IMPROVING THE PROCESS OF CHANGE IN AUSTRALIAN FINANCIAL SECTOR REGULATION

BY

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Various initiatives have recently been proposed for improving the process of regulatory change as it affects the Australian financial sector. This paper argues that, while these initiative are valuable, we also need to do more to engage with the rhetoric of regulation as part of the formulation, as well as the implementation, of regulatory policy.

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1. Introduction

The papers in this collection are concerned with the broad topic of financial regulation: its costs and benefits and the process of regulatory change. The purpose of this paper is to consider ways of improving the process of regulatory change as it affects the Australian financial sector, based on our experience of change over the last decade.

The paper is organized in the following way. Part 2 charts the progress of regulatory change affecting the Australian financial sector since the Financial System Inquiry of 1997, explains briefly the existing regulatory system, identifies some recent initiatives to improve regulation, and sets out some broad principles about the way the system works. Part 3 describes some recurring 'problems' with regulation that have been identified in submissions to government on regulatory reform and in the recent public debate about the efficacy of the regulatory system.

Part 4 looks at recent initiatives to improve the process of regulatory change, and argues that they do not adequately address one of the key underlying causes of these problems: deficiencies in effectively communicating regulatory intent through the various regulatory utterances (including primary and subordinate legislation, instruments, standards and policies) of Government and regulators. Part 5 proposes that, in addition to the improvements proposed by these recent initiatives, we need to

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incorporate into the process of regulatory change a much more sophisticated understanding of the way in which regulatory utterances work as a form of legal discourse in an environment of complexity. Part 6 concludes that jurisprudence, as well as economics, has an important part to play in conceptualizing and delivering successful regulatory change in the Australian financial sector.

2. Background

2.1 A decade of regulatory change

The last decade has been a period of extensive and rapid regulatory change for the Australian financial sector. The Financial System Inquiry (FSI) delivered its Final Report recommending new regulatory arrangements for the Australian financial system in March 1997. Following from that, in 1998, the Australian Prudential Regulation Authority (APRA) was established, and responsibility for consumer protection for the financial sector was transferred to the renamed Australian Securities and Investments Commission (ASIC). Also in 1998, a new regulatory framework for collective investments other than superannuation was enacted. Amendments to banking legislation allowed for the regulation of banks and all other 'authorised deposit-taking institutions' (ADIs) such as building societies and credit unions under a single umbrella. The Payment System Board was established within the Reserve Bank of Australia (RBA) and new payments systems regulation was introduced in the same year.

Change continued into the new decade, responding to both local and international developments. The *Financial Sector (Collection of Data) Act 2001* (Cth) began in 2001. In 2002, the *Financial Services Reform Act 2001* (Cth) (FSR Act) commenced, which extended new licensing, conduct and disclosure rules to a variety of retail and wholesale financial intermediaries, financial market operators and participants, and issuers of financial products. APRA licensing for superannuation trustees was introduced in 2004, and the changes to prudential regulation resulting from Basel II are being introduced progressively from 2007.

These high level changes have been attended by a raft of new and amending subordinate legislation (in the form of Regulations made by the Executive) and of prudential standards, policies, procedures, guidance notes and the like issued by APRA and ASIC, which continue to expand and evolve over time. For example, APRA's standards and policies in relation to insurance were substantially revised following the HIH Royal Commission in 2003, and the operation of the FSR Act was amended by Regulations and ASIC instruments and policy between May and December 2005.

Financial sector entities have also been profoundly affected by regulatory change in the broader economy, including the former

Government's corporate law economic reform program (with CLERP 1 commencing in 2000 and the most recent part, CLERP 9, commencing in 2004); the application of privacy laws to the private sector from December 2001; recent and proposed changes to regulation relating to money laundering and terrorism financing; and changes affecting those financial sector entities that are US registered issuers under the Sarbanes-Oxley legislation. While these regulatory changes are not directed specifically at financial sector entities, they have impacted significantly on them.

2.2 The regulatory framework

Currently, Australian financial sector entities are subject to a complex interlocking system of regulation covering their core activities that derives from a number of different sources. For the most part, this 'regulation' is explicit governmental regulation (in the form of primary and subordinate legislation and of formal policies and standards issued by APRA and ASIC) backed by legal or administrative sanctions for non-compliance. Other forms of regulation (including self-regulation and co-regulation) are used less extensively – these are discussed briefly below.

Under Australia's federal system, the power to legislate with respect to financial sector entities resides for the most part in the Commonwealth Parliament. (The main exception is consumer credit, which is regulated at the State and Territory level.) Commonwealth agencies are responsible for the administration and enforcement of these Commonwealth laws. A quick survey of the main primary legislation regulating the financial sector shows how extensive and complex the regulatory framework is. Legislation administered by ASIC includes: *Corporations Act 2001* (Corporations Act), *Australian Securities and Investments Commission Act 2001*, *Superannuation Industry (Supervision) Act 1993* (SIS Act), *Insurance Contracts Act 1984, Superannuation (Resolution of Complaints) Act 1993, Retirement Savings Accounts Act 1997, Life Insurance Act 1995*, and *Medical Indemnity (Prudential Supervision and Product Standards) Act 2003*. Legislation administered by APRA includes: SIS Act, *Banking Act 1959, Financial Sector (Shareholdings) Act 1998, Financial Sector (Transfers of Business) Act 1999, Financial Sector (Collection of Data) Act 2001, Financial Sector (Collection of Data - Consequential and Transitional) Act 2001, Life Insurance Act 1995, Insurance Contracts Act 1984, Insurance Acquisitions and Takeovers Act 1991, General Insurance Reform Act 2001* and *Retirement Savings Accounts Act 1997*. Legislation administered by the RBA includes: Corporations Act (specifically, Pt 7.3), *Reserve Bank Act 1959, Payment Systems (Regulation) Act 1998* and *Payment Systems and Netting Act 1998*.

