SELF-REGULATION, CLERP AND FINANCIAL MARKETS: A MISSED OPPORTUNITY FOR INNOVATIVE REGULATORY REFORM

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I. INTRODUCTION

After a period of sustained reform to corporate law, attention has finally moved to reform of the regulation of financial markets. These reform proposals are the most important of any introduced since the national scheme of corporate law commenced operation in 1991, for two main reasons. First, they have a broad scope and are designed to operate across a very broad range of financial markets. Secondly, the proposals introduce an innovative approach to regulation by moving from a 'black letter' style of regulation to a form of self-regulation. A critical analysis of the regulatory strategy is provided in this article.

The initial impetus for reform of financial markets came from the Financial System Inquiry.[1] Subsequently, two papers have been released as part of the Corporate Law Economic Reform Program.[2] The most recent of these is a consultation paper entitled "Financial Products, Service Providers, and Markets – An Integrated Framework Implementing CLERP 6".[3] This title captures the two significant elements of the proposed reforms: their scope and the innovative approach to regulation. The consultation paper sets out the basic outlines of the reforms to the regulation of financial markets, and these will be discussed in this article.

The proposed regulatory framework covers a broad range of "financial products" which includes securities, derivatives, futures and life insurance

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1 S Wallis (Chair), *Financial System Inquiry Final Report*, March 1997.

2 Corporate Law Economic Reform Program Proposals for Reform Paper No 6, *Financial Markets and Investment Products Promoting Competition, Financial Innovation and Investment*, 1997 ("CLERP 6"); Corporate Law Economic Reform Program Consultation Paper, *Financial Products, Service Providers, and Markets – An Integrated Framework Implementing CLERP 6*, 1999 ("Implementing CLERP 6").

3 Implementing CLERP 6, note 2 *supra*.

products.[4] The result is that the proposed framework will take over from a number of existing regulatory schemes.[5] The overall goal of the proposed regulatory framework is to establish competitive markets for financial products. The stated aim is that:

> A more efficient and flexible regime for financial markets and products will be achieved through an integrated regulatory framework for financial products. This will provide consistent regulation for functionally similar markets and products.[6]

The rationale for using a system that provides "consistent regulation for functionally similar markets and products" is that:

> Participants will have the capacity to adopt systems and procedures which can accommodate differences between certain transactions without unnecessary prescription or other regulatory restraints. The intention is to provide maximum market freedom so that participants can design systems which accommodate their particular operations, provided that the regulatory objectives of market integrity and investor protection are achieved.[7]

The most significant feature of the proposal to establish an "integrated regulatory framework" is that it aims to create not just competitive markets but competitive markets that are *self-regulating* within parameters defined by public policy.[8] The aim is to rely on competition between functionally similar markets and products to ensure that markets are efficient, effective and responsive to change. This goal of creating a self-regulating system of regulation for financial products marks an important turning point in the development of the Corporate Law Economic Reform Program. It is also the reason that this reform proposal should demand the attention of anyone who is interested in the process of regulatory reform.

An immediate problem which follows on from this approach to regulation is the transitional issue of how to move from the existing state of regulation of financial markets to the proposed state of self-regulating competitive markets. This transitional issue is extremely important because it represents a central problem of regulation. The problem is deciding how to use regulation to initiate

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4 *Ibid* at 9-14. The scope of the proposed regulatory framework will be defined with reference to the "financial products" which it seeks to regulate. The proposed definition of 'financial product' is a broad one that includes four parts. The first is a broad functional definition, the second is a list of inclusions, the third a list of exclusions and the fourth is a regulation-making power which will be the mechanism by which new financial products are included in, or excluded from, the regulatory framework. The list of inclusions provides an indication of the scope of the proposed regulatory framework (at 13). This list includes securities, debentures, derivatives, interest rate or currency swaps, contracts of insurance, the investment component of life insurance, superannuation interests, retirement savings accounts, ADI products, and mortgages over real and personal property.

5 "The framework will replace Chapters 7 and 8 of the *Corporations Law* and the *Insurance (Agents and Brokers) Act* 1984 (Cth). The framework will also bring in elements of the *Superannuation Industry (Supervision) Act* 1993 (Cth), the *Retirement Savings Account Act* 1997 (Cth) and the Banking (Foreign Exchange) Regulations": *ibid* at 1.

6 Implementing CLERP 6, note 2 *supra* at 3.

7 CLERP 6, *supra* note 2 at 42.

8 For a review of the public policy goals underpinning the Corporate Law Economic Reform Program, see note 35 *infra*. For a discussion of "competitive self-regulation" see A Ogus, "Rethinking Self-Regulation" in R Baldwin, C Scott, C Hood (eds), *A Reader on Regulation*, Oxford University Press (1998) 374 at 379-82.

change within a set of cultural or economic practices so that the these practices are transformed and move towards the desired state of affairs. Ultimately, the CLERP 6 proposals may serve to focus attention on the problem of developing ways of using forms of self-regulation as transitional mechanisms to encourage the development of self-regulating systems of regulation.

The argument in this article is that the CLERP 6 proposals do not address this transitional issue in a systematic or innovative way and in this sense represent a missed opportunity for regulatory reform. The main problem with the CLERP 6 proposals is the failure to integrate the various elements of the proposed regulatory framework into a system of self-regulation. This failure to adopt a systematic approach has had two related consequences for the shape and form of the 'integrated regulatory framework' proposed by CLERP 6. First, in some important areas, it has allowed those responsible for developing the Corporate Law Economic Reform Program to shy away from using self-regulatory techniques and approaches. Secondly, it has had the result that the proposals have, in some important respects, tended to revert to traditional command and control styles of regulation.

The first part of this article is an analysis of why it is important to assess the CLERP 6 proposals from the perspective of whether or not the primary features of the proposed regulatory framework are integrated into a system of self-regulation. The primary features of the regulatory framework in this context include processes for rule-making, for enforcement and for the introduction of compliance mechanisms. The second part is a brief review of the primary features of the integrated regulatory framework proposed by CLERP 6. The third, and final, part develops the argument that the proposed integrated regulatory framework introduces only a partial and limited form of self-regulation. The proposal for reform developed by CLERP 6 sits uneasily with the goal of creating a self-regulating system of regulation founded on the operation of competitive markets. Ultimately, it is this discordance between the goals of reform and the details of the regulatory framework proposed by CLERP that is the most puzzling feature of this attempt at regulatory reform.

II. SELF-REGULATION

Self-regulation is more likely to be effective where regulators are required to interact with regulatees on a number of different levels in a systematic way. This means that elements of the scheme of self-regulation have to be integrated so that there is an effective coupling between the system of regulation and the activities being regulated.[9] For this purpose a non-exhaustive list of the elements of a scheme of regulation may include the rule-making function, enforcement and mechanisms for reliance on regulatees' own internal systems of control, for

9 For a discussion of the idea that effective regulation is the result "structural coupling" between politics, law and social life, see G Teubner, "Juridification" in R Baldwin, C Scott, C Hood, note 8 *supra* at 406-10.

example, recognition of compliance systems and codes of conduct. At first glance this may appear to be a weak starting point for assessing the potential effectiveness of a proposed system of self-regulation. However, as this article explains, the CLERP 6 proposals for reform do not comply with this minimal requirement.

There are a large number of institutional arrangements which can be described as "self-regulation".[10] Sometimes the phrase self-regulation is used to refer to self-ordering schemes of regulation operated by market participants without any direct support from the state.[11] This form of self-regulation is sometimes associated with what is known as "deregulation".[12] At other times self-regulation refers to a range of indirect approaches to regulation, in which law is used to establish a process that produces a detailed regulatory scheme.[13] These indirect approaches to regulation are usually contrasted with command and control regulation that seeks to regulate particular activities by relying upon direct commands supported by the application of sanctions.[14]

The growth of direct types of command and control forms of regulation is usually associated with the changing function of law. The legitimacy of law is dependent upon its capacity to achieve effective outcomes in pursuit of public

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10 For example, A Ogus, note 8 *supra* at 376-7 identifies three characteristic features of self-regulation. These are autonomy of regulatees, the degree of legal force of rules and the degree of monopolistic power.

11 See, eg, note 1 *supra* at 258. Self-regulation is at one end of the regulatory spectrum where "there is no specific legislative backing to schemes operated by industry groups". At the other end of spectrum is the "statutory approach" to regulation "where specific and detailed laws are enacted and administered by a regulatory agency": *ibid* at 380.

