Leithner Letter No. 226-228:
26 August-26 October 2018

The hired hand is not the shepherd and does not own the sheep. So when he sees the wolf coming, he abandons the sheep and runs away. Then the wolf attacks the flock and scatters it. The man runs away because he is a hired hand and cares nothing for the sheep.

The Gospel According to John (10:12-13)

… I think I've been in the top 5% of my age cohort all my life in understanding the power of incentives, and all my life I've underestimated it … [Consider] the board of directors of the [typical] major American company. Well, the top guy is sitting there, he's an authority figure. He's doing asinine things, you look around the board, nobody else is objecting … You really get extreme dysfunction … in the typical American board of directors. They only act – again the power of incentives – they only act when it gets so bad it starts making them look foolish, or threatening legal liability to them. That's Munger's rule. I mean, there are occasional things that don't follow Munger's rule, but by and large the board of directors is very ineffective if [the incentives are perverse and] the top guy is a little nuts, which, of course, frequently happens.

Charlie Munger
The Psychology of Human Misjudgement
Speech at Harvard University (June 1995)

It's understandable that CBA's and AMP's financial planning arms kept charging fees when no services were being provided … because there is very little difference between providing financial advice and not providing it. Financial planning services provided by the banks and AMP have always been a joke … The fact that financial advisory practices were continually referred to in the [Royal Commission] this week as "dealer groups" … rather gives the game away. They don't see themselves as advisers, but groups of dealers.

Alan Kohler
"Ban Percentage Fees to Fix the Advice Industry"
The Weekend Australian (21-22 April 2018)

The Royal Commission Has Uncovered Much But Will Change Little – and Might Make Things Worse

The Fantasy

"At AMP," asserted its *Annual Report* (2017),

> we have been helping people own tomorrow and achieve their financial goals for almost 170 years. This strong sense of social purpose drives the AMP culture and all that we do. Three core elements underpin our culture – integrity, help and performance. Integrity ensures we use our expertise to do the right thing; help is at the core of how we support our customers, and we're driving our performance edge to deliver the best results we can for shareholders and customers. We view our governance framework as one of the foundations to support our culture. Our governance framework is designed to provide the right structure and review processes to deliver on our promise for many years to come.

CBA's *Annual Report* (2017) spouted much the same rhetoric:

> Our vision is to excel at securing and enhancing the financial wellbeing of people, businesses and communities. We are guided by our values in every interaction with our customers … and the broader community … Customer focus is the overarching priority of our strategy … Our dedication to our customers and to our vision and values gives us tremendous confidence in the Group's future.

The Reality

Like AMP and CBA, so too Squealer in George Orwell's *Animal Farm*: he portrays himself as a near-martyr who thinks only of others. "Comrades! You do not imagine, I hope, that we pigs are doing this in a spirit of selfishness and privilege? … It is for your sake that we drink the milk and eat these apples." The blunt truth is that pigs in Australia's financial services industry have long feasted insatiably at others' expense. In his summary of testimony to the Royal Commission into Misconduct in the Banking, Superannuation and Financial

Services Industry[1] – whose establishment the government, Australian Banking Association and others strenuously resisted[2] for more than a year before bowing to public pressure – Philip Soos (Banking Inquiry Has Already Exposed Shocking Corruption But It Needs More Time, *The Guardian Australia*, 22 March 2018) summarised some of the symptoms of a deep-rooted problem:

> Faked pay slips, forged documents and cash-stuffed envelopes used as bribes to secure loans are just some of the examples of dodgy practices exposed so far by the banking royal commission … The evidence paints a picture of an industry captured by people falling over themselves to get rich quick on commission-driven schemes … So if you had always thought that Australia's banking system was well-managed by upstanding people and well-regulated by [competent, diligent and incorruptible] bureaucrats, and therefore immune from the systemic disasters seen in the UK and the US 10 years ago, then maybe think again. There is evidence to suggest regular and widespread criminality has been committed … since the 1980s … Rather than rein in runaway household debt, regulators have let the industry run wild while constantly claiming to "keep close watch" over lending practices … [Retail borrowers and investors] have been betrayed by the regulator's neglect, despite [its] knowledge of the … fraud …

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1 A Royal Commission is an *ad hoc*, formal and major public inquiry into a defined issue (usually of great importance and often of considerable controversy) that occurs in Australia, Britain, Canada and New Zealand. A Commission's denotation as "Royal" stems from its creation by the Sovereign (or her representative, i.e., the Governor-General) on the advice of the government of the day and from its appointment by letters patent. It usually possesses coercive powers: it can, for example, compel testimony, the production of documents and other evidence. Its powers are generally greater than those of a judge but are restricted by its terms of reference. In practice – and unlike lesser forms of inquiry – once a Commission has commenced the government cannot terminate it. Consequently, governments usually frame its terms of reference carefully, and generally specify a date by which it must conclude.

2 According to *The Australian* ("AMP's Claim of Support a Furphy," 24 April), "financial giant AMP misled the public by making false claims about its support for the creation of the Royal Commission … [Chairwoman Catherine] Brenner … told *The Australian* it had 'always supported the royal commission …' After correspondence involving a dozen emails, AMP's head of media relations … [stated that it] had been supportive of the commission 'only since it was called. We had no position prior to that.' The Australian Banking Association, of which AMP is a fee-paying member, had aggressively fought against the Commission, claiming it was unnecessary and would undermine the public's confidence in the banking system … The chief executives of Westpac, NAB, ANZ and the CBA had long opposed the [establishment of the] royal commission but on Friday each said they were wrong to do so."

In April, the Commission turned to "wealth managers" – particularly AMP, ANZ, CBA, NAB and Westpac. The bombshells detonated virtually daily:

- On 16 April, AMP confessed that, despite warnings from junior staff, its senior executives had for years deliberately charged clients for services they hadn't received – "which," *The Sydney Morning Herald* rightly noted, "is basically theft" (see Revealed: How AMP Tried to Frustrate the Regulator's Investigations, 4 May).

- Also on 16 April, the Commonwealth Government's corporate regulator, the Australian Securities & Investments Commission (ASIC), disclosed internal research showing that, 90% of the time when giving advice about the establishment of self-managed superannuation funds, advisers fail even to consider – never mind pursue – clients' best interests.

- On 19 April, Commonwealth Bank confessed that it had charged fees to former clients who'd been dead for years. It also admitted that its financial planners were "gold medallists in ripping off" clients. Its IT and other systems were "so hopeless" that it "had no idea what was going on" within its advisory subsidiary. "The one thing [CBA] did have," however, were "systems to make sure [it extracted] fees from clients" (see "CBA Coy on Customer Rip-offs," *The Australian*, 19 April).

- Westpac's planning subsidiary flouted anti-money-laundering laws and shunted clients into inappropriate products. On 20 April it acknowledged that for "business prioritisation reasons" it had deliberately "watered down" its "consequence management system." ANZ and NAB pursued similar activities – in Alan Kohler's words (*The Weekend Australian*, 28-29 April), "such as admitting to withholding stuff from ASIC (ANZ) and falsely signing forms (NAB)." Moreover, according to *The Australian* ("NAB Slow to Compensate Victims," 25 April), senior executives within NAB's financial planning subsidiary "complained bitterly when they were told their bonuses were cut over the scandal" (see also "Banks Put Cash before Customers," *The Australian*, 20 April).