Primary legislation (in the form of Acts of Parliament) is made by the Parliament itself. In contrast, subordinate legislation (in the form of Regulations) is made by the Governor-General in Council (that is, by the Executive through the relevant Minister or Parliamentary Secretary). The power of the Executive to make Regulations with respect to particular matters is delegated by the Parliament in the primary statute. Regulations are used extensively to supplement a number of these primary Acts, especially the SIS Act (which covers superannuation) and Ch 7 of the Corporations Act (which covers financial services, products and markets) (Hanrahan, 2005). As Bottomley (2003) recently pointed out in relation to company law, these Regulations no longer just fill in the details or provide the mechanics for implementation of the principal statue; delegated rule-making now operates effectively as a site for the formation of policy.

Policies and standards made by the relevant regulatory agencies also form part of the regulatory system. Following the recommendations of the FSI, Australia has adopted a 'twin peaks' model for financial regulators, under which APRA is primarily responsible for prudential regulation and ASIC is responsible for the consumer protection and market integrity regulation (Cooper, 2006). These two Commonwealth agencies operate along side the RBA, which is Australia's central bank, and the Australian Competition and Consumer Commission which regulates anti-competitive behaviour across the economy, including in the financial sector.

APRA's enabling legislation states that it is established 'for the purpose of regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards, and for developing the administrative practices and procedures to be applied in performing that regulatory role'. Its regulatory responsibilities cover ADIs, general insurers, life insurance companies, friendly societies and superannuation trustees. The APRA Act goes on to make explicit that, 'in performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia'.

Among other things, the legislation administered by APRA allows it to make standards with which regulated entities are required to comply. The various standards promulgated by APRA, and the guidance notes that accompany them, are APRA's main form of regulatory utterance.

In contrast, ASIC performs several distinct regulatory functions. It is the registrar of companies, and it administers and enforces Australia's company and securities laws. Within the financial sector it regulates (through licensing) financial services providers such as fund managers, broker/dealers and advisers, as well as the operators of financial markets and clearing and settlements facilities. It administers and enforces the governance laws for collective investments other than superannuation, and the disclosure laws that apply to issuers of financial products. More broadly, it has the function of monitoring and promoting market integrity and consumer protection in relation to the Australian financial system and the payments system. In performing its functions, ASIC is required by its enabling statute to strive to 'maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy' and to 'promote the confident and informed participation of investors and consumers in the financial system'.

The legislation administered by ASIC gives it various discretions that it may exercise at different times in the regulatory cycle. These include discretions in some cases to modify or exclude the law as it applies to an individual or class. They also include discretions to take certain administrative actions in relation to licensing and disclosure. Exemptions, modifications and statements about the manner in which it will exercise its discretions (in the form of Regulatory Guides) are ASIC's main form of regulatory utterance.

The regulatory arrangements for the financial sector also utilize, to a lesser extent, other forms of 'regulation' such as self-regulation, quasi-regulation and co-regulation. Self-regulation consists of behavioral controls that operate at the industry or profession level, with no formal involvement from government (for example, the 17 Standards with which members of the Investment and Financial Services Association must comply under the rules of the Association). Quasi-regulation describes indications from government as to how they would like regulated persons to behave, but without formal sanctions attaching for non-compliance (for example, as in the joint ASIC and APRA guide *Unit Pricing: Guide to Good Practice* of November 2005). Co-regulation generally involves giving statutory force to private arrangements (for example, Pt 7.2, Div 3, Subdiv B of the Corporations Act, giving statutory force to the operating rules and procedures of licensed financial markets).[1]

2.3 Recent initiatives to improve regulation

The rate and level of regulatory change over the last decade, and perceived deficiencies in its outcomes, have (perhaps unsurprisingly) been criticised by financial sector entities, their advisers and their customers. In recent years those criticisms have gained some political traction. While licensing and disclosure requirements for financial product issuers and intermediaries have attracted particular complaint, there have been broader calls for 'reducing the regulatory burden'.

In May 2005, Treasury commenced a program of 'refining' the operation of the new financial services regulation introduced by the FSR Act; the refinements project was implemented through the creation of new Regulations and the issue of guidance and relief by ASIC over the second half of 2005. In October 2005 the then Government formed a Taskforce, chaired by Gary Banks, to look at the possibilities for reducing the regulatory burden on business generally. The Taskforce's extensive

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[1] For a more detailed explanation of different forms of regulation and alternatives, see Appendix A to the *Best Practice Regulation Handbook* (OBPR, 2007).

recommendations were made in its report *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business*, finalized in January 2006 and released in April that year. Among other things the Taskforce recommendations resulted in the establishment of the Office for Best Practice Regulation within the Productivity Commission (and sharing its statutory independence). In April 2006, Treasury released a Consultation Paper inviting submissions from interested parties on a broader review of corporate and financial services regulation. Limited changes followed, in the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007* (Hanrahan, 2007).