12 For a critical analysis of the potential of "deregulation" as a form of regulation, see G Teubner, note 9 *supra* at 416-20; I Ayres and J Braithwaite, *Responsive Regulation Transcending the Deregulation Debate*, Oxford University Press (1992) pp 3-18. The concept of "deregulation" has been significantly changed by the recognition of "regulatory space", see C Scott, "Analysing Regulatory Space: Implication for Institutional Design and Reform", presented at Law and Society Annual Conference, June 1998 at 1: "I take the chief characteristic of regulatory space to be the idea that resources relevant to holding of regulatory power and exercising of capacities are dispersed or fragmented". In this sense an activity is never "deregulated" in the absolute sense rather the activity is subject to a different kind of regulation.

13 See for example, "responsive regulation": I Ayres and J Braithwaite, note 12 *supra*, pp 4-7; for an analysis of self-regulation relying upon reflexive law: see note 9 *supra* at 420-7. The recognition of the importance of indirect approaches to regulation is also associated with the notion of the complexity of "regulatory space", see C Scott, note 12 *supra*. The *Financial System Inquiry Final Report*, note 1 *supra* at 258, uses co-regulation to refer to this broader meaning of "self-regulation".

14 A broad definition of command and control regulation is one that focuses on the process of "defining standards of business conduct and production results in all details and enforcing those standards via negative or positive sanctions": G Teubner, "Corporate Fiduciary Duties and Their Beneficiaries: A Functional Approach the Legal Institutionalisation of Corporate Responsibility" in K Hopt and G Teubner (eds), *Corporate Governance and Directors' Liabilities*, Walter de Gruyter (1985) 149 at 159. A narrower definition focuses on the enforcement of standards by use of the criminal law, see A Ogus, *Regulation: Legal Form and Economic Theory*, Clarendon Press, (1994) p 5. A further definition of command and control regulation focuses on the "centrality it accords to the idea that regulation involves and interference that seeks to control or impede the operation of market forces": C Shearing, "A Constitutive Conception of Regulation" in P Grabosky and J Braithwaite (eds), *Business Regulation and Australia's Future*, Australian Institute of Criminology (1992) 67 at 107.

policy goals.[15] The legitimacy of law has thus become associated with its level of effectiveness in achieving these public policy goals.[16] It is perceptions about the failure of direct forms of regulation to achieve public goals that have focused attention on the potential of indirect forms of self-regulation. Interest in self-regulation is therefore based on the empirical assumption that self-regulation will achieve better regulatory outcomes, that it will be a more effective way of implementing public policy goals.[17]

In noting the shift from direct to indirect forms of regulation it is important to acknowledge that direct forms of regulation have failed in the relative sense, by failing to meet expectations regarding the potential for regulation to achieve outcomes. Command and control regulation therefore continues to be an available form of regulation which is used in a wide variety of contexts.[18] Subject to this qualification, there are both empirical and theoretical explanations for the failure of direct forms of regulation.

There is now a broad ranging body of literature which outlines the practical problems associated with the use of command and control forms of regulation. A recent review of this literature has identified five clusters of problems:

- A tendency towards unnecessarily complex rules.
- Over-regulation, legalism, inflexibility and unreasonableness in the design and implementation of regulation.
- The prevalence of evasion and "creative compliance" with regulatory standards through the taking advantage of technical and detailed rules.
- The capture of regulatory agencies by regulatee entities.
- Dependence on strong monitoring and enforcement where sufficient resources, expertise and strategy are not available.[19]

There is a wide range of circumstances in which these problems have been encountered with command and control forms of regulation.[20] A substantial body of literature has provided a theoretical explanation of why command and control forms of regulation have encountered these problems. One such

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15 There is recognition of the changing function of law and regulation in many traditions of legal writing, see, eg, note 9 *supra* at 391-406. The recognition of the move from 'formal' to 'functional' forms of legal reasoning was central to the concerns of critical legal studies, see eg, E Mensch, "The History of Mainstream Legal Thought" in D Kairys (ed), *The Politics of Law: A Progressive Critique of Law*, Pantheon Books (1990) 18, and R Gordon, "Critical Legal Histories" (1984) 36 *Stanford Law Journal* 57 at 59-67.

16 Note 9 *supra* at 402.

17 Eg, I Ayres and J Braithwaite, note 12 *supra*, and *ibid* at 420-8.

18 Eg, A Ogus, note 8 *supra* at 379 (the regulation of hazardous substances).

19 C Parker, *Reinventing Regulation Within the Corporation: Corporate Compliance and Corporate Citizenship* (forthcoming) p 3.

20 N Gunningham and R Johnstone, *Regulating Workplace Safety*, Oxford University Press (1999); A Ogus, note 8 *supra* at 377-8 (the adoption of a form of self-regulation in the area of occupational health and safety). See also A Corbett, "A Proposal for a More Responsive Approach to the Regulation of Corporate Governance" (1995) 23 *FLR* 279 at 301-5 (some problems are encountered with this form of regulation in the context of the regulation of corporate governance).

explanation is the recognition of "regulatory space".[21] This is a complex concept which de-centres the idea of regulation. Recognition of regulatory space involves acknowledgment that the resources relevant to the exercise of regulatory power are not centred on the state or on regulatory bodies. Rather these resources, which include information, wealth and organisational capacities are shared and fragmented between regulators and regulatees. There are several consequences which follow from the recognition of "regulatory space". The first is that regulatory authority and resources are not exercised hierarchically. Instead, these relations can be better characterised as "complex, dynamic horizontal relations of negotiated interdependence".[22] A second consequence is that regulatory space is "holistic" in the sense that it "looks at the interactions of each of the players in the space, and can recognise plural systems of authority and complex of interests and actions".[23]

In this context, it is relatively easy to identify the potential failings of direct approaches to regulation which assume hierarchical relations between regulators and regulatees and which assume that it is unnecessary to consider the relationship between formal and informal systems of authority established between regulatees. In contrast there is growing interest in self-regulation precisely because it is based upon the recognition of the limited capacity of regulation to achieve outcomes. Gunther Teubner has defined the goals of self-regulation in the following way:

> One is therefore forced to abandon ideas of effective outside regulation, the notion that law or politics could have a direct goal oriented controlling influence on sectors of society. The effect of regulatory law must be described in far more modest terms as the mere *triggering of self-regulatory processes*, the direction or the effect of which can scarcely be predicted.[24]

It is against this background that I wish to consider problems of regulatory design and implementation.

This part of the article aims to establish the proposition that the integration of the elements of a regulatory scheme raises the likelihood that there will be an effective coupling between the regulatory scheme and the activities of the regulatees. In the terms used by Teubner, an integrated regulatory scheme will be more likely to trigger the self-regulatory processes which may transform the relevant activities of regulatees in the direction set by public policy goals. There are two main reasons why it is important to integrate the elements of the regulatory regime. The first is based on the experience with strategies used to introduce self-regulation. The second arises out of the need to systematically recognise the limits of regulation when designing and implementing self-regulation.

There is a wide range of strategies for the introduction of self-regulation.

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21 C Scott, note 12 *supra*.

22 *Ibid* at 2.

23 *Ibid* at 3 (footnotes omitted).

24 Note 9 *supra* at 407.

Some strategies focus on enforcement,[25] some on the process of rule-making,[26] and others explicitly focus on the process of internalising public policy goals within the management structures of regulatees, such as reliance upon the introduction of compliance programs.[27] A central feature of these strategies is the way in which they are reliant on a systematic integration of all of the elements of the regulatory scheme. For example, strategies based primarily on the use of enforcement strategies will need to focus on the process of rule making and will often be accompanied by the requirement for regulatees to develop effective compliance procedures.[28] A further example of this phenomenon is the development of government guidelines that aim to identify the elements of "compliance-friendly regulatory innovation":

> Some governments have already attempted to take a comprehensive quality management approach to encouraging compliance-oriented regulation. They have required regulatory policy development to move beyond regulatory impact assessment (which focuses on assessment of compliance costs) to looking at the total factors of regulatory rule-making, monitoring and enforcement that affect compliance.[29]

The interconnectedness of elements of regulation in a range of strategies to introduce self-regulation is suggestive of the importance of design in effective systems of self-regulation. These examples suggest that the integration of the elements of a system of self-regulation will enhance the likelihood of effective coupling of the regulatory scheme and of the activities being regulated.

There is a principled basis to support the argument that the integration of the elements of a regulatory scheme into a system of self-regulation is a central feature of the design of effective systems of self-regulation. This argument begins with recognition of the limits of regulation, in that self-regulation operates in an indirect way by triggering self-regulatory responses within the areas of conduct to be regulated. The design of a scheme of self-regulation will be more likely to respect those limits where there is a systematic analysis of how the different elements of a proposed scheme of regulation will interact to produce a regulation system. This planning in the design of self-regulation will only ever provide estimates of the likelihood of how elements of regulation will interact. It will, however, provide some protection against structural defects in design. In particular it will define clear gaps within the proposed system and will identify obvious areas in which the interaction will give rise to identifiable

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25 I Ayres and J Braithwaite, note 12 *supra*, pp 19-53 (Chapter 2). This chapter provides a systematic analysis of the use of "pyramid of enforcement strategies".

