaken with due consideration of relevant ethical requirements. ASIC supplies this function through an inspection regime.

The extent to which this regime influences the dynamics of ethical performance is determined by four further factors. First, the conceptual rationale and scope of the inspection process itself, including the background and operating assumptions of those carrying out the review. Second, the extent of agreement between each of the institutional actors in the oversight process on what compliance means in practice. Third, the extent to which the findings are made public. Fourth, the methods that are chosen to disseminate to the wider profession the results of individual or collective firm performance. The complexity of this matrix of control makes it essential that each actor is cognisant of — and engages constructively with — overarching conceptions of compliance and fiduciary duty.

Dean Cocking suggests that one way forward is to reinvigorate the norms by which professional groups define themselves. For Cocking, integrity does not necessarily come from strengthened external oversight. Ethical change occurs by situating the inculcation of professional values within an overarching matrix, which gives due cognisance to the fact that technically legal opinion can have a detrimental impact on systemic integrity. Without this shift, technical gaming will render the framework worthless.

considerations: see Slater & Gordon, *Prospectus* (13 April 2007) 81–4, available at <<http://www.slatergordon.com.au/docs/prospectus/Prospectus.pdf>> (‘There could be circumstances in which the lawyers of Slater & Gordon are required to act in accordance with these duties and contrary to other corporate responsibilities and against the interests of Shareholders and the short-term profitability of the Company’: at 84).

III SETTING REGULATORY PRIORITIES

The book begins with an overview of the dynamics governing changes to capital markets in the aftermath of scandal. Malcolm Rodgers argues that it is essential that regulatory agencies are armed with a clear conceptual underpinning of what drives policy implementation. Absent such a framework, he notes a danger of inconsistency, which is an all too common refrain across today's markets, in particular the United States. What should be the appropriate response is, however, exceptionally contested. Jennifer Hill finds 'significant differences' in regulatory strategies. These challenge any assumption of an orderly, seamless progression towards a uniform model of good corporate governance. Her analysis suggests that the most important causal factor impacting design and implementation is whether interest group cohesiveness can set or maintain the system's philosophical underpinnings. Hill concludes that a 'fluid, dynamic and increasingly fragmented picture of corporate governance has emerged' that partially falsifies the convergence thesis of company law and corporate governance. This suggests that it is essential to excavate more carefully what gives regulatory action (or inaction) authority and legitimacy.

As Hill points out, principles may provide more flexibility and discretion but 'their very lack of precision requires the *ex post* exercise of discretion based on a variety of specific factual and contextual matters, and embedded social values.' What this means in practice is conditioned by how market values infuse juridical interpretation, a process examined in detail by Lauren Edelman. In part, however, legitimacy also derives from the accreted weight of tradition, as George Gilligan explains in a compelling historical analysis of self-regulation. The interplay gives significant traction to the value of exploring financial regulation through a structuration lens. As Gilligan points out, 'social structures do not exist without human agency, but those same structures do shape the actions of people. Structures and agency are so interdependent that all change is influenced by earlier institutional praxis and no change can completely remove existing praxis, so that social agents make social facts, but always from existing social praxis.' For Gilligan, as with Edelman, legal rules and norms derive legitimacy and moral force through this interaction, which simultaneously justifies and reinforces the paradigm's ongoing force. The critical question is whether this legitimacy is, in fact, warranted. This has become imperative in the Australian context following the

comprehensive defeat of ASIC in its controversial litigation against Citigroup. The case was designed to clarify the extent to which investment banks owe fiduciary obligations and, if so, whether these can be transacted around. As Pamela Hanrahan argues, enforcement is an inappropriate mechanism to change corporate practice in the absence of explicit fiduciary obligation, thus necessitating a greater emphasis on *ex ante* regulatory techniques. This takes to an the alternative approach adopted by the Financial Services Authority ('FSA') in the United Kingdom.

Despite the much-vaunted disclosure imperatives governing the regulation of capital markets in the United Kingdom, actual compliance with the spirit of its *Combined Code on Corporate Governance* (2003) ('*Combined Code*') is, at best, mixed. Iain MacNeil provides significant evidence to suggest that the 'explain' component of the 'comply or explain' principle 'is often ignored, casting doubt over the willingness of institutional investors to undertake the scrutiny envisaged by the *Combined Code* and the willingness of the FSA to undertake enforcement of the disclosure obligation on which investor scrutiny relies.'

This does not necessarily mean that the FSA lacks credible mechanisms to guide market behaviour. MacNeil rejects a mechanistic account of regulatory effectiveness: 'It follows that there can be no simple conclusions drawn between the low incidence of enforcement action and levels of compliance because compliance is a function of several different factors and it is difficult to separate the causal effect of each.' Critically, as MacNeil demonstrates, enforcement priorities are designed to uphold the integrity of the underpinning principles. To date the defendants accepted the authority of the FSA rather than questioning legitimacy in the courts. If, however, the interpretation of what constituted the principle were challenged, this would open the door to a more complex and costly system of enforcement, precisely because the FSA has made clear that it would rely on expert adjudication.