Coinciding with these initiatives have been new programs, between the Government and the agencies and within the regulatory agencies themselves, to improve their regulatory performance and enhance inter-agency co-ordination. Some of these, including the new Ministerial Statements of Expectation now sent to regulators, have flowed from the *Review of Corporate Governance of Statutory Authorities and Office Holders* conducted by John Uhrig in 2003. These programs include ASIC's Better Regulation program, which commenced in mid 2006.

Recently the newly elected Labor Government has stated its intention to 'reduce productivity-stifling business regulation', a project to be overseen by Craig Emerson MP who has been appointed as Minister Assisting the Finance Minister on Deregulation. While overlap (and inconsistency) between State and Commonwealth business regulation will be a particular priority, it seems likely that aspects of (Commonwealth) financial sector regulation will also be up for review.

2.4 The structure of regulation

Before considering these recent initiatives to improve Australia's financial sector regulation, it is helpful to say something generally about the aims and structure of regulation.

Speaking broadly, the regulatory arrangements for the financial sector administered by APRA and ASIC focus on three broad policy goals. They are: (i) protecting consumers; (ii) promoting stability; and (iii) maximizing efficiency in the financial system (see, e.g., ALRC, 1993; FSI, 1997). Consumer protection aims to protect those dealing with financial sector entities from information asymmetries and to mitigate various types of risk, such as compliance risk (that is, the risk that the financial sector entity will not meet its legal obligations) and, in the case of prudential regulation, institutional risk (that is, the risk that the entity will fail). Stability aims at smooth functioning of the financial system overall, and the absence of financial disturbances (such as Asian financial crisis of 1997) that may impact on the economy more broadly. Efficiency aims to ensure that money and resources in the financial system flow to their highest and best use, by removing distortions to that process. Different regulatory mechanisms are used to achieve these goals, and in different settings across the financial sector these different goals have differing levels of priority. Pursuit of the different goals may, in some cases, create tensions. For example, requirements or restrictions introduced for the purposes of consumer protection may give rise to distortions that impact on efficiency.

The orthodox case for undertaking *regulation* to achieve these goals is that they would not otherwise be achieved for reasons of market failure. For example, the Office of Best Practice Regulation recognizes a need for regulation 'where there is a monopoly and potential abuse of market power; where there is incomplete information or there are information asymmetries between buyers and sellers; where goods or services are 'public goods'; and where there are impacts (externalities or spillovers) on third parties that are not reflected in market prices' (OBPR, 2007, p 60).

The shape of regulation of the Australian financial sector is, of course, influenced by transnational principles in relation to (among other things) banking supervision, insurance regulation, securities regulation (including the regulation of brokers and advisers and of collective investment arrangements), payment systems, and anti-money laundering and counter-terrorism financing. These principles include the Basel Core Principles for Effective Banking Supervision, the Insurance Core Principles, the IOSCO Objectives and Principles of Securities Regulation, the CPSS Core Principles for Systematically Important Payment Systems, and the Financial Action Task Force Recommendations on money laundering and terrorism financing.

As the foregoing discussion indicates, the Australian regulatory framework relies quite heavily on explicit governmental regulation to deal with the incidents of market failure and to give effect to transnational agreements, rather than on alternatives such as self-regulation, quasi-regulation or co-regulation.

Governmental regulation of the financial sector, as of other parts of the economy, can take a variety of forms. Those forms are usefully described by Ogus (1997) as sitting along a spectrum from low to high levels of state intervention. At the low intervention end are information measures, in the middle are standards (which may in turn be target standards, performance standards, or specifications), and at the high end are prior approval requirements (such as licensing) (pp 150-1). Ogus describes the different forms in the following terms:

> "*Information* measures require suppliers to disclose certain facts, but do not otherwise impose behavioural controls. At the other end of the spectrum, individuals or firms may be prevented from lawfully supplying a product or service without obtaining *prior approval* from an authorizing agency; and for such approval they will have to satisfy the agency that certain conditions of quality are, or are capable of being, met. The *standards* technique allows the activity to take place without any *ex ante* control, but the supplier who fails to meet certain standards of quality commits an offence. Standards can be subdivided into three categories which themselves represent different degrees

> of intervention. A *target* standard prescribes no specific standard for the supplier's processes or output, but imposes criminal liability for certain harmful consequences arising from the output. A *performance* (or output) standard requires certain conditions of quality to be met at the point of supply, but leaves the supplier free to choose how to meet those conditions. A *specification* (or input) standard can exist in either a positive or negative form: it compels the supplier to employ certain production methods or materials, or prohibits the use of certain production methods or materials. As such, it is the most interventionist of the standards techniques."

The outliers to this spectrum are, at the low end, economic regulation and private regulation and, at the high end, prohibition. Economic regulation provides economic incentives to entities to behave in a particular way (an example is the tax benefit offered to collective investment schemes that are operated as complying superannuation funds). Private regulation imposes on entities requirements they cannot contract out of, that are enforceable only by the people with whom they deal and not by regulators (an example of private regulation is the implied warranty in relation to the supply of financial services in s 12ED of the ASIC Act). Prohibition involves restricting the offer of products or services to particular clients in some way (an example is the prohibition in the United Kingdom on offering certain complex derivatives to retail clients).

Governmental regulation of Australian financial sector entities draws on a combination of all of these forms of regulatory intervention. Choices between governmental regulation and its alternatives, and (within governmental regulation) between the different forms along the regulatory spectrum, are fundamental to the design of any regulatory system.