26 *Ibid*, pp 101-32 (Chapter 4). This chapter focuses on the development of self-regulatory processes for rule-making and enforcement.

27 C Parker, *The State of Regulatory Compliance*, OECD (1998), and C Parker, "Summary of Scholarly Literature on Regulatory Compliance", presented at Meeting of the Working Party on Regulatory Management and Reform Public Management Committee, OECD, 1999 at 1-2. See also Australian Standard, Compliance Programs (AS 3806 – 1998).

28 Eg, I Ayres and J Braithwaite, note 12 *supra*, pp 38-40, and C Parker, "Summary of Scholarly Literature on Regulatory Compliance", note 27 *supra* at 8-9. See also N Gunningham and P Grabosky, *Smart Regulation Designing Environmental Policy*, Clarendon Press (1998) Chapter 6 (successful regulatory design and for environmental regulation).

29 C Parker, *The State of Regulatory Compliance*, note 27 *supra*, p 11.

defects in the proposed system.

A systematic analysis of the elements of a scheme of self-regulation is not merely important for identifying problematic regulatory designs. It may also prevent those law-makers responsible for regulatory design from using problematic pathways under pressure of strong institutional forces. One source of pressure to avoid adopting innovative approaches to self-regulation is manifest in the clash between the principles of effective self-regulation and some principles associated with the rule of law.[30]

Self-regulation often requires negotiation between regulators and regulatees on issues of rule-making and enforcement.[31] In contrast, a traditional understanding of the rule of law may recognise values which are at odds with the use of negotiation in this way. For example, one principle associated with the rule of law is the importance of knowing in advance the content of legal rules so that a person can plan their activities to comply with those rules. This form of rule-making is consistent with direct approaches to regulation. It is consistent with the notion that power and authority is held by the state and that the exercise of the power should be subject to special restrictions and limitations. This understanding of the rule of law has the potential to clash with the principles underpinning a regulatory system that has been designed to achieve public policy outcomes. In particular, there is a potential clash when regulators are charged with the responsibility of pursuing public policy goals through the exercise of broad powers of discretion to alter or modify statutory rules after a process of negotiation with regulatees.[32]

The potential for a clash between the principles of self-regulation and rule of law principles becomes clearer in the context of a particular example of regulation based on negotiation. One writer has recently suggested that a way to deal with problems of interpretation and implementation of rules is to use a "conversational model of regulation". Julia Black has argued that:

30 For an analysis of some of the elements of this clash of principles, see E Rubin, "Law and Legislation in the Administrative State" (1989) 89 *Columbia Law Review* 369 at 369-85.

31 The concept of 'regulatory space' implies that authority does not necessarily belong to the state-supported regulator. The recognition of other sources of authority within a sphere of regulation will therefore require the regulator and regulatee to negotiate outcomes acceptable to both: C Scott, note 12 *supra* at 9-14. See also I Ayres and J Braithwaite, note 12 *supra*, pp 19-53.

32 See note 120 *infra* for an example of where these and similar factors affected the design of the integrated regulatory framework proposed by CLERP 6.

> Both over- and under-inclusiveness and 'open texture' pose a problem for rules because of the particular nature of rules as authoritative communications. Over-inclusive rules have the effect of punishing conduct which it was not intended should be prohibited by the rule; under-inclusive rules of failing to prohibit or encourage behaviour which would further the rule's purpose; each is an aspect of the rules ineffectiveness. The linguistic analysis of the use of generalizations in conversations suggests two ways in which these effects of over- and under-inclusiveness can be mitigated... The second is a change in the regulatory style which is adopted, not simply the type of rule. If a regulatory or enforcement strategy is adopted which makes either formal or informal use of waivers or modifications of the rules, a similar process of adjustment of the generalization can occur in regulation as occurs in conversation.[33]

It should be clear that this "conversational model of regulation" has the potential to clash with some understandings of the operation of rules in a traditional rule of law framework.

These clashes are not necessarily fundamental nor insoluble. They require an analysis of the values underlying rule of law and how these values can be supported and integrated into the institutional context created by new approaches to regulation.[34] This process of transforming our understanding of the rule of law is a subject of another article. The point here is that conflict between principles of good regulation and the rule of law may result in the adoption of regulatory schemes which bend to comply with traditional rule of law concerns. Where this occurs the regulatory scheme ultimately adopted may revert to a direct form of command and control regulation without sufficient attention being given to whether this will achieve overall regulatory goals.

There are therefore two reasons why the integration of the elements of self-regulation is essential in the design of self-regulation systems. First, an analysis of a range of strategies to introduce self-regulation indicates a high level of interdependence in the relationship between the rule-making and enforcement parts of a regulatory system. Secondly, the effective integration of the elements of a self-regulation system is an important discipline for ensuring that those responsible for regulatory design respect the limits of regulation.

As later sections of this article will show, the regulatory framework proposed as part of CLERP 6 fails to integrate the elements which make up the proposed regulatory scheme. There is, for example, much attention given to the problems associated with the formulation and implementation of rules and scant given to enforcement issues. Further, the failure to plan for the integration of the elements of the scheme of self-regulation has resulted in a reversion to command and control styles of regulation, these being more consistent with traditional understandings about the appropriate regulator-regulatee relationship.

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33 J Black, *Rules and Regulators*, Clarendon Press (1997) pp 37-8.

34 For example, B Cheffins, *Company Law Theory, Structure and Operation*, Clarendon Press (1997) pp 384-6; E Rubin, note 30 *supra* at 408-26. See generally, S Spence, "Administrative Law and Agency Policy-Making: Rethinking the Positive Theory of Political Control" (1997) 14 *Yale J on Reg* 407.

III. AN OVERVIEW OF THE CLERP 6 PROPOSALS

A. CLERP and the Regulation of Financial Markets

This section aims to identify the principles underlying the CLERP review of financial market regulation. It is useful to provide a brief account of the objectives of financial system regulation in the context of the principles underpinning the CLERP review of financial markets. This will provide an overview of the scope of the proposed reforms, and of the innovative proposals for regulatory reform.

CLERP identified the objectives of financial system regulation as:

- Market integrity – to enhance the efficiency and fairness of markets;
- Investor protection – to ensure investors have adequate information, are treated fairly and have adequate avenues for redress;
- Enhanced competition – to facilitate competition between financial service providers; and
- Minimisation of systemic risk – reducing the risk that inability of a financial system participant to meet its obligations as they become due may cause other financial institutions to fail in meeting their obligations.[35]

When applied to financial markets regulation, the goals of regulation identified in CLERP 6 include market freedom,[36] investor protection,[37] information transparency,[38] cost effectiveness,[39] regulatory neutrality and flexibility,[40] and business ethics and compliance.[41] A central principle underlying the CLERP is that there is a limited need for regulation which only arises where there is market failure. A second principle is the importance of co-regulation, or self-regulation, as the primary mechanism for regulating financial markets. The following section provides a brief overview of the proposed regulatory framework, which implements these principles.

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35 CLERP 6, note 2 *supra* at 26.

36 *Ibid* at 27. "Regulation should only modify market freedom where there are clear regulatory objectives and the benefits of intervention outweigh the costs".

37 *Ibid*. While investors are assumed to be the best judges of their own interests, "retail investors are in need of greater protection as they may find it more difficult to, and face greater costs in, gathering the information required to make an informed investment decision".

38 *Ibid* at 28. "Disclosure of information will increase market integrity and efficiency by assisting markets to perform their fundamental function of pricing risk."

39 *Ibid*. "Co-regulation between a government regulatory body and an industry association is efficient as it is more responsive to market developments and places the cost of regulation of regulation directly on consumers who benefit from the regulation".

40 *Ibid* at 29. "Regulation should be applied consistently and fairly across the marketplace as a whole. There should be minimal barriers to entry and regulation should not restrict innovation."

41 *Ibid* at 30. "A regulatory regime for financial markets which encourages industry and professional organisations to contribute to the development of industry best practice standards will contribute to a strong compliance culture within organisations. This will enhance market integrity and investor confidence."

B. The Regulatory Framework

The overall goal of the CLERP is to create an integrated regulatory framework for financial products. The proposed framework aims to combine "efficiency and flexibility" through an "integrated regulatory framework" for "consistent regulation" of "functionally similar markets and products".[42] The mechanism used to combine these elements relies on using legislation to set out principles or standards. These are then applied to, and modified to meet, specific circumstances by the use of delegated legislation or by reliance upon broad discretionary powers granted to the Australian Securities and Investments Commission (ASIC).

