Chapter 1

The Conceptual Underpinnings of Australian Securities Regulation

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I want to organise my remarks under four broad headings: the importance of a clear conceptual framework for the regulatory process; some influences on ASIC's thinking over the last 15 years; some current challenges for ASIC; and the need to bring the academy and the regulatory community closer together.[1]

I A CLEAR CONCEPTUAL FRAMEWORK

Regulatory organisations like ASIC tend to be very transaction-focused. At any one time, most ASIC staff will be spending their working days dealing with transaction-level issues. Some of this work is a response to external transactions: an application for a licence to conduct a financial services business; an application for relief to facilitate for an IPO, or a new financial product; examination of a prospectus or takeover documents; and so on. ASIC staff might be working on a specific policy to provide guidance on how we approach the law as it applies to a given fact situation; or on our response to a particular law reform proposal.

Sometimes, the 'transaction' in question is created by the interplay between external conduct and regulatory response: we draw up

[1] The views expressed in this article are the author's alone and do not necessarily reflect the position of either the Australian Securities and Investments Commission or its individual Commissioners.

notices to seek information in response to a complaint about misconduct; we conduct 'desk-based' or on-site reviews to determine whether a financial market participant (or class of participants) is complying with their obligations, for example in how they manage conflicts of interest; or we commence a formal investigation into suspected misconduct with a view to bringing administrative, civil or criminal action against a miscreant, if the evidence supports it. But this myriad of transaction-based activities does not make sense internally or externally unless it can be accounted for in a conceptually coherent way.

The legislation that created ASIC and the laws it is ASIC's job to administer do not of themselves supply that coherence. They do supply some of the starting points: there are high-level 'mission-statement' expectations set out in s 1 of the *Australian Securities and Investments Commission Act 2001* (Cth); that Act and the other legislation we administer create obligations for us and give us extensive and sometimes intrusive powers to go about our job. I defy anyone to derive conceptual coherence by looking at the many obligations the legislation we administer creates for the regulated population. Some parts of it hang together and look like the product of a single mind; others are a patchwork of history, politics, and sometimes dubious drafting.

Above all, the legislative framework does not account for a key feature of regulatory activity: the exercise of regulatory discretion in just about everything we do. Our kind of regulatory policy is discretionary; so is most compliance and enforcement work. Even where we have a statutory obligation to do a piece of work — decide a licence application, or a request for relief — we have enormous discretion about the way we do that work and the resources we devote to it.

So in broad terms it is up to the regulator to supply conceptual coherence to the work it does. This does not necessarily mean esoteric or elaborate theories about regulation, about the behaviour of regulated populations, or about the efficacy of, for example, civil over criminal remedies. Nor am I suggesting we should be striving for a unified theory of everything-to-do-with-regulation. But a conceptual framework does, at a minimum, need to provide a clear and well understood basis for the decisions that the regulator's staff will take every day, and arm the regulator with the ability to communicate its thinking in a variety of venues. What questions will such a conceptual framework answer? Let me suggest four that seem absolutely necessary: Why are we doing what we're doing? Why is it important? What outcomes are we seeking? What

regulatory tools will best produce those outcomes? In devising answers to those questions, we need a robust conceptual framework with at least the following key characteristics. It will be:

a) externally and whole-of-system focused: our job is to connect the big book of laws we administer to the real world (if you can call the world of capital markets and financial services the real world). In this country, we are seen as primarily as an economic regulator. If we succeed, we will contribute to the effectiveness of the economic system as a whole.
b) conduct focused: our job is to influence the behaviour of those we regulate — how they interact with their clients or the markets they participate in; how they behave in the boardroom; what conduct and attitudes they bring to the table when preparing disclosure documents; and so on.
c) value data and information about results: it is not what we do that counts, but what outcomes we produce. We need to be able to measure or otherwise account for outcomes in a meaningful way, and be able to tell whether we're making a difference.
d) guide the choice of regulatory tools: we are a regulatory agency with a broad range of tools at our disposal to produce results. Tools of persuasion, compliance monitoring and enforcement tools are all part of our armoury, and we need to make confident, well-informed decisions about what tool, or combination of tools, to use to produce a particular result.
e) be the basis of the regulator's accountability: a regulator needs a clear and comprehensive starting point as the basis for its own assessment of its performance, and to ground a credible account to its stakeholders of what it has achieved.

It will also need to be pragmatic — practice-focused in a real sense — and able to guide decisions about how we allocate resources, how we structure the organisation, what qualities we are looking for in our staff, and so on. In short, to guide all the decisions we make as managers of a regulatory agency.