3. Understanding the problem

The recent initiatives described in Part 2.3 above suggest that there is a 'problem' with Australian financial sector regulation. Is there? Viewing the regulatory system from a distance, the answer to that may appear to be 'no'. The International Monetary Fund has concluded that Australia's approach to prudential and market conduct regulation is sound overall (IMF, 2006). Among OECD nations, the Australian regulatory framework for the financial sector is considered one of the strongest (OECD, 2006, Ch 5). Participation in the Australian financial sector on all measures has grown exponentially over the last two decades, suggesting a high level of stability and confidence in the system. These are all indications of a regulatory framework that, at a macro level, is working well.

Closer up, however, a different picture emerges. There is a widespread view among regulated entities and consumers that the regulatory system for the financial sector can and should be improved, particularly in areas covered by the FSR Act and in other areas where the regulatory responsibilities of ASIC and APRA intersect (including in relation to the licensing and governance of prudentially regulated entities).

Submissions to the FSR Refinements Project, the Regulation Taskforce and the other recent initiatives express a variety of concerns about the current regulatory framework. In a report prepared for the Business Council of Australia in 2005, Access Economics reported ‘general industry discontent with significant additional costs for dubious benefit to either industry or consumers’ in relation to the FSR Act (BCA, 2005, Appendix 2). More broadly, many of the concerns raised in submissions reflect recurring criticisms of regulatory regimes generally – that particular rules and requirements are inefficient; that the drafting or structure of regulatory utterances is unclear; or that Government and regulators are unresponsive, ‘uncommercial’ or insufficiently accountable in the creation of new rules or the administration or review of existing ones.

Added to this are concerns about what might be deemed the ‘proportionality’ of application of parts of the framework, particularly in areas related to licensing, governance and disclosure. Thirdly, there are broader concerns about the way the regulatory regime operates as a *system* – that is, the way the different parts work together and the emergent properties that this interaction produces.

3.1 Efficiency, clarity and accountability

The concerns emerging from the various submissions and from recent public debate about the state of Australian financial sector regulation reflect in many respects what Ruhl and Salzman (2003) have identified (in the context of US environmental regulation) as the three main critiques that underpin much of the literature on regulation generally. These critiques centre on whether (and if so, why) particular elements of the regulatory system lack efficiency, clarity or accountability.

Inefficiency in regulation is probably the dominant critique. On this approach, a rule is inefficient (and therefore socially harmful) when the total costs to society of devising, complying with and enforcing the rule exceed the benefits (tangible and intangible) that it produces. The concern here is that the costs of the rule (including compliance costs for regulated entities, enforcement costs for regulators, opportunity costs and effects on competition) may not be outweighed by the benefits the rule produces.

The next is main critique of regulation is lack of clarity. The problem here is one of incoherence in the regulatory stock – Ruhl and Salzman talk about ‘rules that are complicated, difficult to understand, ambiguous or contradictory… [with the result that] it becomes difficult for a regulated party to know whether it is in compliance with a particular law’. This lack of clarity is often exacerbated by difficulties in locating a particular rule, for example, because the principal legislation is amended by subordinate legislation or by a regulatory instrument in a way that is not readily apparent on its face.

The third critique relates to accountability – a critique that Ruhl and Salzman describe as ‘institutional’ arising out of ‘the democratic deficit of the administrative state’. Where the power to make rules to which legal or administrative sanctions attach resides in institutions other than the Parliament (for example, in the Executive or in a regulatory agency), those institutions may be insufficiently accountable to voters with the result that they are vulnerable to rent-seeking by special interests or subject to regulatory capture or institutional bias. Bottomley (2003) observes that the trend towards ‘the use of forms of regulation alongside the primary statue’ raises concerns, including: ‘the loss of ready public scrutiny of rule-making; the difficulty in monitoring the degree to which specialised interests can now affect the content of those rules; and the fractured way in which we must now get access to the rules once they have been made’.

3.2 Proportionality

Discussions about the current regulatory arrangements for the Australian financial sector often raise concerns about what, for want of a better term, can be described as the ‘proportionality’ of application of parts of the regulatory regime. Regulators are sometimes accused by regulated entities of overcomplicating regulatory requirements by reading into legislation more than is there, or by being too prescriptive or inflexible in applying the law or exercising their discretions. In turn, regulators accuse regulated entities (or, more accurately, their legal advisers) of being too literalist, risk-averse or ‘technical’ (read, tricky) in interpreting the regulatory requirements. The disclosure requirements in Ch 7 of the Corporations Act are a clear example. A similar problem arises where ‘guidelines’ issued by regulators are applied by regulated entities as requirements, for example in connection with governance, licensing or reporting requirements.

The net effect of this perceived disproportionality is that the compliance burden imposed by the regulatory regime is ratcheted up beyond government’s (stated) intention when the regime was designed and put in place. For example, a regulated entity might make a defensive decision is prepare a lengthy disclosure document to manage its liability risk, despite indications from government that shorter documents were envisaged. This kind of ratcheting up is not only inefficient, it also has implications for market access and competition. It is interesting that the blame for this disproportionality is often laid squarely with lawyers, who it seems are generally seen as part of the problem of overregulation, rather than (as this paper argues) part of the solution to it. Surprisingly there is little (if any) attention paid to what it is in the design or drafting of the regulation that leads to this occurring, or how the rhetoric of regulation could be changed to avoid it (particularly through more sophisticated analysis of the impact of different liability and sanctioning arrangements).