A significant feature of this regulatory framework is the extent to which it focuses on the rule-making element of the process of regulation. There are some references to enforcement. There is some reliance on measures aimed at encouraging industry participants to internalise the underlying goals of the proposed regulatory framework.[43] Among the latter is the requirement imposed on regulatees to create compliance programs along with recommendations for the use of industry-based codes of conduct.[44] However, the predominant feature of the proposed regulatory framework is the extent of the focus on the process of rule-making. As later parts of the article will indicate, this is one of the primary weaknesses of the proposed regulatory framework.

The framework aims to combine these goals in the following way:

- A broad functional definition of "financial product" to capture new products without the need for legislative amendment.[45] The definition of financial product defines the coverage of the proposed regulatory framework.
- A single licensing regime for all persons providing financial services. In order to obtain a licence, a "financial service provider" will have to meet specific criteria. The grant of the licence will be subject to conditions to ensure compliance with these criteria.[46] ASIC would be empowered to grant a licence subject to the licence criteria set out in regulations.[47]
- Minimum standards of conduct for financial service providers including the obligation imposed on financial service providers to disclose basic information about their identity, their relationships with product issuers, any potential conflicts of interests they may have, and their complaint resolution mechanisms.[48]
- Financial product disclosure at point of sale for retail investors. Every

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42 Implementing CLERP 6, note 2 *supra* at 3.

43 *Ibid* at 110-16 (Chapter 10 – Misconduct and Enforcement).

44 Notes 122-125 *infra* .

45 Implementing CLERP 6, note 2 *supra* at 9-14.

46 *Ibid* at 19-38 (Chapter 2). Note that only principals will be required to obtain financial service providers' licenses. Principals are to be responsible for their employees and agents.

47 *Ibid* at 23-5.

48 *Ibid* at 39-50 (Chapter 3).

product issuer will be required to disclose information with reference to a number of defined categories. ASIC would be entitled to use its power to exempt or modify this requirement after consultation with industry and consumer groups.[49]

- Codes of conduct setting out best practice in particular industries. ASIC is to have the power to approve codes of conduct as being consistent with the law.[50]
- Licensing of financial product markets. Every person operating a market facility will have to be licensed and will have to meet broadly expressed and flexible criteria. The Minister will be responsible for granting licences to operate financial product markets.[51]
- Licensing of clearing and settlement facilities. Every person operating a clearing and settlement facility will be required to obtain a licence subject to broadly defined criteria. The Minister will be responsible for licensing clearing and settlement facilities.[52]
- Compensation arrangements for retail participants for losses caused in defined circumstances during the execution of a market transaction.[53]
- General provisions dealing with transfers of securities,[54] and general prohibitions on misleading and deceptive conduct and harmonisation of ASIC's enforcement powers.[55]

Without reference to the detailed provisions needed to support each of these elements, it is possible to develop a general understanding of the ways in which this framework seeks to meet the goals in the CLERP review. This framework endeavours to assist the creation of efficient markets, with minimal barriers to entry, by relying on an innovative approach to the process of rule formation. Legislation will be used to state desired outcomes, which intermediaries, for example, the Minister and ASIC, apply to particular circumstances created by particular products and markets. In addition, the framework subjects financial service providers, licensees of financial product markets and licensees of settlement and clearing facilities to co-regulatory responsibilities. They will be required to comply with the conditions imposed in their licences.[56]

C. Investor Protection

In addition to the goals of market efficiency based upon consistent, uniform *and* flexible regulation, CLERP recognised the importance of investor protection. The proposed regulatory framework seeks to meet this goal by

49 *Ibid* at 51-60 (Chapter 4). The categories of information which product issuers are required to disclose are set out at 52-3.
50 *Ibid* at 61-4 (Chapter 5).
51 *Ibid* at 65-82 (Chapter 6).
52 *Ibid* at 83-96 (Chapter 7).
53 *Ibid* at 97-106 (Chapter 8).
54 *Ibid* at 107-10 (Chapter 9).
55 *Ibid* at 111-15 (Chapter 10).
56 Notes 123-125 *infra*.

applying different levels of regulatory oversight to financial products when they are made available to "retail" rather than "wholesale" clients.[57] Products made available to wholesale clients will be subject to the regulatory framework, to ensure that retail clients have access to these markets and to ensure the integrity of wholesale markets.[58] However, financial service providers who provide services to wholesale clients would not be subject to all of the elements of the regulatory framework. In particular, financial service providers in these circumstances would not be subject to the following conduct and disclosure requirements:

- Professional indemnity insurance or fidelity fund requirements.
- Complaints handling mechanisms.
- Requirements to provide a "Financial Services Guide".[59]
- Suitability requirements.[60]
- Disclosure of information about the financial product at point of sale.[61]

The basis for this distinction is that "sophisticated and regular participants in the financial system" are able "to determine the level and type of disclosure and reporting to meet their needs".[62]

IV. CLERP 6: A LIMITED FORM OF SELF-REGULATION

A. Introduction

There are innovative aspects to the regulatory framework proposed by CLERP 6. The scope of the regulatory framework is broad. The use of legislation is an important development in the regulation of financial markets. Broad principles have been formulated which rely on the intermediary bodies of the Minister and ASIC, to make rules to apply to particular products and markets. By contrast, there is in the current regulatory structure a tendency to rely too heavily on complex 'black letter law' rules. Perhaps most importantly, the proposed framework is an 'open' one, designed to encourage and accommodate innovative developments in financial markets.

However, the difficulties in achieving these goals cannot be overestimated. Securities, futures and derivatives markets are complex "regulatory spaces".[63] Competing sets of incentives and disincentives affect the way in which these markets operate. Significant problems are encountered by regulators operating

57 "Retail client" is defined to exclude a number of categories of "wholesale" investors: Implementing CLERP 6, note 2 *supra* at 147.

58 *Ibid* at 14-15.

59 Note 48 *supra*. This is the document in which the financial service provider discloses information about themselves to the client.

60 Implementing CLERP 6, note 2 *supra* at 43-6. This is the "Know your Client" rule ensuring that a financial service provider has a reasonable basis for making a recommendation to a particular client.

61 Note 49 *supra*.

62 Implementing CLERP 6, note 2 *supra* at 15-16.

63 Note 12 *supra*.

in this regulatory context. For example, one criticism of the CLERP 6 proposals is that:

> The nature of financial products – derivatives, options, warrants, equities – means that you have to treat them in different ways... It is quite possible that when ASIC starts to look at these things in detail it will have to use policy statements and regulations to put back a lot of the separate requirements which are applicable to different kinds of products.[64]

Innovative use of self-regulation is a way of avoiding a return to regulation by detailed rules. An integrated system of self-regulation will be one where the regulatory framework defines the outcomes expected by both the regulator and the regulatees. Within these boundaries there will be a variety of mechanisms to encourage the regulator and regulatees to negotiate on the most effective way of achieving the stated outcomes. In this way it would be possible to maximise the potential to achieve these regulatory goals.

The CLERP 6 framework makes use of a number of self-regulatory mechanisms. There is almost no consideration of the problem of how to integrate these regulatory mechanisms into a system of self-regulation. In a number of areas CLERP 6 relies on a traditional command and control style to legitimate the rules under which market participants will be required to work. In those areas where there is proposed to be extensive use of self-regulatory mechanisms to achieve regulatory goals there is a very restricted definition of the space in which they are designed to operate. In particular there is little analysis of how to integrate regulatory mechanisms, such as codes of conduct, the use of compliance systems, or complaints mechanisms into a system of self-regulation.

The following parts of the article deal with each of these problems. Part B is a detailed analysis of two parts of the proposed regulatory framework which appear to implement the central features of a system of self-regulation. These parts are those dealing with licensing of 'financial service providers' and with the disclosure of information to customers at the point of sale. This analysis highlights the tendency to rely on a command style of regulation and the failure to integrate the elements of the proposed regulatory framework into a system of self-regulation. Part C is a broad overview of remaining parts of the proposed regulatory framework. It includes examples of where there is reliance upon a command style of regulation and of where there is a failure to analyse the range of ways in which self-regulatory mechanisms can be integrated into a system of self-regulation.

B. Limitations in the Proposed Model of Self-Regulation

The CLERP 6 framework does recognise interdependent relationships between market participants and the regulator in the delivery of financial services. It relies on a complex process of rule-making to formulate appropriate rules concerning the delivery of financial services and products. Two prominent examples are the licensing of financial service providers and the regulation of product disclosure for retail investors.