- Also on 20 April, a Fair Work commissioner, Donna McKenna, raised several issues: first, an "award-winning, celebrity financial adviser" (who until that day had hosted a TV show and written a newspaper column) would have cost her $500,000 in fees, taxes and lost superannuation if she had accepted his "risible" advice; second, one of this advisor's members of staff had impersonated clients during phone calls in order to obtain information about their superannuation; third, this advisory firm's Financial Services Guide falsely claimed that the celebrity advisor held a Masters of Commerce degree; finally, and even as an experienced lawyer, Ms McKenna found the Financial Planning Association (the peak body representing financial planners; its internal memoranda described her complaint against the celebrity advisor as "nitpicky" and a "barrage of aggressive and presumptive accusations") "difficult." She concluded: "if someone with my educational and occupational background hits a wall when attempting to engage disciplinary processes … what hope are other people going to have?" ("Confessions of a Victim of Bad Financial Advice," *The Australian Financial Review*, 26 April).[3]

- On 26 April, FPA admitted that, because it feared "unhelpful" publicity, it sought to keep secret its investigation of "damning" allegations against the aforementioned "award-winning, celebrity financial adviser." For the same reason, it doesn't disclose the names and employers of advisers and planners who have lied to or stolen from their clients. Later that day, the CEO of the Association of Financial Advisers was asked: "how can an organisation that is seeking to make itself attractive to potential members … regulate the conduct of those members? Isn't there an inherent conflict in those two propositions?" The CEO was unrepentant: "I don't think so" (see [Royal Commission Shows Us Why Financial Planning, in Its Current Form, Isn't Worth the Risk](), ABC News, 30 April).

  - Also on 26 April, the boss of "Australia's 10th-largest advice outfit" reluctantly agreed that its "client protection policy" – which demanded that clients sign a waiver absolving the advisor and firm of any responsibility for poor or no research, inept advice, etc., that produced losses –

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[3] A busy schedule and a drunken nanny allegedly drove the "award-winning, celebrity financial adviser" to commit these acts. According to *The Australian* ("Star Quits Planning Industry after Grilling," 6 June), "under a list of 'ameliorating circumstances' he told a conduct review commissioned in October last year that the period in question was 'an unusually busy time … In addition to a full workload, I am a very hands-on single parent to two children' … Documents [submitted to the FPA] show he partly laid the blame for the poor advice on being a 'single' dad and being forced to 'fire' his nanny when he 'discovered she smelled of alcohol on two occasions at a school pick-up' … A later e-mail to the FPA's chief executive revealed that the [star planner declared] that his 'support for the FPA' was 'at a conclusion.' 'I'm very disappointed with this process and the FPA's treatment of members over this seemingly minor matter.'"

was "Orwellian." The Commissioner (retired justice of the High Court, Kenneth Hayne, AC, QC) then asked: "does it then follow that [such a waiver] is itself misleading or deceptive?" Shortly thereafter the boss collapsed and paramedics rushed him to hospital (see "Witness Collapses as Royal Commission Turns Orwellian," *The Australian*, 27 April and "'Clients Left Out to Dry': Dover Collapse Prompts Calls for Compo Scheme," *The Age*, 11 June 2018).

- On 27 April, Counsel assisting the Commission concluded: "on the evidence, it is open to the Commissioner to find" that AMP, ANZ, CBA, NAB and Westpac, among others, committed acts of misconduct, misleading and deceptive conduct, etc., thereby breached the Corporations Act and could therefore face criminal charges. (In an unrelated matter, on 1 June the Australian Competition and Consumer Commission stated that ANZ, Citigroup and Deutsche Bank, as well as several of their employees, would face criminal prosecution arising from a cartel that allegedly accompanied the issue of $2.5 billion of ANZ shares in 2015.)

- On 30 April, in its statement that announced the resignation of its chairwoman (its CEO had quit earlier that month), AMP "carefully avoided any acceptance of the fact it was caught stealing from customers and lying to the regulator. Somehow those basic facts have gone missing in a flurry of words about good governance which are nothing but a joke … AMP has stolen … from clients but there is a $12 billion empire to defend" (see "AMP Announcement on Brenner's Resignation Is a Joke," *The Australian*, 30 April).

Although unrelated to the Royal Commission, on 1 May, in its Final Report of the Prudential Inquiry into the Commonwealth Bank of Australia (CBA), the Australian Prudential Regulation Authority (APRA) criticised CBA's "accountability, culture and governance." APRA commenced this inquiry on 28 August 2017 – in the wake of accusations by AUSTRAC (the Commonwealth's financial intelligence agency) that CBA had knowingly breached anti-money-laundering and counter-terrorism financing laws on no fewer than 53,700 occasions. (On 4 June, CBA announced that it had agreed to pay $700m – by far the largest civil penalty in Australian corporate history – in order to "settle" these breaches.) APRA found "widespread … complacency, a reactive stance in dealing with risks … and [a refusal to learn] from experience and mistakes." Responding to the report, CBA accepted an "enforceable undertaking" that it says will address APRA's recommendations. In APRA Talks Tough but Feathers the Commonwealth Bank with Light Touch Penalties (ABC News, 1 May), Ian Verrender commented:

> For all the searing criticism, the irony … is that [APRA] perpetuates the very climate it condemns. Despite [CBA's] litany of wrongdoings, APRA has imposed no real penalties … Once again, we have a regulatory body delivering the legal equivalent of a slap with a wet lettuce. Rather than fines or charges, the bank regulator instead has resorted to "enforceable undertakings," essentially exacting a promise from the CBA that it won't do this kind of thing ever again.
>
> The only problem is no-one, it seems, pays the slightest attention to these "undertakings." [ASIC] has embraced "enforceable undertakings" as its weapon of choice for more than 15 years. In fact, it signed one with the CBA just a fortnight ago, over the theft of $118 million from its own customers following its policy of deliberately charging for financial planning services it had no intention of delivering.[4] It signed another with the CBA and NAB in December 2016 over their involvement in rigging the foreign exchange market for five years until 2013. No executives were fined. No-one was called to account. Even more memorably, ASIC signed "enforceable undertakings" with AMP back in 2006 for … deliberately overcharging [clients]. Given recent revelations, it would appear there was little enforcement in the undertakings. If anything has changed in the intervening 12 years, it is that fee gouging appears to have become entrenched …" (see also Banking Royal Commission Casts Doubt on Regulator ASIC's Enforceable Undertakings, ABC News, 17 May).[5]

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[4] On 9 May, CBA announced that it had "reached an in-principle agreement with [ASIC] to settle the legal proceedings in relation to claims of manipulation of the Bank Bill Swap Rate (BBSW). As part of the in-principle settlement, CBA will acknowledge that … [it] attempted to engage in unconscionable conduct in breach of the ASIC Act. CBA will also acknowledge that it did not have adequate policies and systems in place to monitor the trading and communications of its staff in order to prevent that conduct from occurring. Subject to Federal Court approval of the settlement, CBA has agreed to pay [$25 million] … CBA has also agreed to enter into an enforceable undertaking with ASIC …"

[5] Culminating a wretched week, on 3 May *The Age* reported that CBA "has admitted it lost historical bank statements belonging to almost 20 million personal accounts in a 2016 incident it chose not to make public. It's understood two magnetic tapes that contained customer statements were scheduled for destruction by the bank when they disappeared in May 2016 … The

Also unrelated to the Royal Commission but drawing much the same conclusion is the Productivity Commission's report – the most thorough of its kind since the early-1990s and released on 28 May – entitled Superannuation: Assessing Efficiency and Competitiveness. According to *The Australian* ("Great Super Rip-off Exposed," 29 May), this

> scathing review of the sector found [up to one-third of] savers [have been] shunted into underperforming funds, others dudded by rampant fee gouging, and too much money … being spent on bells and whistles, such as smartphone apps, in the high-fee retail fund sector.

Commenting to the media, one of the report's authors dubbed Australian superannuation an "unlucky lottery;" the other labelled it a "perverse absurdity." The Minister for Revenue and Financial Services reckoned that "super has become worse than a honey-pot; it's a trough" from which privileged insiders devour outsiders' savings. According to Paul Kelly ("Top-to-Bottom Reform Required to Eliminate Systemic Flaws," *The Australian*, 29 May),

> the financial losses sustained by millions of people [from] an entrenched system … mean the harm to the community is far greater than the malpractices of the banks exposed by the Royal Commission[6] … One of the PC's most damning findings is the super system

alarm was raised when the certificate of destruction was not produced, and a search for the tapes came up empty. It's thought the tapes were "most likely" destroyed by someone else who came across them, but that has never been confirmed. After investigating the incident and concluding the missing tapes were probably destroyed, the bank resolved not to tell its customers about the breach. CBA says it discussed the decision not to inform customers with the Office of the Australian Information Commissioner, and that OAIC advised it would not pursue the issue further. But this week, OAIC contacted CBA again, requesting additional information on the matter and the course of action undertaken by the bank."