3.3 Complexity

Also evident in the recent debate are concerns that there might be a broader, structural problem with the current approach to regulation that either contributes to, or is separate from, problems of efficiency, clarity, accountability or proportionality. This problem has to do with the effect of *complexity* on the operation of the system as a whole, and the failure of the current approach to address that effect.

In its submission in response to the Corporate and Financial Services Regulation Review Consultation Paper of April 2006, the Corporations Committee of the Law Council of Australia raised ‘concerns about the extent to which the approach to reform reflected in the release of the Consultation Paper can achieve the Government’s stated aims of reducing regulatory burden and improving regulatory efficiency in the areas of corporate and financial services regulation’ (LCA, 2006). The Consultation Paper had sought public comment on whether particular parts of the regulatory framework for corporations and financial services should be amended or removed. The Committee argued that the approach adopted in the Consultation Paper ‘cannot and does not address the broader issue of structural reform in the approach to corporate and financial services regulation’. It observed that:

> “the stated aim of the Consultation Paper is ‘to achieve A Simpler Regulatory System that not only tackles complexity by reducing and simplifying our laws, but also tries to make sense of complex systems’. With respect, the Committee considers that the process adopted here is unlikely to achieve that broader aim. While it is necessary in the short term to ‘lop off’ particular parts of the regulatory regime that are unduly burdensome or impractical, this does little to address broader problems of regulatory structure. Indeed, where this approach relies on adding specific exemptions and modifications to the legislative framework, it exacerbates those problems, by making the legislation even more complex and inaccessible.”

What the Committee’s submission is alluding to, at least in part, is a distinct critique of regulation that arises out of a recognition that a regulatory regime is a complex *system*, rather than just an atomistic collection of discrete rules and requirements. As a large, dynamic system that comprises many actors and agents interacting with each other over time, a regulatory regime exhibits many of the attributes typical of complex systems (Hornstein, 2005). It is adaptive, in that changes in conditions produce responses and counter-responses that cycle through the system. It has emergent properties – that is, properties of the system that are not shared by its individual parts. It is highly sensitive to initial conditions; early or primary choices influence all subsequent choices and (ultimately) the whole direction in which the system moves (Roe, 1996), making it highly path-dependant.

In particular, complex systems such as regulatory regimes are characterized by non-linearity – that is, they do not operate on simple cause-and-effect principles. Actions and interactions by and between agents produce feedback and feed-forward loops throughout the system. In response, complexity theory is what Hornstein describes as 'strongly antireductionist', in that it proposes that the behavior of complex adaptive systems cannot be explained in a mechanical, linear way. Understanding how a complex system behaves (or is likely to behave, if an element of it is altered) is not, on this approach, a matter of breaking down that complexity into a series of simple interactions. Instead it is necessary to look at the system as a whole and take into account these attributes of complexity in explaining or predicting how the system behaves.

Ruhl and Salzman talk about these attributes of complexity as imposing what they call a 'system burden' on compliance that arises from the *collective* operation of rules in a regulatory system (Ruhl and Salzman, 2003, p 763). They consider that regulatory regimes exhibit behaviors such as feedback, emergence, path dependence and non-linearity that are typical of complex systems, and that simultaneously produce overall system resilience and locally unpredictable and unstable outcomes in system behavior. When new elements ('agents') are added to the system, they argue, these system properties are amplified, 'changing the underlying character of the system itself'. They equate these 'qualitative effects on system behavior … with system burdens on compliance with regulatory law'.

4. Improving the process of regulatory change

The recent initiatives to improve regulation (or at least to reduce the regulatory burden) discussed in Part 2.3 above clearly respond to a number of the problems with regulation identified here. The FSR Refinements Project aimed to remove some inefficient rules (generally, by providing piecemeal exemptions to particular requirements for particular entities) and to improve the clarity of Ch 7 of the Corporations Act (although in this respect it has not really succeeded). The formal communication between the Minister and the regulators recommended by the Uhrig Report is now in place, strengthening the accountability of the regulators to Government. ASIC's Better Regulation initiatives aim (among other things) to improve the accessibility of its regulatory utterances (including instruments and regulatory guides) and to enhance responsiveness and accountability to the regulated community.

Importantly, too, attention has been focused on what must be done to improve the process of regulatory change as a means of addressing the underlying *causes* of these problems, rather than just their manifestations.

4.1 Recommendations of the Regulation Taskforce

In Ch 7 of its Report, the Regulation Taskforce recommended that the process of regulatory change should be improved by requiring better analysis, better consultation, and stronger enforcement of good process in regulation making.

The first group of recommendations made by the Taskforce relate to analysis. The Taskforce endorsed the Government's stated view 'that rigorous cost-benefit analysis [should] be employed in regulation-making' and recommended that 'such analysis should be used to compare different regulatory options, and should incorporate adequate risk analysis'. It also recommended that 'departments and agencies responsible for making regulations should build a capacity to undertake cost-benefit analysis (including risk assessment)'.

This approach is consistent with what Hutter describes as risk-based approaches to regulation, which entail (at a minimum) 'the use of technical risk-based tools, emerging out of economics (cost-benefit approaches) and science (risk assessment techniques)' and which reflect a 'cost benefit analysis culture' that 'moves away from informal qualitatively based standard setting towards a more calculative and formalised approach' (Hutter, 2006).