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64 *Butterworths Company Law Bulletin*, Butterworths (1999) at [105].

(i) Financial Service Providers' Licences

It is proposed that there be a single licensing regime covering securities dealers, investment advisers, futures brokers and advisers, insurance agents and brokers, and foreign exchange dealers.[65] Any person who carries on a "financial services" business will be required to apply to ASIC to obtain a "financial service provider's licence".[66] The criteria for the grant of the licence will be prescribed by way of regulation. The criteria require ASIC to be satisfied that the applicant:

- Has appropriate financial resources and internal controls;
- Has relevant competence, skill and experience to carry out the proposed activities;
- Has adequate systems of training and supervision of its representatives;
- Can demonstrate ongoing compliance with the law;
- Can meet additional prescribed criteria; and
- Finally, ASIC must have no reason to believe that the applicant will not discharge the obligations of a licensee in an efficient, honest and fair manner.[67]

The process for granting licences to provide financial services is a central part of the proposed CLERP 6 framework. It includes self-regulatory mechanisms. For example, legislation will not provide details of the financial resources and internal control requirements. Specific requirements will be developed by way of ASIC policy statements, rules of market operators and ASIC approved industry codes of conduct.[68] A similar process is to be followed in order to define the standards for meeting the competence, skill and experience requirements. This is a clear example of using a process of negotiation between ASIC and market participants to tap into the knowledge and experience of both parties. This process is designed to produce rules that fit into the "regulatory space" and meet the goals of the regulatory system.

The use of particular self-regulatory mechanisms is not sufficient to ensure the effective operation of a system of self-regulation. There is significant potential for blockages to be placed in the path of the development of these self-regulatory mechanisms. The criteria for the terms of the grant of licence are to be prescribed by way of regulation.[69] While it is not envisaged that legislation will include specific standards to be met by applicants for financial service providers'

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65 Implementing CLERP 6, note 2 *supra* at 21.

66 *Ibid.* The proposed definition of "financial services" is a broad one that includes: providing advice about financial products; dealing in a financial product on behalf of someone else; dealing in one's own financial product; making a market for a financial product; operating a registered managed investment scheme; or providing a custodial or depositary service. Only principals will be required to obtain a financial service providers' licence.

67 *Ibid* at 23-5.

68 *Ibid.*

69 *Ibid* at 25.

licences, there is no indication of the degree of flexibility to be given to ASIC to develop or apply these standards. It is not clear whether the processes of negotiation planned in the proposed framework will produce a body of rules, to be applied to all applicants within a particular industry or category of licence. This model would continue to have some of the 'top-down' elements of command and control styles of regulation and is not an innovative solution to the problem of developing criteria and standards for the granting of licences.[70]

There are some indications that this modified form of 'top-down' rule-making is the one envisaged by CLERP. There is no indication that ASIC will have a broad discretion to allow applicants flexibility in determining how they will meet the licence criteria. Against the background of the general approach taken by CLERP, the failure to provide any such affirmative indication suggests that ASIC and applicants for licences will have only limited flexibility in determining the range of options available to individual applicants to comply with the licence criteria. In addition some of the criteria suggest that the process of rule-making is a process of limited negotiation between the regulator and regulatees. For example, one of the criteria is that applicants must be able to demonstrate ongoing compliance with the law.[71] It appears that compliance in this context denotes the use of a formal set of mechanisms within an organisation to ensure compliance with specific standards. This is, however, a very limited notion of the potential for compliance systems.[72]

This limited concept of the role of compliance is not consistent with new approaches to regulation or self-regulation. One commentator has argued that the focus of regulation will:

> [T]urn from being predominantly concerned with compliance with technical rules to a concern with compliance with regulatory goals by whatever means is appropriate and feasible including enforced self-regulation, incentive-based regimes, harnessing markets, conferring private rights and liabilities, relying on third party accreditation to standards and insurance based schemes.[73]

The objective of such regulation is "to *steer* corporate conduct towards public policy objectives in the most effective and efficient way, without interfering too greatly with corporate autonomy and profit".[74] The potential for the development of compliance systems within organisations is that they offer the opportunity for regulators and regulatees to bridge the gap between regulatory systems and managerial decision-making processes. One of the goals of effective compliance systems is to ensure that managerial decision-making

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70 If this is the process adopted the concerns raised by some in the industry about the inevitable development of complexity in rules generally, and in the licence criteria in particular, may turn out to be correct: *Butterworths Company Law Bulletin*, note 64 *supra*. For a review of the 'bureaucratic rigidities' developed by some self-regulatory organisations operating under the *Financial Services Act* 1986 in the United Kingdom: B Cheffins, note 34 *supra*, pp 381-4.

71 Text accompanying note 67 *supra*.

72 C Parker, "Summary of Scholarly Literature on Regulatory Compliance" note 27 *supra* at 1. This form of compliance may be defined as "obedience by a target population with regulatory rules or with government policy objectives".

73 *Ibid* at 12.

74 *Ibid* (emphasis added). See also text accompanying notes 21-4 *supra*.

processes are modified so as to take into account regulatory principles and goals.

In theory, a flexible regulatory regime, that sets outcomes rather than rules, allows the compliance program to fit better into the company's normal operating procedures, training programs and business goals. It is correspondingly more cost-efficient and competitive. Indeed, a strategic compliance system geared towards a flexible, outcome oriented regulatory regime may even enhance a company's competitive position.[75]

This approach to compliance is yet to be fully realised. It does however indicate that a broader notion of compliance allows for more extensive negotiation over the particular mechanisms which an organisation will use to achieve regulatory goals. In the context of the grant of financial services providers' licences, this wider view may not be consistent with the legislation's defined criteria. It may not be possible for licensees to negotiate over the most effective means of achieving the relevant licence criteria. A simple example of this may arise over conflicts as to what amounts to an acceptable compliance system. An applicant may be required to develop a compliance system based on the "obedience model"[76] rather than taking the approach of modifying its own management systems internalise regulatory goals and objectives.

A further indication of reliance on modified command and control styles of regulation is the failure to ensure open channels of communication between regulators and regulatees by providing for a range of enforcement mechanisms. There is relatively little attention given to consideration of the range of enforcement strategies and tools that should be available to the regulator.[77] This is somewhat surprising in the light of the recent addition of enforceable undertakings to the range of enforcement tools available to ASIC.[78] It is even more surprising in the light of the relative sophistication of the enforcement strategies adopted by other regulators such as the ACCC.[79] The failure to address this part of the regulatory scheme is indicative of a broader failure to recognise the importance of integrating *all* of the regulatory mechanisms into a *system* of regulation.

(ii) Disclosure

There are two parts of the proposed scheme regulating disclosure of information by financial service providers about financial products. The first is the scheme regulating disclosure of information for retail customers and the second is that dealing with wholesale customers. The following sections deal with each of these regulatory schemes.

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75 *Ibid* at 13.

76 Note 72 *supra*.

77 Note 55 *supra*. For a review of problems encountered with enforcement in the regulation of financial markets in the United Kingdom, see B Cheffins, note 34 *supra*, pp 412-18.

78 *Australian Securities and Investments Commission Act* 1989 (Cth), ss 93AA, 93A.

79 See generally, C Parker, "The Emergence of the Australian Compliance Industry: Trends and Accomplishments" (1999) 27 *Aust Bus LR* 178.

(a) Retail Customers

The proposed scheme to regulate disclosure of information to retail customers provides broad powers to the regulator to formulate rules. This discretion can only be exercised after negotiation between the regulator and regulatees concerning levels of disclosure for specific financial products. This creates the potential for the creation of an integrated, and self-regulating sub-system of regulation. It is an example of how self-regulatory mechanisms can be integrated into a regulatory system. A problem created by this approach to regulation is the extent to which this 'island' of self-regulation can work in a regulatory scheme which otherwise only makes limited use of self-regulatory mechanisms.

It is proposed that where financial products are offered for sale the financial service provider will have to provide retail customers with a financial product information statement ("FPIS").[80] There will be no obligation to prepare an FPIS for wholesale customers and retail customers will be able to opt to be treated as wholesale customers.[81] Information addressing specified criteria, limited to those issues that are relevant to the particular financial product, as set out in legislation,[82] will be required in the FPIS. In order to facilitate this ASIC will have an exemption and modification power.[83] It is proposed that ASIC would only use this power after consultation with industry and consumer groups.[84]

The disclosure regime for financial products will not apply to offers or invitations to subscribe for securities of a corporation.[85] Securities are defined to include shares, debentures, legal or equitable rights or interests in shares or debentures, and interests in registered managed investment schemes. Offers or invitations to subscribe for securities of a body will continue to be regulated in Part 7.12 of the *Corporations Law* and will, subject to the specified exceptions, require the preparation of a prospectus.[86] The rationale for retaining a separate regime regulating the process of fundraising is that there are different information requirements for those investing in securities than for those purchasing a "financial product". In particular, for offers of securities, there are information asymmetries between the issuing corporation and the investor where

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80 Implementing CLERP 6, note 2 *supra* at 52. For the distinction between 'wholesale' and 'retail' transactions see note 57 *supra*.