And on 1 June, CBA revealed that in 2016 its staff had mistakenly failed to include ".au" at the end of the domain name "cba.com" – and thereby sent more than 600 emails that contained data of 10,000 customers to an overseas company. In January 2017 CBA started to block any internal emails addressed to the cba.com domain, and in April of last year it bought this domain name in order to resolve the issue. "Our investigation confirmed that no customer data has been compromised as a result of this issue. We acknowledge, however, that customers want to be informed about data security and privacy issues and we have begun contacting affected customers."

6 Of the 14.6 million superannuation accounts that the PC analysed, approximately one-third fell below its performance benchmark – meaning that a typical worker in such a fund will retire with a balance that's 53% lower than a benchmark fund. Further, more than one-third of super

is geared more to the interests of funds than members (see also Paul Kelly, "This Great Super Rip-off Must End," *The Australian* 30 May).

The Underlying Problem: Quis Custodiet Ipsos Custodes?

"Evidence of lies, deceit and fraud just keep on coming at the [Royal] Commission," ABC News reported on 26 April, "much of it [having] occurred under the noses of directors holding some of the country's most prestigious positions." These directors, as well as professional bodies, etc., are ducking key questions: did they *really* not know? If not, why not? Whether they didn't, or did know but did nothing about it, or did know and also committed misconduct, criminal offenses, etc., is now immaterial: Australia's financial services industry is under siege. If it were a stock, it'd be a prime candidate for short sale.

ASIC's deputy chairman informed the Commission on 16 April that "poor conduct and consumer rip-offs" are so widespread that financial advisors and planners are "not entitled to call themselves professionals."[7] *The Australian Financial Review* (The Remarkable Hypocrisy of AMP, 20 April) concluded that the Commission "has exposed the industry's gross hypocrisy" i.e., it crows that it maintains high ethical standards whilst systematically picking its clients' pockets. One of the Reserve Bank's retired governors, Bernie Fraser, also joined the chorus of chastisement. On 26 April, he wheezed that the Commission had exposed a "cesspool" of misbehaviour. "Thieves and liars want to get

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accounts are so-called "unintended multiples." The PC estimates that their annual cost (unnecessary fees, etc.) is ca. $1.9 billion; their eventual cost will be ca. $51,000 per retiree.

7 But is ASIC professional? In Regulator ASIC Has a 'Culture of Subservience to the Big Banks,' Says Former Employee (25 April 2018), ABC News reported: "ASIC has a culture of subservience and acquiescence when it comes to the big banks, says a former lawyer for the corporate watchdog … 'If I wanted to get a job with a bank, I'd go work for a bank instead of doing the banks' work through ASIC." ASIC's main problem, he said, is that it defers to the banks, lawyers and their lobbyists. 'I thought my job as a lawyer within the regulatory policy branch at ASIC would be to enforce the law, because that's what it says in the ASIC Act … But while there he said he saw exactly the opposite. 'I saw ASIC literally changing the law, amending the Corporations Act to benefit the banks and the lobby groups for the banks,' he said. ASIC has the power to take the law as drafted by Parliament and make certain changes, within strict rules. But … 'ASIC made changes to the law to benefit the banks, at the request of what is now known as the Financial Services Council. The question of protection of retail investors was a distant second.' He said the banks, their lawyers and their lobby groups still treat ASIC with contempt. 'They lie about big things, they lie about small things, they do it as a matter of course. I saw that when I was there 12 or 13 years ago — it's still going on today.'"

their hands on your money," concluded *The Weekend Australian* ("System Shaken to Its Core by Rogues," 28-29 April).

Alas, few people (whether cosseted insiders or disadvantaged outsiders) realise that pervasive incompetence, systematic malfeasance and outright criminality are merely symptoms of an underlying disease. The Roman poet, Juvenal, asked: "who will guard the guardians?" Don Chipp, the former Liberal cabinet minister and inaugural leader of the Australian Democrats, put this question in trenchantly Australian terms: who'll "keep the bastards honest"? *Whether in its classical or colloquial variant, this question encapsulates a fundamental problem: how can people in positions of responsibility be held to account?* At any point in time, some will succumb to the temptation to abuse their authority, i.e., reward themselves and harm others. And at some junctures – today, it seems, is one – many apparently do so. Referring to Australia's financial services industry, we might elaborate Juvenel's question: who advises the advisors? Who manages the managers? Who regulates the regulators?

As Juvenel's mother tongue (Latin) suggests, this problem is ancient. Further, our forebears understood it much better than we do today. Perhaps Adam Smith understood it best. "In every civilised society," he wrote in *The Theory of Moral Sentiments* (1759),

> There have been always two different schemes or systems of morality current at the same time; of which the one may be called the strict or austere; and the other liberal, or, if you will, the loose system. The former is generally admired and revered by the common people, and the latter is commonly more esteemed and adopted by ["insiders"]. The degree of disapprobation with which we ought to mark the vices of levity, the vices which are apt to arise from great prosperity … seems to constitute the principal distinction between those two opposite schemes or systems … The wiser and better sort of the common people, therefore, have always the utmost abhorrence and detestation of such excesses, which their experience tells them are so immediately fatal to people of their condition.

Smith reminds us that throughout history venal insiders have fleeced relatively principled outsiders. Neither Smith nor Juvenel would be surprised to learn that Australian bankers, company directors, financial advisors, government regulators, industry bodies, mortgage brokers, etc., have routinely and systematically placed their own short-term interests before – and thereby severely injured – the long-term interests of people they purport to serve. Smith was first and foremost a moral philosopher. Yet he was far more attuned to the realities of commerce and industry (both in his day and ours) than are today's corporate bureaucrats and regulators, tenured and self-absorbed academics at cookie-cutter business schools and MBA factories, etc. The origins of his insights stem from his intense dislike, not so much of Oxford University *per se* (where he studied from 1740 to 1746), but of systems like Oxford's whose instructors receive salaries independent of results (or even efforts). Indeed, Oxford's colleges – like today's universities – were "generally contrived not for the benefit of pupils" but for "the ease of the masters." Such was the dons' repose, Smith asserted in a passage that's as relevant today as it was then, that universities had become "sanctuaries in which exploded systems and obsolete prejudices found shelter and protection, after they had been hunted out of every [other] corner of the world." (Do these words remind you of today's financial services industry in Australia? Of this country's many other protected industries – especially its universities?)

More generally, and far more than most of today's academics, bureaucrats, journalists and politicians, Smith held considered and realistic views about human nature. True to the Calvinism of 18th-century Edinburgh, his conception was gloomy. He famously observed in *The Wealth of Nations* (1776) that "people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public or some contrivance to raise prices." Further – and bearing in mind that he wrote before the rise of the welfare-warfare state – although "the violence and injustice of the rulers of mankind is an ancient evil" it is not as bad as "the mean rapacity, the monopolising spirit of merchants and manufacturers." Consequently, and also because they are "silent with regard to the pernicious effects of their own gains," businessmen "neither are, nor ought to be, the rulers of mankind."