The second main group of recommendations made by the Taskforce concerns the need for 'coordinated and comprehensive consultation practices'. They include that 'for matters of major significance, an initial policy 'green paper' should be made available to relevant parties and, prior to finalization, the details of complex regulations should be tested with relevant business interests, including through exposure drafts for significant matters'.

The third group of recommendations relates to the enforcement of good regulatory processes. Particular emphasis is placed on the use of Regulation Impact Statements (RIS) as part of the process of regulatory change at the governmental level. The Taskforce recommended that, except in exceptional circumstances, a regulatory proposal with material business impacts should not proceed to Cabinet unless it is accompanied by an adequate RIS. The Taskforce considered that an RIS should be deemed to be inadequate if: it fails to document relevant existing regulations at all levels of government and explain why they do not suffice; it contains inadequate cost-benefit analysis of regulatory options; it fails to quantify compliance costs of options; in contains inadequate risk analysis and assessment; or it fails to document directly relevant international standards and, where a proposed regulation differs from them, to identify the implications and fully justify the variation.

4.2 Limitations of this approach

While the improvements to the process of regulatory change proposed by the Regulation Taskforce and under the other recent initiatives are undoubtedly helpful, my concern is that they do not go far enough in addressing what I see a distinct contributing cause of the problems identified above. Many of these problems are caused (or contributed to) by deficiencies in the formulation and expression of the underlying regulatory intent by Government (through primary and subordinate legislation) and regulators (through standards, instruments, policy statements and guidance notes). In other words the design and drafting of regulatory utterances made by Government and regulators is not always working effectively. Where this is so, regulation can be inefficient (in that it is over- or under-inclusive or is not congruent with the underlying policy objective) or unclear (which increases the information burden required to comply with it, and increases the risk of errors of compliance). Failure to communicate regulatory intent appropriately or to design appropriate enforcement arrangements results in disproportionality in the application of the regime by regulators and regulated entities. Failure to address the challenges raised by complexity exacerbates the ‘system burdens’ that Ruhl and Salzman argue interfere with the effective operation of the regulatory system as a whole.

In my view, whether regulatory utterances *effectively* communicate how proposed regulatory interventions are intended to work is a key determinant of the overall success of the regulatory system. Accordingly we need to do a better job of ensuring that they do work as effectively as possible. This requires us to build into the process of regulatory change a mechanism for dealing explicitly and coherently with issues related to the rhetoric (that is, the design and expression) of these regulatory utterances. Importantly, this needs to occur as an integral part of the *formulation* of regulatory policy, not just as a ‘second tier’ activity to be undertaken once policy decisions have been made.

5. Regulatory rhetoric and policy

If making sure that regulatory intent is effectively communicated by Government and regulators is so important, and if deficiencies in the design and drafting of their various regulatory utterances is causing or contributing to the kinds of problems identified in Part 3 above, what should we do? It seems to me that we need to improve the process of regulatory change by creating within it the space and mechanisms for issues of regulatory rhetoric (that is, issues to do with the design and drafting of regulatory utterances) to be analyzed and addressed as part of the policy process.

I am using the concept of ‘rhetoric’ here in a broad sense, to mean the way in which both the design and the language of a regulatory utterance influence the way in which people respond to it. This is broader than statutory interpretation of the kind undertaken by courts – indeed one of the challenges we face in engaging with the rhetoric of regulation as part of the process of formulating regulatory policy is that insights about how a court might apply (retrospectively) a particular rule to extant and knowable circumstances may not apply to a regulator or regulated entity interpreting it (prospectively) in the context of an uncertain future.

Incorporating an understanding of the effect of regulatory rhetoric on the operation of the regulatory system involves two steps. The first is recognizing that issues of regulatory rhetoric are relevant to the formulation of regulatory policy. The second is actually engaging with those issues.

5.1 The first step

The first step is to acknowledge that issues concerning the effective communication of regulatory intent are not 'simply' tradesman-like questions of wording, that are separate from or subordinate to considerations of policy. 'Regulation' is inseparable and indivisible from the regulatory utterances through which it is expressed. Further, it must be understood that regulation is not a simple cipher for economic principles – instead it is a form of legal discourse that has its own structure, grammar, imperatives and limitations. These determine what can be achieved through regulation, and how. The process of regulatory change needs to take into account the nature (and limitations) of governmental regulation as a form of legal discourse as part of the *formulation* of policy, not just in the *implementation* of policy.

Under the previous Government business regulation came to be seen primarily as an economic, rather than legal, function. Ministerial responsibility for corporate and financial services regulation was transferred from the Attorney-General to the Treasurer in the mid 1990s, and a program of legislative reform known as the 'corporate law *economic* reform program' replaced earlier projects in 'simplification'. High level inquiries into regulatory arrangements (such as the FSI and the Regulation Taskforce) have conspicuously omitted practising and academic lawyers from their membership. Perhaps as a result, recent recommendations for improving the process of regulatory change deal with legal questions related to the expression of regulation only obliquely.

For example, the Regulation Taskforce recommended that cost-benefit analysis should be used to compare different regulatory options, noting that 'in many cases a regulatory proposal may yield a net benefit to society, but at a higher cost than an alternative with better design features (for example, a more light-handed or less prescriptive approach)'. However the bases on which these different alternatives should be devised and evaluated, having regard to operation of the regulatory system as a whole, are not considered. As a result, meaningful comparison of 'regulatory options' as required in an RIS is difficult.