81 *Ibid* at 14-17.

82 *Ibid* at 52-3. The matters to be dealt with include: information to identify the product issuer; characteristic features of the product; expected benefits which a consumer will receive; the risks associated with the product; details of amounts payable; internal inquiry and complaints handling mechanisms; taxation considerations; cooling off arrangements; availability of further information on request and any other material information.

83 *Ibid* at 53.

84 *Ibid* at 53, 56.

85 *Ibid* at 52.

86 *Corporations Law*, ss 66, 92(2), 1017, 1018. The definition of "securities of a corporation" for the purpose of determining when a prospectus must accompany any offer or invitations to subscribe for securities is subject to proposed changes in the Corporate Law Economic Reform Bill 1998 (Cth), Chapter 6D.1 and Item 34 of Schedule 3.

the issuing corporation has possession of the relevant information.[87]

Both the CLERP 6 proposals and the fundraising provisions of the Corporate Law Economic Reform Program Bill 1998 (Cth) share some common elements in relation to defining appropriate levels of disclosure for retail investors. The Bill proposes the introduction of profile statements, which are to be used in conjunction with prospectuses in fundraising.[88] Profile statements are expected to be a primary source of information for retail investors.[89] The contents of the profile statements are specified in the *Corporations Law* but ASIC is given the power to approve profile statements for offers of securities of a particular kind.[90] ASIC would only approve industry specific profile statements after consultation with that industry. In this sense the process for determining the level of disclosure required in profile statements is similar to that proposed in an FPIS.[91]

The level of disclosure required in an FPIS and in profile statements is a good example of flexible procedures centred on negotiations between the regulator and regulatees being used to meet regulatory goals. The flexibility allowed to ASIC to modify disclosure requirements after consultation with industry and consumer groups ensures that information is disclosed to retail investors in a cost effective and useful way. There is potential to create a complex and sophisticated system of regulation which meets the goals of the regulatory system and the needs of the market participants. It appears to be the area in which the regulator is given the broadest mandate to negotiate with consumers and industry to produce regulatory outcomes.

(b) Wholesale Customers

The proposed scheme regulating the disclosure of information to wholesale customers raises an altogether different set of questions. The proposal is a form of de-regulation: there are no disclosure requirements imposed on financial service providers, or financial markets where their customers are wholesale customers.[92] One question raised by this proposal is whether this form of de-regulation is effective self-regulation. The argument in this part of the article is that reliance upon de-regulation, even for sophisticated investors, represents a lost opportunity to deploy a regulatory mechanism which could improve the effectiveness of the proposed regulatory framework.

Wholesale financial service providers will have to be licensed, but will not be required to provide FPIS for their wholesale customers.[93] When wholesale customers participate in 'over-the-counter' markets there will be no requirement

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87 For a brief review of the rationale for the regulation of fundraising through prospectus disclosure, see CLERP Paper 2, *Fundraising, Capital Raising Initiatives to Build Enterprise and Employment*, 1997 at 11.

88 Corporate Law Economic Reform Program Bill 1998, proposed ss 709(2), 714, 717.

89 Explanatory Memorandum, Corporate Law Economic Reform Program Bill 1998 at [8.12].

90 Corporate Law Economic Reform Program Bill 1998, proposed ss 709(3) and 714.

91 Text at note 84 *supra*.

92 Implementing CLERP 6, note 2 *supra* at 14-17. Retail customers may opt to be treated as "wholesale customers" for the purposes of particular transactions.

93 See text accompanying notes 57-62 *supra*.

on the financial service provider to disclose information.[94] This will extend to 'market maker' activity, which refers to:

> [A]ctivities where both bids and offers are regularly quoted and the person quoting holds out that they are prepared to buy or sell a financial product at the bid and offer prices that they quote.[95]

This means that where wholesale customers participate in such a market, the market maker will not be required to disclose information about the specific financial product.[96]

In addition, it seems that a "financial product market" can be designated as a wholesale market. A financial product market is a complex concept, requiring multiple buyers and sellers where the market operator will not, at least initially, be a party to the transaction.[97] A wholesale market would be one where only wholesale customers, or retail customers who opt to be treated as wholesale customers, could access the market. As a consequence there would be no requirement for the financial service provider to disclose information about the financial product being disposed of on the market.

The rationale for not imposing any mandatory disclosure requirements on financial service providers dealing with wholesale customers is to allow "sophisticated and regular participants in the financial system the flexibility to determine the level and type of disclosure and reporting that meets their needs".[98] This is a form of de-regulation in that it is assumed that wholesale financial product markets are efficient, and that this efficiency will ensure that wholesale customers demand, and receive, appropriate levels of information. The problem with this proposition is that in *some* markets for financial products, regulation of disclosure may enhance the depth and effectiveness of markets by reducing the overall level of information costs for intermediaries and for investors.

The following part of the article outlines some of the arguments that have been proposed to justify mandatory disclosure regulation. It is argued by analogy that this debate can be a basis for criticising the CLERP 6 proposal not to impose any obligation to disclose information to wholesale investors. There are two parts to the argument.

The first focuses on the notion that mandatory disclosure regulation may reduce the overall cost, incurred by all market participants, of obtaining, processing and verifying information. It is also suggested that this form of regulation may alter the structure of securities markets by increasing the depth of the market, that is, the number of traders, and the robustness of the market. On this basis it is argued that the decision not to impose any obligation to disclose

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94 'Over-the-counter' markets are those where the contract between the parties involves bilateral negotiation between counterparties who each accept the counterparty risk, that is, the risk that the counterparty will not be able to perform their legal obligations: Implementing CLERP 6, note 2 *supra* at 66.

95 Implementing CLERP 6, note 2 *supra* at 146 (Dictionary).

96 *Ibid* at 14-15, 66. It is proposed that market maker activity not constitute "a financial product market" but a person operating as a 'market maker' must obtain a licence as financial service provider.

97 *Ibid* at 66.

98 *Ibid* at 15.

information to wholesale investors may have unforeseen effects on markets: increasing the overall costs of obtaining, processing and verifying information.

The second part suggests that the failure to impose any mandatory disclosure requirements may reduce the relative efficiency of emerging markets for new financial products. In these emerging markets there is a period during which professionally informed traders are learning how to obtain, process and verify relevant information. Regulation may be a trigger to enhance the capacity of professionally informed traders to identify relevant information, and as a result may enhance the development of markets for information.

(iii) Mandatory Disclosure Regulation

There has been extensive debate on the efficacy and efficiency of regulation requiring mandatory disclosure of information by issuers of securities. This regulation has taken two forms: first, the requirement to prepare a prospectus when securities are issued, and secondly, the requirement to periodically disclose information that is material in determining the value of those securities. The problem has been assessing how this form of regulation affects the operation of markets for securities.

One response to this problem has been that mandatory disclosure rules are unnecessary where securities markets are efficient.[99] One writer has stated:

> The economic assumptions necessary to operationalize the efficient capital markets hypothesis are simple. Information has value. This value can be exploited for economic gain by securities traders who (1) make human capital investment in acquiring the evaluative skills necessary to identify mispriced securities, and (2) engage in rivalrous competition with competing traders to implement trading strategies that provide profits to the most effective traders while simultaneously driving securities prices to their correct or efficient levels. Consequently, rivalrous competition among securities professionals drives securities prices to their efficient levels. The implications of this analysis are clear. If market forces in the form of rivalrous competition among market professionals are driving securities prices to their correct levels, then the regulatory regime of mandatory disclosure ... is simply unnecessary.[100]

This argument is similar to one proposed by CLERP 6 for not requiring mandatory disclosure by financial service providers when dealing with wholesale clients.[101] Each is based on the premise that professional investors are in a position to obtain, and make effective use of, information without any rules requiring disclosure of information.

There is no general agreement that this is a sufficient basis for removing mandatory disclosure rules. Some arguments suggest that there may be valid

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99 "The common definition of market efficiency is that 'prices "fully reflect", all available information' is really shorthand for the empirical claim that 'available information' does not support profitable trading strategies or arbitrage opportunities": R Gilson and R Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 *Virginia Law Review* 549 at 554-5.