Smith understood what today's elites blithely ignore or strenuously deny: pious declarations of virtuous intentions avail nothing. Indeed, as smokescreens that mask some elites' malign plans, they're worth than useless – they're dangerous. Perhaps the most subversive truth (don't they understand it, or do they appreciate it all too well?) from which elites seek to distract attention is: *incentives influence behaviour; specifically, the motivations of the owners of capital on the one hand and of its managers on the other differ diametrically.* In Smith's words,

> being the managers of other people's money than of their own, it cannot well be expected that [managers] should watch over it with the same anxious vigilance with which partners in a private copartnery frequently [do] … Negligence and profusion therefore must prevail more or less in the management of [wealthy people's estates by people who own relatively little wealth] …

Self-made owners of capital wish first and foremost to preserve it; subject to this condition, they also desire that it generate income; finally, owners seek to fructify their capital and bequeath it to their heirs. As a result, their incentive – and hence focus – is generally and largely long-term.[8] If they're not significant owners of capital, on the other hand, its managers face very different incentives. They, too, seek income; wanting capital (and thus any fundamental interest in its preservation), however, in order to generate it they must supply their labour to its owners. They desire, in other words, a regular salary; hence their focus is short-term. Smith denounced the "negligence … resulting from the separation of ownership and control in a business enterprise."[9] *Given the trade-off between his own short-term salary and the capital-owner's long-term fructification of capital, the manager's incentive is to favour his immediate benefit at the expense of the owner's eventual reward.* The Royal Commission documented in dismaying detail this insight's implication: salary-extractors lacking any "skin

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8 For a book-length elaboration, see Chris Leithner, *The Bourgeois Manifesto: The Robinson Crusoe Ethic versus the Distemper of Our Times* (CreateSpace, 2017).

9 This problem, also known as the "principal-agent" problem, spawns "moral hazard." John (10:12-13) alludes to it: "the hired hand is not the shepherd and does not own the sheep. So when he sees the wolf coming, he abandons the sheep and runs away … The man runs away because he is a hired hand and cares nothing for the sheep." If they believe that the owner won't notice (or react promptly), hired hands will be tempted to imitate the wolf, i.e., consume the owner's sheep. According to Jörg Guido Hülsmann, "moral hazard is the incentive of a person A to use more resources than he otherwise would have used, because he knows, or believes he knows, that someone else B will provide some or all of these resources. The important point is that this occurs against B's will and that B is unable to sanction this expropriation immediately." Further, "moral hazard can arise when an economic good is not effectively controlled by its owner (the "principal") but by a different person called the "agent," for example, an employee … Informational asymmetries produce moral hazard in conjunction with this separation of ownership and control. The agent, who is fully informed about his own activities, has an incentive to act in his own material interest against the material interests of his less informed principal. Whenever the principal cannot effectively monitor the activities of his agent, … the latter has an incentive to increase his own (monetary and psychic) income at the expense of the former" (Jörg Guido Hülsmann, What Causes Moral Hazard? *The Free Market*, April 2008).

in the game"[10] will, in a distressing number of instances, become indifferent, incompetent, negligent, profligate, venal, corrupt and even criminal.[11]

Adam Smith's "Obvious and Simple System of Natural Liberty"

Notwithstanding his scorn of businessmen and capitalists who seek political favours, the self-made man – financially independent and critically thinking, who figuratively and literally minds his own business and ethically accumulates capital – emerges as the hero of Smith's philosophical framework. In *The Wealth of Nations* he concludes

> in the midst of all the exactions of government … capital has been silently and gradually accumulated by the private frugality and good conduct of individuals … It is this effort, protected by law and allowed by liberty to exert itself in the manner that is most advantageous, which has maintained the progress of England towards opulence and improvement in almost all former times, and which, it is to be hoped, will do so in all future times.

Smith regarded selfishness as a vice and self-interest as a virtue.[12] The voluntary exchange of goods and services, labour and capital by self-interested

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10 "To be successful in business and investing," says Warren Buffett, "you've got to have skin in the game, a stake in the company." Specifically, directors and executives must use their own money to buy considerable amounts of the company's stock, such that this stake comprises a significant portion of their financial net worth. See William Safire, "Skin in the Game," *The New York Times*, 17 September 2006 and Nassim Nicholas Taleb, *Skin in the Game: Hidden Asymmetries in Daily Life*, Random House, 2018.

11 It's hardly just asset managers in the private sector: because they also lack "skin," Smith also excoriated civil servants (he would surely have scorned the phrase "public servants") and governments. In general, "there is no art which one government sooner learns of another, than that of draining money from the pockets of the people." And with respect to the state's finances, "when national debt levels have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by a bankruptcy; sometimes be an avowed one, but always by a real one, though frequently by pretended payment." Further, and bearing in mind Smith's distaste for the rule of plutocrats, "England … has never been blessed with a very parsimonious government … It is the highest impertinence and presumption, therefore, in kings and ministers, to pretend to watch over the economy of private people, and to restrain their expense by sumptuary laws … [Kings and ministers] are themselves always, and without any exception, the greatest spendthrifts in the society. Let them look well after their own expense, and they may safely trust private people with theirs. If their own extravagance does not ruin the state, that of their subjects never will."

buyers and sellers, who rely upon neither fraud nor force but rather the principle of *caveat emptor* ("let the buyer beware") and the common law of contract, represents an "obvious and simple system of natural liberty" whose checks and balances constrain greed and encourage plain-dealing. Smith acknowledged that individuals aren't innately virtuous – indeed, the contrary is closer to the mark. Accordingly, and because rascals are as likely to populate its ranks as to staff the counting-houses, governments should regulate little – and as little as possible. *Instead, self-interested individuals with "skin in the game" provide the basis of effective self-regulation.* The dynamics of voluntary and lightly regulated exchange encourage the owners of property to respect other owners' interests. Hence what's perhaps the most oft-quoted passage in *The Wealth of Nations*:

> Man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and show them that it is for their own advantage to do for him what he requires of them … It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner,[13] but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.

Smith's "invisible hand" – *a spontaneous, not designed, social mechanism that achieves benign consequences but doesn't require benevolent intentions* – is the perhaps most vital (and surely the least understood) idea that emerged from the Scots Enlightenment.[14] According to Smith, lightly-regulated transactions en-

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12 For a concise and readable overview, see Gary Calles, Self-Interest Is Not Selfishness (Mises Daily Article, 15 April 2015).

13 Did self-love or love for her son motivate Smith's mother? For most of his life (he never married), his mother, Margaret, cooked his dinner, washed his cloths, etc.; and after Margaret's death and until the end of his life, Smith's cousin, Janet, met his domestic needs. "Women are almost entirely absent from Adam Smith's thinking," Dayna Evans says, "but they were not absent from his life. Men have only been able to act in self-interest because there have been women taking care of the children, taking on the housework, providing free labour" (see Adam Smith Isn't the Real Economic Hero – His Mother Is, *The Cut*, 13 June 2016).

14 Hence the foundations of classical liberalism: human capabilities are innately and severely limited; there are no "solutions" – only imperfect trade-offs that necessarily leave unmet needs; justice comprises a clear and inviolate set of processes ("principles of natural justice") rather

courage people to inform themselves and learn lessons, i.e., correct the mistakes and miscalculations they'll inevitably commit. Hence industry, frugality, prudence, patience, fortitude and adaptability are key attributes required to buy, sell and invest successfully – and the invisible hand rewards these traits. Enlightened self-interest, i.e., the desire to avoid loss of custom, reputation, and thus money, restrains but hardly eliminates fraud, negligence and the like; hence the desire to gain a reputation for reliability (and attract repeat customers and reap long-term profit) is a necessary but insufficient condition for honesty, thoroughness, timeliness and the delay and moderation of pleasure. In Smith's system of natural liberty, trickery exists. Equally, however, so too do arrangements that detect and punish it – and thus deter its recurrence.

For Ethics' Sake, Advocate Capitalism – and Reject Its Damaging Antidotes

As Smith and his Victorian descendants demonstrated, the lightly-regulated (and mostly self-regulated) commercial society contrasts sharply and favourably, both morally and materially, to the heavily-prescribed mercantilist (i.e., political) society. Alas, today business and government ignore or deride the Scots Enlightenment's ideals of enterprise, small and unobtrusive government and private property, the rule of law and markets. As Alan Kohler observed in *The Australian Financial Review* (5 February, 2002):

> very few people actually preach capitalism in public, especially CEOs. Mostly they preach its antidotes and constraints: regulation, triple bottom line, corporate governance … corporate citizenship, leadership in the modern age, transparency.