Of course, the enhanced consultation proposed by the Regulation Taskforce may provide an opportunity to think about regulatory rhetoric. The Taskforce recommended that, in 'significant' matters, 'details of complex regulations should be tested with relevant business interests including through exposure drafts' (this has generally occurred for financial sector regulation in recent years).

While consultation can produce useful feedback on exposure drafts (assuming there is adequate time to consider the issues and the comments received are taken into consideration), it nevertheless has significant limitations as a substitute for proper and expert consideration of technical issues related to regulatory design and drafting. Lawyers asked to comment on exposure drafts are often constrained in what they can say by the commercial interests of their clients. The period for consultation is often unreasonably brief; consideration of these complex issues can take a great deal of time (which respondents are expected to provide *pro bono*). Comment is generally sought only on specific proposals, without the opportunity to consider the broader systemic context within which the proposal sits. For these reasons it is not enough for Government and regulators to rely on a noisy crowd of (self-selecting) respondents to address the broader implications of particular proposals for the operation regulatory system as a whole.

5.2 The second step

The second step is to incorporate into the process for regulatory change a framework for better understanding the policy possibilities (and implications) of different choices in relation to the design and drafting of regulatory utterances.

This is, in itself, a highly challenging exercise. The translation of regulatory intent into regulatory utterances involves complicated choices that trigger all sorts of conflicting constraints. The obvious first choice to be made is between governmental regulation and some other action, such as self-regulation or quasi-regulation. If governmental regulation is proposed, then choices between the different types of regulatory intervention along Ogus's scale (from economic or private regulation at one end, through disclosure, standards and licensing, to prohibition at the other) must be made.

Once a particular type of regulatory intervention is chosen, considerations of design come into play. Who should flesh out the content of the regulatory requirement – the Parliament, the Executive or the regulator? How precisely should the requirement be expressed? What consequences should flow from failure to observe the requirement (or from a concern that the regulated entity may fail to observe the requirement in future)? Should those consequences follow whenever there is non-compliance, or only where it is the result of (say) reckless or intentional wrongdoing, or negligence? On whom should those consequences be visited – a corporate entity or its individual officers or both? To whom should implementation of the rule fall – the courts or a regulator?

It is important to understand that each of these design choices (and the many others that must be made before we even come to the actual wording of a particular rule or requirement) involves a series of trade-offs. For example, delegating responsibility for fleshing out the content of a regulatory requirement to a regulator may increase the responsiveness of regulation and capture the expertise of the delegate, but it comes at a cost in terms of accountability and accessibility (Rubin, 1989; Ramsay, 1992; Bottomley, 2003; Hanrahan, 2006).

Deciding the optimal level of precision that is appropriate in a particular rule or requirement can be difficult. In Australia choices about the appropriate level of precision in a particular rule are often expressed as a choice between black letter law and 'fuzzy law' (Green, 1991)– in the United States the distinction is drawn between 'crystals and mud' (Rose, 1998). In recent years the fashion (if not the practice) in regulation has been to favour less precise or detailed rules, which is sometimes (wrongly) equated with 'principles-based regulation'.[2] However the uncritical assumption that this is always the best option is sometimes unhelpful. Bottomley (2003) points out that 'we need to be wary of 'one size fits all' models of corporate regulation (such as arguments about 'fuzzy law' or the debate between mandatory and enabling rules').

A more open-ended regulatory requirement might be expected to produce lower compliance costs than a detailed, prescriptive one, in that a regulated entity need do only what is necessary *for it* to achieve compliance (and is not subject to a laundry-list of inapt requirements). However this will not be the case if the open-ended nature of the rule makes the regulated entity feel uneasy or insecure. Where the regulated entity cannot achieve a reasonable level of comfort (having regard to the consequences that flow from non-compliance) that it has done enough to comply with the rule, the result might be higher costs through deeper or wider attempts to comply than are necessary. Conversely, more detailed rules might result in what is sometimes described as a 'checklist mentality' in relation to compliance that is not appropriate in the particular circumstances. Putting a detailed rule next to a more general one will impact on the way in which both operate, as neither is interpreted or applied in a vacuum.

Accordingly deciding on the appropriate level of precision can require a combination of sophisticated analysis and inspired guesswork. Diver (1983) argued that the 'optimum precision' of a particular rule is that which achieves the best balance between rate of compliance, over- or under-inclusiveness, costs of rulemaking, and costs of applying the rule. In some circumstances, a detailed rule best achieves this balance, while in others a more general one will. Diver's approach provides us with some guidance about how to decide whether a proposed rule or requirement should be expressed in general or specific terms. These things, however, are difficult to measure and can give rise to conflicting constraints.

Decisions about the consequences that should attach to a breach of a rule or requirement are also fundamental to its design. At first blush it may

[2] Principles based regulation should sometimes use general rules, and sometime more specific ones (Financial Services Authority, 2007).

seem like a good idea to apply heavy sanctions or give regulators draconian powers in relation to regulatory requirements to encourage compliance, but this may contribute to problems of disproportionality by encouraging defensive compliance behavior or making it unfeasible for regulated entities and their officers to take a common-sense approach that acknowledges that 'full' compliance in an environment of complexity may not always be possible.