100 J Macey, "Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at 60" (1994) 15 *Cardozo Law Review* 909 at 928.

101 Note 98 *supra*.

reasons for retaining mandatory disclosure rules.[102] One of these is based on the view that information is a public good. A public good has two characteristics. These are: that one person's use of the good does not affect the total supply available to others; and that owners of the information cannot prevent those who have not paid for the good from using it.[103] On this basis it is argued that producers will tend to produce sub-optimal levels of the good:

> The socially optimal amount of a good is supplied when the marginal cost of the good is equal to the sum of the individual consumer's marginal benefit. However, due to the inability to exclude certain individuals from consumption, or charge them commensurably, the owner will be underpaid by a section of the community (the so-called 'free riders'). This latter source of demand is not factored into the owner's supply decision. The result is that marginal benefits to *society* of extra supply will exceed the private marginal costs (or benefits) to the *supplier*. From a collective standpoint this will mean under-production and under-consumption of the good in question. Proponents argue that that social welfare can be improved in a Pareto sense by government regulations moving the private output closer to the social optimum.

While there are relatively few commentators who are prepared to discount this argument altogether, its strength is difficult to assess.[104] A number of factors indicate that markets may ensure the production of optimal levels of information. These include the impact of competitive markets on the supply of information, such as widespread use of technology which reduces the cost of obtaining, processing and verifying information and the voluntary disclosure of information by firms in response to market forces.[105]

Another more promising argument, providing a rationale for the use of mandatory disclosure, focuses on the impact that information costs have on the operation of efficient capital markets. This argument suggests that the use of mandatory disclosure rules may be justified whether or not those rules improve the relative efficiency of markets.[106] Markets will be "relatively efficient" when prices of securities rapidly change in response to new information.[107] The rapidity of the response to new information will depend upon the capacity of those who receive it, such as professionally informed traders, to move the price of securities by trading on the basis of the information. In a relatively efficient market, prices will respond to new information even though the information is

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102 There are a range of contentious arguments, which support mandatory regulation of disclosure, by challenging the Efficient Capital Markets Hypothesis, see, for example, L Cunningham, "From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Markets Hypothesis" (1994) 62 *Georgia Law Review* 546 (non-linear dependence between stock prices and the availability of information), and D Langevoort, "Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited" (1992) 140 *University of Pennsylvania Law Review* 851 (the application of noise theory to securities markets). While each of these criticisms of the Efficient Capital Markets Hypothesis has some intuitive appeal there is insufficient agreement about the weight of these criticisms. The Efficient Capital Markets Hypothesis continues to attract a wide degree of support.

103 M Blair and I Ramsay, "Mandatory Corporate Disclosure Rules and Securities Regulation" in G Walker, B Fisse, I Ramsay (eds), *Securities Regulation in Australia and New Zealand*, LBC Information Services (1998) 74.

104 Note 100 *supra* at 927-8; *ibid* at 74-6.

105 Note 103 *supra* at 75-6; note 99 *supra* at 641, n 243.

106 Note 99 *supra* at 638.

107 *Ibid* at 559-61.

only available to a small proportion of traders, the professionally informed traders.[108]

One effect of mandatory disclosure regulation is that it shifts the costs of obtaining, processing and verifying information from professional traders to the entities that issue the securities. In some instances this could amount to a simple re-distribution of wealth in favour of professional traders.[109] However, there is some evidence to suggest that the total information-related costs may be reduced when imposed on issuers of the securities.[110] The total costs to the issuers of providing information may be relatively smaller than the total costs to professionally informed traders who would be required to initiate the search for information. In particular the costs of verifying information may be significantly reduced where they are imposed on the issuer rather than on individual traders.[111]

Mandatory disclosure regulation may therefore reduce the overall cost of information incurred by all market participants. Equally important, this form of regulation may change the structure of the market. The reduced costs of obtaining, processing and verifying information will potentially increase the number of professionally informed traders and may also therefore increase the overall level of trading on the market.[112] The impact of these changes may be the creation of deeper, more robust capital markets which in turn may promote additional public policy goals.

(iv) The Regulation of Disclosure

This analysis of the impact of disclosure regulation on information costs has profound consequences on the ability of mandatory disclosure to promote broad regulatory goals. In the first instance this rationale for regulation is based on the benefits to capital markets that arise as a consequence of reducing the information costs of professionally informed traders. This distinct possibility that regulation of disclosure could affect the structure of capital markets was not considered by CLERP. The mere existence of a market made up of professionally informed traders will not necessarily ensure a reduction in the overall costs of information.

A second consequence of relying on this rationale is the impact on the regulatory framework. In order to determine when mandatory disclosure would be justified it would be necessary to assess the characteristics of individual markets. This would include an assessment of the costs of obtaining, processing and verifying information to various market participants as well as the depth and robustness of the market, and the impact of the imposition of disclosure regulation. This process would be applied to each particular market within the

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108 *Ibid* at 565-72. This is particularly important in relation to new *firm specific* information.

109 Note 103 *supra* at 76-8 (public choice theory as an explanation of the regulation of disclosure).

110 *Ibid* at 69.

111 Note 99 *supra* at 602-9, 635-42; *ibid* at 81-3; F Easterbrook and D Fischel, *The Economic Structure of Corporate Law*, Harvard University Press (1991) pp 309-14.

112 In assessing the strength of this argument it would be important to take into account the reduction in the number of securities issued which would arise because of the extra costs to issuers associated with mandatory disclosure regulation.

overall regulatory framework. This process would ordinarily fall to an independent regulator, which would rely on its powers to exempt or modify the operation of the law in particular circumstances. This complex, case-by-case approach to regulation is in contrast with the 'bright line' rule preferred by CLERP 6. That rule provides that deregulation of the market for information will produce efficient and effective outcomes because of the presence of sophisticated investors.[113]

At another level, this rationale for disclosure regulation raises some deeper and perhaps more important questions. Efficient capital markets effectively integrate the needs of professionally informed traders for specific kinds of information with the sources of supply of that information.[114] As these markets have developed, professionally informed traders have learnt how to obtain, process and verify relevant information. Accompanying this process has been the development of a sophisticated market for information. The legal regulation of disclosure requirements has supported the development of this market by improving the learning capacity of professionally informed traders. It is plausible therefore that the effective integration of the professionally informed trading mechanism with the market for information is a complex process able to be slowed or inhibited by de-regulation of information disclosure requirements.

In those emerging markets that are growing up alongside traditional securities markets, such as markets for derivative products including 'over-the-counter' markets, professionally informed traders are in the process of developing an understanding of how to obtain, process and verify relevant pieces of information. At the same time as these traders are becoming more sophisticated in their understanding of the information necessary to trade on particular markets, pathways are being formed for the purpose of obtaining this information in a timely and cost effective way.

Against this background it is arguable that a form of self-regulation may increase the relative efficiency of some of these emerging markets by assisting professional traders to learn about information. This form of regulation would be one that required the financial service provider to disclose material information concerning the particular financial product. However, there would be negotiation between the regulatees and the regulator as to the form and content of information to be provided by the financial service provider.[115] This approach to regulation may increase the relative efficiency and robustness of markets by improving the integration between the particular emerging markets and the market for information. In this sense regulation would be a trigger to improve the capacity of market participants to learn about and to respond to the

113 See text accompanying notes 92-97 *supra*.

114 This comment focuses on the role of professionally informed traders who play an important role in creating efficient markets. There are other trading mechanisms, for example, universally informed trading, uninformed trading, and derivatively informed trading. Each of these trading mechanisms plays a role in maintaining the efficiency of capital markets and each is based upon different informational requirements: note 99 *supra* at 565-92. For the purposes of the argument in this article it is not necessary to focus on these trading mechanisms.

115 A model for this could be the approach to the regulation of disclosure for retail investors, text accompanying notes 80-84 *supra*.

particular risks and opportunities created in particular markets.[116]

(v) A Limited Concept of Self-Regulation

This part of the article has sought to establish two propositions. First, that there are some good reasons for regulating the disclosure of information to wholesale investors in some circumstances. Secondly, that regulation of the disclosure of information is a form of regulation that is consistent with the use of self-regulation. CLERP has failed to seriously consider whether disclosure regulation in this context would assist with the design of a regulation system that would meet the public policy goals set out by CLERP. The failure to seriously consider using this form of regulation may be explained by reference to the limited form of self-regulation which informs the CLERP proposals. The association of 'deregulation' with 'self-regulation' may explain why the opportunity to use disclosure regulation to develop an innovative approach to regulating financial product markets was not taken up.