A regulator who does not have a solid framework of this kind runs some grave risks. For example, regulatory decision-making may not be consistent, or be seen as capricious and unprincipled in a literal sense. That will undermine confidence in our ability to deliver. The regulator

may be less able to account externally for our work in a persuasive way — and therefore likely to lose the confidence of key players in the system. Lack of confidence can manifest itself in any part of the system. It may be on the part of the government who funds us, or the on the part of consumers or the community more generally who help shape the political environment in which we operate.

Above all, lack of confidence on the part of the regulated population has immediate and serious consequences, and directly undermines the regulator's ability to deliver. That is because it usually means the regulator is less able to rely on persuasion as a way of delivering regulatory outcomes. And regulators of our type always need to be aware that persuasion is the cheapest of the tools available to the regulator — less costly than intensive supervision programs or enforcement actions. In short, what I have been arguing is that a clear and rigorous conceptual framework is crucial for the effectiveness of the regulatory process. Such a framework forms the basis of our ability to communicate persuasively with all our stakeholder groups, and to deliver on our underlying mandate.

II INFLUENCES ON ASIC'S THINKING

Under this heading I want to mention a few ideas, born in the academy, that have influenced in a fundamental way our approach to the regulator's task over the last 15 years. I plan only to mention a few. This is of course an invidious task. My selection is illustrative only and does not mean that we have not been open to other ideas, or that ASIC staff have not been diligent in keeping up with academic and other debates. I want to illustrate the openness of ASIC as an organisation to the rigorous and holistic analytical thinking that characterises much academic work. And I also want to provide an insight into how ideas that begin life in the academy can have a profound effect on the way a regulator goes about its job.

The work of Ian Ayres and John Braithwaite has influenced ASIC's thinking over many years.[2] Sometimes, I perhaps should add, in ways that its authors might not recognise, or would want to disclaim responsibility for. Nonetheless, ASIC's thinking about its role as a regulator owes much to the concepts of 'responsive regulation' and the

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[2] Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992).

'regulatory pyramid'. Our understanding that being a regulator means more than being an enforcement agency, our concepts about having a 'regulatory toolbox' to choose from, the importance of choosing the right tool for the right task, and related ideas, are now so deeply embedded in ASIC's thinking that their intellectual origins have perhaps been obscured. In effect, an entire generation of regulators has absorbed these ideas, often without engaging with the original academic work. Thinking 'pyramidally' about our regulated population is also part of the way we think as an organisation and a culture. At the base of the pyramid, and — we hope — occupying a large proportion of it, is that part of the population who are naturally disposed (for whatever reason) to compliance. They need help, but most times education and persuasion will get them there. The second band is comprised of those who need the threat of detection and the occasional taste of coercive powers to keep them on the straight and narrow. In ASIC, these are colloquially known as those who 'keep playing until the referee blows the whistle'. And finally there is the apex part of the pyramid: the naturally non-compliant for whom enforcement looks like the only remedy that will work almost all the time.

For close to ten years, the work of Malcolm Sparrow from the Kennedy School of Government at Harvard has been a significant influence on many of us in ASIC. Malcolm ran a 5 residential school for senior staff from ASIC and other Australian regulators in 2000 and has been a regular visitor to Australia since then. From his work we take the fundamental notion that the job of the regulator is to 'pick important problems and fix them'; that this requires systematic collection of ex ante and ex post data, and both rigour and innovation in designing regulatory responses; that causation — especially in financial services regulation — is often hard to demonstrate; and that regulators often need to communicate through the use of 'stories' (accounts about why they think the interventions they made resulted in observable changes in the underlying data sets). We have also drawn heavily on his knowledge of and experiences in other regulatory disciplines: policing; occupational health and safety regulation; environmental regulation; taxation administration; and so on.

I could not leave out of this list of examples of work done in the academy that has influenced ASIC the empirical work done over many years at the Centre for Corporate Law & Securities Regulation under Ian Ramsay's leadership. This body of work is different in its influences

from the two I have already mentioned, but is no less important. I single it out because of the close relevance of many of the topics researched to ASIC's activities and daily preoccupations. For example, in 2006 the Centre published research on corporate law reform and delisting, employee share ownership schemes and an empirical study of the operation of the takeovers panel (I also note also Emma Armson's work). All these were topics that, one way or another, came across my desk as a regulator last year. ASIC values highly access to data-rich analyses of current regulatory topics.

III CURRENT CHALLENGES

Now I want to turn to three current issues that are on ASIC's agenda. All arise from the recent debates about regulation in this country, and, one way or another, reflect issues raised in the report of the Government's Taskforce on Reducing Regulatory Burdens on Business, *Rethinking Regulation*.[3]

(A) *Accounting for Regulatory Performance*

One recommendation in the Banks Report was that regulatory agencies in the financial sector need to account more fully and effectively for the performance of their regulatory functions: outcomes-based reporting. This recommendation tied in with an existing Government initiative that responded to an earlier review — the Uhrig review. That review called for better accountability by regulatory agencies, and proposed that there be a formal exchange of letters between government and regulators in the form of a Statement of Expectations (government to regulator) and a Statement of Intent (regulator to government). Leaving aside the bureaucratic niceties, what this calls for is for regulators to do more in their public reporting than simply relate the activities they undertook. It asks for regulators to really think about, document and report on the community-wide and economy-wide outcomes they deliver in carrying out their mandated functions. The question is, what difference did you really make?