The idea of the John Braithwaite's enforcement pyramid is now well entrenched in Australian thinking about regulation – one could imagine that a rational regulated entity would focus most of its compliance efforts on trying to avoid non-compliance that would attract regulatory action at the top of the pyramid, and less on levels lower down. If this were so then we could use the relative intensity of different regulatory utterances to calibrate the regulatory system, by distinguishing those things that are 'really' important in the regulatory framework from those that should yield if a choice between them must be made. But this is not always possible. To a regulated entity, the prospect of an adverse administrative action (such as a decision by a regulator to refuse a licence application, issue a stop order in relation to a disclosure document, or commence an investigation) at a crucial stage in the implementation of a particular transaction can be a matter of much greater concern than the vague threat of a criminal prosecution in the future if the transaction fails. The temptation is to do whatever is necessary to get the transaction 'through the regulator', regardless of quality or aptness of the arrangements demanded by it. Inevitably this results in a ratcheting up of the compliance burden across the whole system.

Similarly the use of a civil penalty (rather than criminal) sanction in connection with a regulatory requirement might be thought of as signaling a lower relative 'seriousness' in the requirement. However the fact that civil penalty arrangements make it far easier for regulators to ask that serious consequences be imposed on regulated entities (without having to meet the criminal burden of proof or comply with criminal rules of evidence and procedure) means that a rational regulated entity might be tempted to treat the civil penalty provision as more serious than the criminal one because its chances of actually suffering an adverse consequence as a result of non-compliance is in practice much higher. (This is particularly so where a civil penalty regime is attached to regulation affecting corporations rather than individuals, given that corporations cannot be imprisoned.)

These design choices essentially require us to anticipate how various participants in the regulatory space will respond to them. The task of anticipating how differently-positioned participants might respond to these choices is complicated, first, by their diversity and the non-rationality of aspects of their decision-making and, secondly, by the non-linearity of the regulatory system.

Governmental regulation is a form of juridical discourse that occurs *between* the participants in a regulatory system (Black, 2002). The meaning of regulatory utterances is not immanent to the text – ultimately regulation means what it is understood by the participants in the regulatory system to mean. Accordingly the nature, circumstances and incentives of the person who ‘hears’ a regulatory utterance are as important in anticipating its effect as the words used (and must be taken into account in designing it).

Regulated entities are not homogeneous. For example, an entity that is prudentially regulated is likely to have a different mindset in relation to compliance management from one that is not. Where prudentially regulated and non-regulated entities sit inside the same corporate group, that mindset might be expected to seep into compliance management in the non-regulated entity. Even between entities that are in the same business, differences are to be expected – these are differences in organizational culture. Cultural differences may result in different approaches to compliance, and differing understandings of whether, and if so to what extent, non-compliance with regulation can be thought of (and managed as) a business risk.

Not only do different regulated entities understand regulatory utterances differently, they do not always respond to them in expected ways. Herein the limitation of economic models that assume rational choice. Their decision-making may be complicated by a whole range of factors, ranging from a cultural decision about the entity’s approach to compliance to perceived opportunities for competitive advantage.

Also, the effect of regulatory utterances is not limited to those to whom they are specifically directed. Sometimes they echo through the regulatory space. For example, how will the entity to which it is directed extrapolate the signals the legislator or regulator is sending about its approach to regulation in the specific instance, to its broader approach to compliance? Beyond this, how will regulated entities to which the utterance is *not* directed understand it? Will they see it as signaling a tougher or more lenient approach within government to a particular type of problem, and adapt their behaviour in analogous areas to avoid or attract a similar utterance? How will other participants (such as consumers, courts or the media) understand it? Will it create a moral hazard problem?

The task of anticipating how participants in the regulatory space will respond to different design and drafting choices in regulatory utterances is further complicated by the complex nature of the regulatory system. Complexity theory suggests that such systems are essentially non-linear in character and that reductionist analysis is ultimately unhelpful. In situations of complexity, quantitative approaches such as cost-benefit analysis and its more sophisticated offshoots (including the approach proposed by Diver in relation to decisions about precision) break down when confronted by the non-linearity of the regulatory system. Going back to Hutter's comments about the 'cost benefit analysis culture' that is now the dominant paradigm for regulatory change, the worry is that technical risk-based tools emerging out of economics and science have limitations that are not well understood or acknowledged. Qualitative insights must also come into play in making decisions about the design and drafting of regulatory utterances. These qualitative insights are most likely to come, it seems, from jurisprudence.

6. Conclusion

Like most complex regulatory regimes, Australia's system of financial sector regulation could, in many respects, be made to work better. Problems of inefficiency, incoherence, unaccountability, disproportionality of application and complexity all arise (in different places and to varying degrees) within the system.

Recent initiatives by Government and regulators have focused on how improvements to the process of regulatory change might address the causes (not just the manifestations) of these problems. This is an important step forward.

However this paper argues that those recent initiatives fail to address a crucial contributing cause of these problems – the sub-optimal translation of regulatory intent into regulatory utterances by Government and regulators. The design and drafting of regulatory utterances is often (wrongly) treated as a second-tier activity that is subordinate to, rather than an integral part of, decisions about regulatory policy. As a result, potential improvements to the functioning of the regulatory system as a whole that could come from a richer engagement with juridical perspectives on the rhetoric of regulation are not realised.

To overcome this, we need to make a significant investment in gaining, and applying, better theoretical and practical insights into the way decisions about regulatory rhetoric impact on the operation of the regulatory system as a whole and on the participants in it.

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