Since 2002, matters have worsened. This, as Smith reminds us, is because

> in the courts of princes, in the drawing-rooms of the great, where success and preferment depend, not upon the esteem of intelligent and well-informed equals, but upon the fanciful and foolish favour of ignorant, presumptuous and proud superiors; flattery and false-

than the attainment of particular results ("social justice"); knowledge comprises the fragmentary and unarticulated experiences of the more than the alleged expertise of the few; incentives trump (allegedly benign or laudable) intentions. Hence, too, classical liberals' advocacy of social arrangements that underpin this "invisible hand," of property rights and limited government, and of the rule of law and voluntary transactions (see in particular Thomas Sowell, *A Conflict of Visions: Ideological Origins of Political Struggles*, Basic Books, 2002 and *Knowledge and Decision*, Basic Books, 1980).

> hood too often prevail over merit and abilities … This disposition to admire, and almost to worship the rich and the powerful, and to despise or, at least, to neglect, persons of poor and mean condition … is … the great and most universal cause of the corruption of our moral sentiments.

Today, the general public's disposition to trust the state – an egregious instance of Stockholm Syndrome if there ever was one – ranks among the principal corrupters of morality. Andrew West, in Less Government Regulation and More Laissez-Faire Required to Prevent Further 'Enron' Scandals (*Capitalism*, 7 March 2002), noted that Alan Greenspan – one of the most prominent graduates of New York University's Stern School of Business (who subsequently became chairman of the Board of Governors of the Federal Reserve System) – foresaw more than 50 years ago that *the state's myriad statutes and regulations beget events such as the Enron and other messes that surfaced in 2001-2002 – and the banking, financial planning and other outrages that emerged in Australia earlier this year.* In The Assault on Integrity (1963), Greenspan wrote:

> Reputation, in an unregulated economy, is a major competitive tool. It requires years of consistently excellent performance to acquire a reputation and to establish it as a financial asset … Thus the incentive to scrupulous performance operates on all levels … It is a built-in safeguard of a free-enterprise system … Government regulation is not an alternative means of protecting the consumer. It does not build quality into goods, or accuracy into information. Its sole "contribution" is to substitute force and fear for incentive as the "protector" of the consumer.
>
> What are the results? To paraphrase Gresham's Law: bad "protection" drives out good. The attempt to protect the consumer by force undercuts the protection he gets from incentive. First, it undercuts the value of reputation by placing the reputable company on the same basis as the unknown, the newcomer, or the fly-by-nighter. It declares, in effect, that all are equally suspect … Second, it grants an automatic guarantee of safety to the products of any company that complies with its arbitrarily set minimum standards … The minimum standards, which are the basis of regulation, gradually tend to become the maximums as well. A fly-by-night securities operator can quickly meet [the state's] requirements, gain the inference of re-

spectability, and proceed to fleece the public. In an unregulated economy, the operator would have had to earn a position of trust.

… Protection of the consumer by government regulation is thus illusory. Rather than isolating the consumer from the dishonest businessman, [the state's regulations are] gradually destroying the only reliable protection the consumer has: competition for reputation … Government regulations do not eliminate potentially dishonest individuals, but merely make their activities harder to detect or easier to hush up [italics added].

West observed that over the years Baruch Lev, a professor of accounting and finance at NYU, has contributed much food for thought to the subject of corporate regulation. In the manner of Benjamin Graham ca. 60-70 years before at Columbia,

Professor Lev brought [to class] a financial report prepared by U.S. Steel from around 1903, [approximately 30 years] before the government established the [Securities and Exchange Commission and] got involved in accounting standards. *He pointed out that in almost every respect, U.S. Steel's [voluntary and unregulated] financial statements offered as good or better disclosure and better information than [required and regulated] financial statements do today.* And they were provided more frequently [i.e., monthly]. Back then, U.S. Steel and its auditor had to earn investors' trust in the marketplace. Now, companies just try to get away with murder, while minimally adhering to the letter of the law and accounting rules [italics added].

West's conclusion echoed Greenspan's: "investor scepticism is the first line of defence against fraud in a free economy, but becomes dull in a regulated environment." Thomas Donlan (*Barron's*, 15 July 2002) agreed:

As long as the stock market was going up, lawmakers, officials and so-called investors never minded much about corporate governance. They never minded about the veracity of press releases. They never minded the many warnings from those who said it wasn't different this time. Those who drove the market so high without regard for fundamental value excused all manner of mistakes and malfeasance. The federal government cannot exorcize the blame that rests on the

> boom and its bulls. [The bust] and public scepticism are reforming the market more effectively than new laws ever could.

Alas, these days all but a few Australians emphatically reject this vital lesson. Amazingly, and despite repeated and cumulatively overwhelming evidence to the contrary, they apparently continue to believe that "their" government will protect them against "bad apples" in the financial services industry. The reality, as a mammoth literature elucidates, is "regulatory capture."[15] According to evidence heard at the Royal Commission, during the past decade ASIC has launched only one criminal proceeding against a financial planner – and none against bankers and mortgage brokers. Similarly, during the past five years it's taken only one civil action. Yet its most recent random survey of advisers and planners demonstrated that 75% failed to implement their clients' best interests (see "Not Just a Few Bad Apples," *The Australian*, 4 May 2018).

The man in the street thus has things exactly back-to-front: ASIC doesn't exist in order to protect retail investors against large corporations. Quite the opposite: intentionally or otherwise, ASIC punishes benighted outsiders on behalf of its anointed masters (i.e., the Commonwealth Government and the kingpins of the financial services industry). "It's hard to know what's worse," *The Australian* (3 May) editorialised: banks' actions "or the lack of action by watchdogs." In December 2009, it warned that "the standards ASIC sets for financial planners are considered a joke in the industry;"[16] And on 30 April, in "Mum and Dad Investors Pay for ASIC's Failures," it editorialised: "ASIC has too often been a part of the problem, not the solution." According to *The Weekend Australian* ("Financial Watchdog Has Failed, Says MP," 28-29 April), the chair of the parliamentary committee that oversees the financial services industry "believes that if ASIC had been doing a proper job as regulator, much of the improper

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[15] Regulatory capture is a form of government failure which occurs when a regulator, created by the government purportedly in order to act in the public's interest, instead advances the concerns of special interest groups that dominate the industry or sector it allegedly regulates. Government agencies suffering regulatory capture are called "captured agencies." This mammoth literature derives from George Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science*, vol. 2 (1971), no. 3, pp. 3-21.

[16] Just what are these "standards"? "Almost four years after *The Weekend Australian* revealed it was possible to become a fully-qualified and government-accredited financial adviser with just four days' work, little has changed. Private education providers are still spruiking diplomas of financial planning that cost about $1,500, involve 'no exams' and are delivered 'completely online.' There are no prerequisites, with future planners needing not even to have completed high school" (see "It's Not Too Late: How to Qualify in Four Days," 5-6 May).

and fraudulent conduct revealed by the Royal Commission would have been detected and punished. 'They do owe Australians a proper explanation … why they have failed'" (also see "Regulators' Culture in Question," *The Australian*, 17 May). Realistically, there's little chance that they'll get one.[17]

Plus Ça Change, plus C'est la Même Chose

The evidence presented to the Royal Commission is merely the latest episode in a long-running and sordid serial with local variants in other nations. The previous instalment occurred a decade ago, the one before that almost 20 years ago, etc. Each time, academics, bureaucrats, journalists, and politicians, etc., bewailed the "crisis of ethics" (see, for example, "Tillerson Warns of 'Crisis of Ethics' Among U.S. Leaders," *The Wall Street Journal*, 16 May 2018). The WSJ's Peggy Noonan penned "Capitalism Betrayed" on 28 June 2002, i.e., in the wake of the Enron and other scandals, but she could just as easily have written it in Oz today:

> Something is wrong with – what shall we call it? … We'll call it Big Money. Something has been wrong with it for a long time, at least a decade, maybe more … A new generation of moral and ethical zeroes rose to run Big Money over the past decade, and nobody quite noticed but they were … running the system into the ground … Those who invested … have been cheated and fooled by individuals whose selfishness seems so outsized, so huge, that it seems less human and flawed than weird and puzzling. Did they think they would get away with [these] scams forever? Did they think they'd never get caught?