[3] Taskforce on Reducing Regulatory Burdens on Business, Parliament of Australia, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (January 2006) ('the Banks Report').

This is a considerable challenge, and not amenable to simple solutions. As with our counterparts internationally, we spend considerable time and energy thinking about these things internally. There is no clearly established and effective methodology that has been tested in a variety of market and environmental conditions. It's hard, but it makes sense to strive to fulfill that expectation. In the work that we do in this area over the next year or so, we need all the help we can get.

(B) *Costs and Benefits of Regulation*

At the heart of much of the debate about 'over-regulation' in this country is industry concern that much regulation to which it is subject is burdensome, and more costly than it should be. In particular, neither the manufacturers of regulation nor its administrators have an adequate understanding of the costs imposed by the decisions they take, or subject their regulatory proposals to rigorous analysis, especially cost-benefit analysis. In our business, this is a hard ask. In principle, it should not be impossible to ascertain with some reliability the costs imposed by decisions to introduce new or changed regulation, or to administer it in a particular way. But there are two formidable hurdles.

First, cost information is held by regulated entities, not the regulator. How can industry be persuaded to part with reliable information that it might not be in their interest to provide? Second, accounting systems do not have a general ledger category called 'regulatory costs', let alone a category that might give an answer to the real question: what is the incremental ('dead-weight') cost to industry of that regulatory decision, especially by contrast with alternatives to achieving an equivalent quality result. And if costs are hard, benefits are even more difficult, especially if the goals are to have comparably derived measures for costs and benefits that facilitate balanced decision-making.

In the regulation of financial markets and financial services, the benefits might be the absence of things that, absent regulation, might otherwise occur (for example, large scale fraud, or distortion of efficiencies in markets). Are these invisibles amenable to quantification? Alternatively, regulatory benefits might consist of something even less tangible, for example market confidence, or the willingness of consumers to participate fully in markets for financial services and products. How can these be accounted for in a meaningful way and compared to the

costs imposed by regulatory decisions? What we don't yet have — and what we need to develop — is a well-thought-through and rigorous analysis, not of the need for cost/benefit analysis, but of what methodology or combination of methodologies might, over the long term, provide reliable information to those who make decisions about regulation.

(C) *Principles versus Rules — Practical Implications for Regulators*

As a matter of policy, the Australian Commonwealth Government and ASIC support 'principles-based' regulation. In essence, this means legislative requirements should, wherever possible, mandate outcomes to be achieved, rather than prescribe detailed processes or rules. This leaves to a regulated entity the choice of working out a way to comply that is optimally efficient for it. But this approach to the legislative framework poses a number of challenges for the regulator responsible for administering legislation made in this way. For example, what is the role of the regulator in filling the gaps between high-level legislative principles and market reality? How much is it up to the regulator to deliver on market needs for certainty? Will principles-based regulation increase the risk of surprise in the administrative and enforcement decisions the regulator makes? In a practical sense, does principles-based regulation make enforcement action more difficult because of the degree of ambiguity inherent in legislation written in outcome terms rather than as specific rules of conduct? And we need to remember that, in dealing with these questions, ASIC is in an unusual position compared to many of its counterparts internationally. ASIC has no positive rulemaking power: it cannot make binding rules of conduct that are enforceable at law. Its enforcement actions will always require proof of non-compliance with the text of the legislation.

IV PARTNERSHIPS BETWEEN REGULATOR AND THE ACADEMY

The list of examples of issues currently facing ASIC is the basis of my closing comments about relations between the academic and regulatory communities. In searching for ideas about how to tackle these important and challenging issues, I am often surprised to find that there is less research and academic thinking on these issues than I would hope.

Assuming my research techniques are not so woefully inadequate that I am simply not finding available material, what might explain it? And, more importantly, what might be done about it? If I am right in thinking that the kinds of issues I have mentioned today are important (as I think they are), and that they are intellectually challenging and would benefit by rigorous research, thought and analysis, how can we close the gap? We have started in some areas. We are beginning partnerships with academic economists and finance experts to help encourage broad thinking about cost-benefit issues in regulation. But we need more. That is a challenge for us as regulators and for you as the possible source of some of this work. I hope my remarks this morning have drawn attention to a need for us to come closer together in examining issues that in the end are important not just for ASIC or the academy, but for the broader community in which we are both actors.