This articulation of gatekeeper responsibility brings us to the problem of whether market integrity can be vouchsafed by a process that rewards 'creative compliance'. Flaws in the audit process exacerbate the problem. For Nicholas Hodson, a practitioner with 20 years experience as an auditor and forensic investigator, the audit is an exceptionally inefficient instrument to detect fraud. Through an extended hypothetical example he illustrates the danger of reliance on technical expertise: '*People* commit fraud: it is not the system, the controls, the processes, it

is the people. While people at one end of the scale may be lazy, not very bright or prepossessing, at the other end they are extraordinary, do astounding things, put forth incredible effort, show unbelievable fortitude and will.⁷

The problem extends to issues that are ethically debatable but within the realms of the law, which informs Dean Cocking's critique of professional norms outlined above. This issue has also informed much of Doreen McBarnet's work on business ethics. For McBarnet, 'creative compliance' depends on cultural terms of reference. Part of the problem, as she conceives it, is that the flouting of underpinning principles in favour of narrow short-term advantage is deemed 'both clever and legitimate'. She criticises professional legal and accounting treatments that construct authoritative rules, transact around them and then use the transactional mechanism as a justification for following legal practice. To combat this, she argues for the inculcation of 'ethical compliance', a project that requires recalibrating the corporate social responsibility ('CSR') discourse. Rather than voluntary (and unenforceable) expression of commitment to core values, ethical compliance becomes constitutive of citizenship. Linking to the endogeneity of law themes developed by Edelman and Gilligan, McBarnet argues that the critical test is not whether an individual expression of CSR surpasses legal requirements but rather whether actual corporate practices meet the underpinning spirit.⁴⁶ To be successful, however, requires the institutionalisation of a much broader conception of what constitutes accountability. Melvin Dubnick cautions that effective accountability cannot be understood within one vector; rather it must be embedded throughout the matrix, based on an agonistic acceptance of underlying purpose.⁴⁷ Despite the ending of business quiescence over regulatory costs, the rise of private equity offers a time-limited opportunity to reconfigure the regulation of capital markets precisely because it represents a profound ideational challenge to the shareholder conception of the corporation. As O'Brien explores, disputation generates the opportunity to partially reconstruct the social contract governing the corporation and the market in which it

⁴⁶ Doreen McBarnet, 'After Enron: Corporate Governance, Creative Compliance and the Uses of Corporate Social Responsibility' in Justin O'Brien (ed), *Governing the Corporation: Regulation and Corporate Governance in an Age Of Scandal and Global Markets* (2005) 205; see also Doreen McBarnet, Aurora Voiculescu and Tom Campbell (ed), *The New Corporate Accountability: CSR and the Law* (2007).

⁴⁷ Melvin J Dubnick, 'Orders of Accountability' (Speech delivered at the World Ethics Forum: Leadership, Ethics and Integrity in Public Life, Oxford, 2006).

is nested. Notwithstanding the mediating effect of attempts to inculcate responsible corporate citizenship, governance is largely presented as a mechanism to ensure shareholder protection. Positing wealth maximisation for shareholders as the primary purpose of the corporation reduces the capacity of governance to deal with the ideational challenge presented by private equity.

Given that most leveraged buy-outs offer substantial premiums over underlying market prices, shareholders are rarely compromised, unless the sale process is itself fundamentally flawed. More generally, the dynamics of private equity make the efficacy of the gatekeeper function, accorded to intermediaries by law or professional norms, potentially unsustainable in the longer term. As O'Brien makes clear: 'at issue is not the legitimacy of private equity, but rather how the financial and social impact can be managed.'

For Seumas Miller, perennial market failure is inextricably linked to conceptual ambiguity. Miller argues that 'the basic normative question that needs to be asked of a business corporation, or financial market, is the same as for any other social institution, namely: What collective good(s) does it exist to provide?' The failure to reach a common understanding of 'purpose' makes Miller reach a damning conclusion: 'Without an answer to this question, an integrity system for the financial services sector — and a regulatory system insofar as it is concerned with institutional (ethical) integrity, as it surely must be — is quite literally without one of its basic purposes: it does not know what ethical ends it is seeking to embed in its target institution.' The mere establishment of key regulatory performance indicators cannot vouchsafe integrity within the rubric of financial capitalism. Taking a holistic approach to the problem, Miller suggests the need to design an overarching integrity system, which is defined as 'an assemblage of institutional entities, roles, mechanisms and procedures, the purpose of which is to ensure compliance with minimum *ethical* standards and promote the pursuit of *ethical* goals.'

This book has been designed as the first step on that process.