Like George W. Bush then, so Australia's Prime Minister, Malcolm Turnbull, today. "President Bush must be feeling a bit blindsided by his buddies on Wall Street," *The Wall Street Journal* reported on 9 July 2002:

> They are the ones who repeatedly entreated him to keep the government out of their affairs. But last week, they led the stampede

[17] On 30 April, *The Australian* editorialised: "ASIC claims to 'contribute to the financial wellbeing of all Australians' by promoting 'investor and consumer trust and confidence.' … Investors who have entrusted their hard-earned savings to [major financial] institutions … have been betrayed by them, and by ASIC's negligence and incompetence." See also "Woeful Watchdogs Did Little to Help" (5 May).

> for tougher government action – and left the president behind in a cloud of dust, endorsing much weaker solutions for restoring market confidence. The business and financial worlds, of course, always have been foul-weather friends of government. When times are good, they see Washington as a nuisance; when times are bad, they come begging for help.

Having bewailed the poor standards, handwringers earnestly asserted that yet more laws and regulations, "cultural change," etc., were urgently required in order to restore proper norms. "A Restoration of Character Should Top the Reform List" jabbered the WSJ's lead editorial on 1 July 2002. The Royal Commission will likely serve much the same pabulum when it submits its final report.[18] The notion that laws can convert bad people into good was then – and today remains – ludicrous. *It's obvious that the laws that existed in the U.S. before 2000 failed to prevent the ethical outrages that occurred during the Dot Com bubble; and it's equally evident that the statutes enacted in Australia at that time have been woefully insufficient to prevent the outrages that have occurred since then.* As in the early-2000s and again today: the cause of financial malfeasance derives not so much from greedy personal motives as from perverse institutional incentives – created not least by governments' labyrinth of decrees!

Diversity of Ethnicity, Sex, Etc., Is Irrelevant; What Matters Is Uniformity of Sensible Incentives

Juvenal asked: "who will guard the guardians?" Adam Smith's answer is twofold. First, the state and its byzantine laws and regulations certainly won't: instead, they confound outsiders and abet insiders' selfishness. Second, the "obvious and simple system of natural liberty" is imperfect; yet it will outperform any scheme which princes and their flatterers might concoct. The invisible hand encourages market participants to refine their innate selfishness into enlightened self-interest. Its crux is at least as old as the Code of Hammurabi (ca. 1754 BC) – which decreed (229), among other things, that "If a builder builds a

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18 The early signs are discouraging. In *The Australian* (30 April), George Williams, Dean of Law at the University of NSW, predictably advised "if sharp practices are to stop, government must intervene." Oblivious to the fact that it already has – massively and invidiously – he therefore counselled more of the same: "tougher penalties are part of the solution, but … it is more important to establish stronger corporate cultures and forms of regulation that prevent customers being harmed." To a four-year old with a hammer, everything resembles a nail; and to a cloistered academic the knee-jerk reaction to every symptom is more laws and regulations – which in the real world make things even worse.

house for someone, and does not construct it properly, and the house which he built falls in and kills its owner, then that builder shall be put to death." *Today's conventional wisdom is thus diametrically incorrect: it's not so-called "diversity" but uniformity of sensible incentives that encourages morality.* In particular, when directors and managers lack "skin in the game" they'll be tempted to fleece clients and shareholders; but when everybody possesses the same encouragements, they'll tend to pull in the same direction.

Unfortunately, today's pampered corporate bureaucrats are NOT the heirs of Adam Smith's self-made owners of capital. In *The Australian* on 9 May 2018, Elizabeth Proust preached a tenet of The Establishment's gospel:

> The business case for diversity on boards is irrefutable. Diverse boards and leadership teams lead to better outcomes for stakeholders and for shareholders. Diversity leads to greater innovation, more rigorous questioning and stronger bottom lines.

And in *The Weekend Australian* ("Boards Need More Women, Foreigners, Tech Gurus," 19-20 May), Alan Kohler scaled Mount Political Correctness. The thin air seemed to impair his judgement:

> … shareholder value and thus profit can no longer be the only benchmark for corporate success … a properly balanced board of directors guiding a big modern corporation needs not only a proper proportion of women, but also of globalists, technologists and Millennials …

"I'm not even sure it's legal," Janet Albrechtsen rightly retorted ("In Defence of Capitalism," *The Weekend Australian*, 19-20 May):

> A director is not elected on a platform of social values. Directors have a legal responsibility to maximise [the] profits of a company within the confines of the law and within acceptable risk parameters. So if somebody comes along and says we demand you consider social values [such as the proportion of women, etc., on the board] the question is "whose social values"? [Directors] are not politicians. [They're] not elected by socio-economic groups en masse.

Empirically, what's indisputable is that Proust and Kohler are mistaken. During the past several years, women have chaired the boards of both AMP and CBA; does anyone believe they asked tougher questions than their male colleagues? Recent revelations of these entities' directors' misdeeds have already cost their shareholders ca. $1 billion and could cost several billion more; is *that* what Kohler means when he says boards should be "less focussed on profit alone"? Katherine Klein, a professor at the Wharton School of Business at the University of Pennsylvania, summarises the inconvenient truth:

> Many commentators suggest that gender diversity in the corporate boardroom improves company performance because of the different points of view and experience it offers. However, rigorous, peer-reviewed academic research paints a different picture. Despite the intuitive appeal of the argument that gender diversity on the board improves company performance, research suggests otherwise … The results of … meta-analyses, summarizing numerous rigorous, original peer-reviewed studies, suggest that the relationship between board gender diversity and company performance is either non-existent (effectively zero) or very weakly positive. Further, there is no evidence available to suggest that the addition, or presence, of women on the board actually causes a change in company performance (see Does Gender Diversity on Boards Really Boost Company Performance? *Knowledge@Wharton*, 17 May 2017).[19]

A director's *sex* (or ethnicity, etc.) is immaterial: but his – or her! – *incentives* are paramount. In *The Weekend Australian* (5-6 May), Judith Sloan hit the nail on the head:

> The public has every right to be suspicious about the motivations of many company directors [female as well as male] … Few have any real skin in the game – by owning a large number of shares, for instance – which often leads to cavalier attitudes when it comes to spending other people's money, in this case the company's, and the taking of risks.

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[19] We know *a priori* that Proust's assertion is false and that Klein's conclusion is true. As Warren Buffett famously declared, "When a management [whether male or female, Anglo-Celtic or "ethnic," etc.] with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact." See also this.

The director who owns a significant number of that firm's shares – which, in turn, comprises a substantial percentage of her total financial net worth – demonstrates a real commitment to the business. *Just as receipt of salary encourages a director to think like an employee, proprietorship encourages her to think like an owner.* "As a director," noted *The Australian Financial Review* ("Directors Need More Skin in the Game," 18 May),

> if you own shares … you will experience greater reward from the company's long-term success and, conversely, greater pain from the company's failures … That is a great alignment of interests and a motivator to work tirelessly to build world-class businesses [and is completely] different from being a director who is looking to collect fees to sustain an income …

Alas, the typical director of a large Australian firm owns few (and often none) of its shares. Indeed, as the AFR noted, "in some cases, non-executive director candidates … consider [owning] shares as a conflict of interest"! Importantly, boards didn't create this perversion of incentives: APRA and the Corporate Governance Council (CGC) of the Australian Securities Exchange did. Judith Sloan writes ("It's about Directors' Agenda, not Their Gender," *The Australian*, 15 May) that these "faux legislators" have imposed "postmodern drivel" upon ASX-listed and APRA-regulated entities – most notably, AMP and the banks. Alas, The Establishment shows absolutely no sign that it'll mend its destructive ways. *It's therefore hardly surprising that some directors have behaved so abysmally. Indeed, it's startling that more haven't done so; consequently, we should expect that appalling behaviour will continue.* In Independent Directors Lie at Heart of Finance Sector's Trials (*UNSW Newsroom*, 3 May), Peter Swan, a professor of finance at the University of New South Wales, elaborates:

> Just as fish rot from the head, the same is true of companies headed by boards. *One might naively believe that shareholders can elect boards that look after their interests, but the CGC technically "recommends" (but in reality requires) that a majority of board members must not only be "independent" of management, but also "independent" of significant shareholders – a "lock the gate" clause designed to keep shareholders out.* Surely, one should not require directors to be independent of the very shareholders they are supposed to represent! *So much for the alignment of interest between the company and its shareholders that would normally protect shareholders … from rapacious management.* [Hence] the

> kind of conduct that has become the norm in the financial sector. Worse still, the board nominating subcommittee must in turn be made up of "independents." These committees recommend more independents, squeezing out all the other more responsible categories of people …
>
> There would be [fewer] problems here if "independents," who are part-time and largely professional directors with negligible share ownership, were also equipped to monitor management and to replace genuinely non-performing chief executives if it ever becomes necessary. Unfortunately, this is largely not the case. *Indeed, their very independence means they cannot have any special knowledge of or connection with the firm when joining the board. That mitigates against them being able to monitor management effectively or even provide worthwhile strategic advice* … It is not only boards and executives who are to blame and perhaps should face jail. It must be shared with the two institutions, ASX and the regulator, APRA, since together they have locked shareholders out [italics added].

"All of this talk about 'independent' directors is a complete misunderstanding of the functions of a company and the functions of capitalism," Albrechtsen ("In Defence of Capitalism") correctly notes:

> The guy [or girl] who has got no shares, the "independent director" – what's his motivation? It can go both ways. [It might be] "I don't want to make a mistake, so let's be conservative." Alternatively, perhaps he thinks "well, it's not my money, so let's blow it." I think the ASX is completely off-base with this need for so-called independent directors.

In research conducted over the years, Swan finds that "independent" directors deliver *poorer* – not better – corporate performance (see, for example, this). Directors of major corporations are glorified employees: that is, they receive big salaries independent (pardon the pun) of results. *They thereby possess a strong incentive to preserve and augment their privileges, but lack any corresponding motive to promote shareholders' interests.*[20] Albrechtsen concludes: "mediocrity has been

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[20] It's hardly necessary to add that there's no linkage between executive remuneration and stock performance (see, for example, "Money for Nothing," *The Wall Street Journal*, 14 May).

embedded into boardrooms by a set of … governance rules." In "Romantics and Utopians – A Dream Team to Ignore" (*The Australian*, 9 May), she reveals insiders' shell-game: "dreaming up wishy-washy regulation won't protect … [shareholders. But] it will create the perfect storm of ambiguity for directors to escape liability." The mainstream has long celebrated its allegedly benevolent intentions – and decreed demonstrably vicious incentives. The "moral hazard" is two-fold. *First, as the Royal Commission has shown, insiders rob outsiders; second, in its wake little will change and may well worsen:*

- The absurdities that Smith denounced at Oxford in the mid-18th century extend far beyond today's university campuses. Like academics, so too most bankers, financial advisers, mortgage brokers and regulators: they're employees rather than capitalists, i.e., their remuneration stems almost exclusively from salaries and "bonuses," and they receive these rewards independent of actual results – and, it seems, despite woeful and even appalling results. *Their orientation, therefore, is necessarily and overwhelmingly short-term; not surprisingly, they routinely succumb to the temptation to lie to and steal from the owners of capital.*

- Neither the Royal Commission, nor academics, journalists, the Commonwealth or its corporate regulator, etc., has diagnosed this distemper; accordingly, none will prescribe an effective remedy.[21] In other words, *insiders will fail to detect – and will thus leave untouched – perverse incentives that generate poor results. The Australian* ("System Rebooted to Fail Again," 27 April) correctly concluded that the federal government has "designed a system which, having failed, will fail again. And whom will it fail most? Those who most need it."

You Show Me the Incentive and I'll Show You the Outcome

What, then, to do? *Directors of Leithner & Co. don't claim that they've resolved Juvenel's ancient problem; they have, however – with Adam Smith's aid – greatly mitigated it.* First, the Company has no employees: it has only Directors. Moreover, these Directors receive no salary. Second, it has no clients – only shareholders. As a result, *the Company's employees can't cheat its clients: there are neither em-*

[21] In his 2007 lecture accepting the Swedish National Bank's Prize in Economic Sciences in Memory of Alfred Nobel (commonly and erroneously called "the Nobel Prize in Economics"), Leonid Hurwicz arrogantly asserted, in allusion to Juvenel, "it would be absurd that a guardian should need a guard."

ployees to do the double-dealing nor clients to deceive. Finally, Directors own all of the Company's ordinary shares and are the biggest owners of its Redeemable Preference Shares; further, these shares comprise significant percentages of their total wealth. *Through these stakes, they have plenty of skin in the game – and any attempt by Directors to dud the Company's shareholders would, because it'd harm Directors most, be self-defeating.*

Individually, these traits are highly unusual; collectively, we're tempted to say that – at least in an Australian context – they're unique. They serve a fundamental purpose: *Leithner & Co.'s Directors are major owners as well as managers of the Company's capital*. Like Warren Buffett and Charlie Munger (the Chairman and Vice-Chairman, respectively, of Berkshire Hathaway, Inc.), they eat their own cooking;[22] *accordingly, they're strongly incentivised to act as proper stewards of capital.*[23] They receive not a penny of salary; instead, they receive a percentage of cash profits. That is, concrete results rather than lofty intentions underpin their rewards. In order to maintain and increase their ownership, they reinvest their share of profits into the Company. Consequently, and among other things, their incentive is to undertake long term investment rather than short-term speculation and to minimise costs in order to maximise cash profits – and hence dividends.

Leithner & Co.'s 19-year track record corroborates its ability to invest for the long-term and generate dividends; Canstar, which runs Australia's biggest financial products comparison site, substantiates our capacity to run a frugal ship. It recently examined how management fees differ among managed funds – and whether funds that charge higher fees also produce better returns (see Do Higher Fees Charged by Managed Funds Result in Higher Returns? 6 March 2018). It stated:

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22 Berkshire's Owner's Manual states: "In line with Berkshire's owner-orientation, most of our directors have a major portion of their net worth invested in the company … Charlie and I cannot promise you results. But we can guarantee that your financial fortunes will move in lockstep with ours for whatever period of time you elect to be our partner." In other words," said *The Financial Times*, "the interests of the managers are closely aligned with those of [other] shareholders" ("Berkshire Directors Eat Their Own Cooking," 24 August 2016).

23 Clear and sensible incentives have other happy consequences. For example, they eliminate the need for inane statements of "values." The Royal Commission has abundantly confirmed that such statements are mere compendia of babble, cant, drivel, hypocrisy and outright bald-faced lies. They're worse than useless: they use flowery language to promise, in effect, that employees will love their clients as they love themselves – whilst distracting clients' attention from employees' incentives to cheat, mislead and steal.

managed funds charge [a fixed and] ongoing fee for managing your investment, often called the management fee or management expense ratio (MER). This ratio may not include all administrative fees, so it's important to check a fund's prospectus for a full picture. For managed funds rated in Canstar's 2018 Star Ratings, the management fee ranges from 0.19% up to 2.50%, with the range varying across fund types [see Table 1].

Table 1:
Comparing Leithner & Co.'s Recent Expense Ratios to Australian Managed Funds' MERs

Type of Fund	Min MER	Avg MER	Max MER
Aust Cash/Fixed Interest	0.19%	0.46%	1.00%
Aust Shares Large Cap	0.35%	1.01%	2.05%
Aust Shares Small Cap	0.77%	1.27%	2.50%
Aust Real Estate Invest Trust	0.35%	0.85%	1.58%
Global Fixed Income	0.35%	0.59%	0.78%
Global Shares Large Cap	0.35%	1.09%	2.02%
Global Shares Small Cap	1.12%	1.32%	1.50%
Multisector Aggressive	0.35%	1.20%	2.20%
Multisector Balanced	0.35%	0.84%	2.42%
FUNDS' MEANS	**0.46%**	**0.96%**	**1.78%**
LEITHNER & CO.	**0.12%**	**0.16%**	**0.19%**

Fees are one of the most significant determinants of returns; the lower is the total fee, on average, the higher is the total long-term return.[24] Canstar finds that if you invest $100,000 in an Australian managed fund, it'll charge you an average of $960 and as much as $2,500 per year. If it earns a pre-fee return of 7.5%, the management fee averages 13% (and can rise as high as 33%) of the pre-fee return; net of the fee, then, the return falls to 5.0-6.5%. Fees add lead to the saddlebags: the higher the fee, the higher must be the pre-fee return in order to grow the investment. Leithner & Co. doesn't levy a fixed and ongoing charge for the management of its assets; nor does it impose admin charges, commissions, etc.[25] It does, of course, incur expenses. Table 1 expresses the

24 "On average," stated *The Australian*, citing recent research from Morningstar, "the more a person pays for experts to manage their superannuation savings the worse the investments perform" ("Big-Four Planners 'Could Be Charged' for Failing Clients," 1 May; see also Marta Vidal, et al., "The Relation between Fees and Return Predictability in the Mutual Fund Industry," *Economic Modelling*, vol. 47 (June 2015), pp 260-270).

expenses incurred during each of the past three financial years as percentages of total assets on 30 June of the corresponding year. Its average expense ratio over the past three financial years (0.16%) is less than one-fifth of the average MER (0.96%) of the funds that Canstar analysed: for every $100,000 of assets, Leithner & Co. incurs ca. $160 per year of expenses. Further, its *highest* ratio during these years is a mere one-tenth of the analysed funds' average maximum MER; it's also equivalent to these funds' *lowest* MER.[26]

Leithner & Co.'s principles of "corporate governance" are very similar to – but even purer than – Warren Buffett's (see Robert Miles, *The Warren Buffett CEO: Secrets from the Berkshire Hathaway Managers,* John Wiley & Sons, 2002). Buffett and the CEOs of Berkshire's wholly-owned subsidiaries receive comparatively low salaries: Buffett's, for example, has been fixed at $100,000 per year since the 1980s – that's now a mere 1% of the median ($11.5 million) annual compensation of a Fortune 500 CEO. Further, neither Buffett nor any of his executives receive options over shares. Critically, however, although their salaries are comparatively modest, Buffett's and his lieutenants' financial net worth is great. In his *Chairman's Letter to Shareholders (1989)*, he wrote: "Most of [Berkshire's] managers have no need to work for a living; they show up at the ballpark because they like to hit home runs. And that's exactly what they do." *Specifically, shares of Berkshire Hathaway comprise virtually all of Buffett's and most of his senior managers' wealth*. In Miles' words,

> Berkshire has a select group of managers. Primarily, they are centimillionaires who work hard for billionaire board members and long-term millionaire shareholders … This unique structure has led to superior investment and management successes and has proven to be Buffett's finest cultural and structural strategy (pp. 4-5) … *The "owner-CEO" method is the best way to align the interests of the long-term shareholder with those of the manager* (p. 350; italics added).

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25 As owners of Company's common shares, Directors receive 20% of its cash profit; the dividend paid to these owners is thus, in effect, a performance fee. Importantly, it's paid upon the achievement of *outcomes*. In sharp contrast, the typical funds manager's bread and butter – his management fee – is paid on the basis of *inputs* (that is, quantity of funds under management), i.e., before he generates a penny of return for investors.

26 Unsurprisingly, Canstar "found that across all types of managed funds rated by Canstar, a higher [management] fee does not guarantee better returns … Of course, every now and then you'll find a fund where the long-term returns outweigh the higher fees attached. But this is certainly not always the case."

Conclusion

In 1830, in *Harvard College v. Amory*, Justice Samuel Putnam of the Massachusetts Supreme Court rendered the seminal decision that, for the next 150 or so years and in British countries as well as the U.S., provided a moral basis of the management of others' assets. Putnam stated:

> All that can be required of a trustee … is that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested.

This decision spawned the prudent man rule: one person or entity (trustee) who controls another's (beneficiary's) assets, funds, property, etc. – or an advisor who's in a position of influence rather than control – must invest as (i.e., expose the assets to risks that) a person of reasonable intelligence would consider wise. In other words, *the trustee must invest beneficiaries' assets (and the advisor must advise the client) as a prudent man of reasonable intelligence would invest his own property.* Among other things, the trustee or advisor must balance factors such as the long-term need to preserve the estate, the amount and regularity of income that the beneficiary requires in the short-term, etc.

Clearly, this rule is now merely of antiquarian interest: in Australia, as testimony to the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* has amply demonstrated, advisors, directors, executives, managers, regulators and others, whether they're men or women, have routinely ignored – indeed, systematically flouted – it. "What I've learnt from the Royal Commission," writes Alan Kohler (*The Deal*, June 2018),

> is that things are worse than I thought. I've known for years that the use of financial advisers as sales people … was continuing despite [various legislation] … What I didn't [realise] was that this system had corrupted these organisations' souls … There is a deliberate disconnect between what clients think they're getting and what advisers know they are providing. That's also known as deception. This doesn't apply to [everyone, of course, but] any business that's based on a deception is fundamentally corrupt …

In the Commission's wake, the notion that Australian bankers, financial advisors, mortgage brokers, etc., typically act as clients' stewards is plainly risible. Moreover, and given the damage they've inflicted upon themselves (ranging from shredded reputations to large class-action lawsuits), the contention that the industry's leaders – male or female – pursue enlightened self-interest is also laughable: some are charlatans and others are buffoons; many are blithely yet blatantly selfish. Perhaps worst of all, the Commission's final recommendations, when they appear next year, will likely (by prescribing ever more regulations whilst leaving undisturbed the principal-agent problem and the moral hazard it spawns) make matters even more woeful than they are now.

What, then, to do? Eschew fashionable babble and embrace rational action. It's no coincidence that Australia's rulers abhor, denigrate and fear capitalism: if it prevailed they'd lose their highly-salaried sinecures. Precisely for this reason, we applaud Adam Smith's invisible hand – may it slap many an insider from his (or her) privileged perch! Further, and unlike the mainstream, we don't claim that we're innately virtuous; nor do we spout damaging drivel such as "diversity" and "equality" (which merely entrench elites' rapacious "entitlement" to corporate welfare). Instead, we've created incentives align our interests to other shareholders'. *As a result, by pursuing our own self-interest we necessarily promote all shareholders' self-interest.*

The Establishment seeks to strengthen managers' control and weaken capitalists' ownership; it also segregates shareholders and directors. Consequently, these days the typical major corporation resembles a staid passenger liner: the anointed luxuriate in first class and the benighted languish in steerage. When insiders run the ship aground (or strike an iceberg, etc.), they take reserved seats on comfortable lifeboats: outsiders, on the other hand, must take their chances and make their own way. In diametric contrast to the mainstream's pathologies, and like Berkshire Hathaway, Leithner & Co. fuses ownership and control: the result is harmony. *Mainstream corporate governance creates inherent and insoluble conflicts of interest; ours begets a natural confluence of interest.* As one of our shareholders, you're neither a client nor an employee – you're a fellow-proprietor and business partner. The Company is, figuratively, a manoeuvrable yacht. Its shareholders own it: of these, Directors sail it and the others are voyagers. Thanks to Adam Smith, among others, over time it has steered a reasonably safe and steady course through occasionally rough seas.

Chris Leithner