C. Overview of the CLERP Model of Self-Regulation

The preceding part of this article analysed some examples of innovative uses of self-regulatory mechanisms in the CLERP 6 regulatory framework. The conclusion in this Part was that even in these areas the CLERP 6 proposals adopted a limited and constrained form of self-regulation. In some ways this seems to arise from perceived problems with integrating self-regulation with a traditional understanding of the limits on the exercise of public power. In particular there are a number of examples in the CLERP 6 proposals where it was decided not to grant broad discretionary power to ASIC to formulate rules or to use exemption or modification powers. The reason for rejecting the grant of these functions to ASIC appears to be that the exercise of this kind of discretion should be subject to the same level of accountability as other exercises of public power.

On the one hand, self-regulation has the potential to redefine the process of rule-making within the legal system. It would allow negotiation between regulatees and regulators over the formulation of specific rules that apply to limited areas of operation. This process of negotiation is often accompanied by the grant of broad discretion to the regulator. On the other hand, a traditional view of the exercise of public power requires that rule-making be the result of a formal legal process. CLERP 6 appears to have resolved this conflict by endorsing the view that rule-making involves the exercise of public power and should therefore be subject to formal accountability processes. As a consequence, the opportunity for introducing a more systematic form of self-regulation has been lost.

This part of the article is a short review of the CLERP 6 proposals for reform against this backdrop. First, there is a brief overview of the range of instances in which CLERP 6 has relied on a command and control style of regulation.

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116 This approach to the regulation of disclosure overcomes some of the difficulties created by traditional command and control approaches to regulation of disclosure, see A Corbett, note 20 *supra* at 314-16.

Secondly, there is a brief account of the failure to maximise the potential of proposed self-regulatory mechanisms.

(i) Reliance on a Command and Control Style of Regulation

There are at least three major areas in the CLERP 6 proposals, central to the regulatory framework, which involve the exercise of discretion by a regulatory authority. These are:

- The definition of "financial product";
- The licensing of financial product markets; and
- The licensing of clearing and settlement facilities.

The proposed definition of "financial product" represents the first instance in which CLERP 6 relies on a traditional understanding of the exercise of public power (and as a result returns to a command and control style of regulation). The definition of "financial product" is a central part of the proposed scheme of regulation. It defines the boundary of the proposed regulatory framework. The proposed regulatory framework applies to all products falling within this definition. This definition is an open one, ensuring that new products and derivatives are included in the regulatory system without the need to use legislation to amend the law. The proposed definition includes four parts. There is a broad functional definition of "financial product", a list of products that are included, and excluded, and a regulation-making power to include or exclude particular products.[117]

The Financial System Inquiry had recommended that the discretion to include or exclude particular products be granted to ASIC.[118] In rejecting this approach the Implementing CLERP 6 paper stated:

> A number of submissions suggested that ASIC should be given a broad power to include or exclude products to ensure that the regulatory framework applies flexibly to meet developments in financial markets... The functional definition of financial product will be sufficiently broad to address the concerns that the new regulatory framework will not be able to keep up with developments in the financial markets. Any additions to the coverage of the regulatory framework should be subject to Parliamentary scrutiny either through regulations or by amendments to legislation. This will also provide greater certainty for the financial markets as to the scope of the regulatory framework.[119]

This passage clearly articulates the rationale for limiting the discretion granted to a regulator such as ASIC. This rationale is founded on a traditional understanding of appropriate limits on the exercise of public power.

The significance of this proposal to limit ASIC's power to include or exclude particular products from the definition of "financial product" is that it re-introduces a command and control style of regulation. It moves the rule-making function towards formal law-making processes, and further away from the participants in the markets that the regulatory framework is designed to regulate.

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117 Implementing CLERP 6, note 2 *supra* at 9-14.

118 Note 1 *supra* at 279 (Recommendation 19).

119 Implementing CLERP 6, note 2 *supra* at 14.

This increased distance between the source of rule-making and regulatees in the market removes a regulatory mechanism used to encourage regulatees to adopt and internalise the goals of the regulatory system. The use of this command style of regulation limits the self-regulatory capacity of the regulatory framework proposed by CLERP 6.

In two other areas involving the exercise of discretion, CLERP 6 followed a similar approach thus creating a similar impact in limiting the self-regulatory capacity of the proposed regulatory framework in relation to the definition of "financial product". These two areas are the licensing of financial product markets and the licensing of clearing and settlement facilities. Financial product markets and clearing and settlement facilities are crucial elements supporting the operation of financial markets. In each case it is proposed that a person wishing to operate one of these facilities must meet a selection of defined criteria. In each case the Financial System Inquiry recommended that ASIC be authorised to alter or modify the definition of "financial product" or to licence the operation of these facilities.[120] In each case CLERP 6 has proposed that the criteria for the grant of these licences be included in legislation and that the Minister be responsible for granting licences.[121]

(ii) Failure to Integrate Mechanisms of Regulation

At the same time as CLERP 6 has tended toward the adoption of a command style of regulation, it also proposed the deployment of self-regulatory mechanisms, including the use of codes of conduct,[122] compliance systems[123] and complaints handling procedures.[124] It is proposed that industry based codes of conduct be developed in consultation with ASIC, that these codes establish best practice standards and that there be the option of these codes being approved by ASIC.

The proposals recommending the use of these self-regulatory mechanisms are important. While there is great potential for each of these mechanisms to become an important site of self-regulation, difficult issues must first be resolved. For example, there are a number of ways in which compliance systems can be used as part of a regulatory framework. A compliance system may be a set of procedures designed to ensure that the organisation complies with an existing set of rules.[125] Alternatively, compliance may be concerned with ensuring that an organisation adopts the most effective and efficient systems to

120 Note 1 *supra* at 282 (Recommendation 21), at 285 (Recommendation 24).

121 Implementing CLERP 6, note 2 *supra* at 67-9, 86-8.

122 *Ibid* at 61-4 (Chapter 5).

123 *Ibid* at 23-5 (establishment of procedures to ensure compliance with the law is one of the criteria for the grant of licences for financial service providers), at 67-9 (financial product markets), at 86-8 (clearing and settlement facilities).

124 *Ibid* at 23-5 (the adoption of procedures to investigating and resolving complaints is one of the criteria for the grant of licences for financial service providers), at 67-9 (financial product markets), at 86-8 (clearing and settlement facilities).

125 *Ibid* at 24. The use of effective compliance procedures is one of the criteria for the grant of a financial service provider's licence). The terms in which compliance is discussed in CLERP 6 suggests that it is an example of the use of a command and control style of regulation.

comply with regulatory *standards or goals*. Compliance in this latter sense may involve negotiation with a regulator about how to achieve a particular standard or goal. The regulator may in effect delegate the discretion in checking compliance with a standard or principle to the organisation: the regulator's concern is outcomes, not processes.

The innovative use of self-regulation will involve analysis of how codes of conduct, compliance systems and complaints handling procedures are integrated into the overall regulatory framework. In particular there will need to be analysis of how these mechanisms interact with rule-making processes. For example, is there the option for the regulator to use exemption or modification powers in relation to legislative rules in those circumstances where the regulator forms the view that a particular organisation or industry is better placed to formulate regulatory rules? There will also need to be analysis of the way these self-regulatory mechanisms will interact with the enforcement strategies available to the regulator.

CLERP 6 does not seriously address any of these issues in its proposal to include these self-regulatory mechanisms in the regulatory framework. The failure to consider these issues is indicative of the command style of regulation, which forms a central part of the proposed regulatory framework. The failure to address these issues may also indicate that these proposals are designed to have a relatively limited scope of operation.

V. CONCLUSION

The title of this article characterises the CLERP process as a missed opportunity to adopt innovative regulatory reform. The body of the article has qualified and expanded on this argument. The argument is qualified by the acknowledgment that in some areas, for instance in the regulation of disclosure to retail investors and possibly in the grant of financial service providers' licences, the proposed regulatory framework does make use of some innovative regulatory mechanisms. The reforms in this area are an example of the way in which self-regulation can be used to achieve regulatory goals.

Despite this qualification, the central argument in this article is that the failure to integrate the elements of the proposed regulatory framework into a system of self-regulation does represent a missed opportunity for innovative regulatory reform. It is a missed opportunity because the proposed regulatory framework does not include a clear understanding of either the limits of regulation, or of the potential for a system of self-regulation to be an effective form of regulation. The main theme of this article is that the CLERP 6 proposals do not lay the foundation for the creation of an effective system of self-regulation.

The starting point for this argument is that in a general sense the CLERP 6 proposals do not integrate the elements of the proposed regulatory framework into a system of self-regulation. The proposed regulatory framework focuses primarily on the rule-making function of regulation. There is little consideration of how strategies of enforcement could either enhance the effectiveness of the

proposed framework or of how enforcement strategies may affect the approach taken to developing rule-making processes. In addition, where there are proposals for the introduction of self-regulatory mechanisms, for example, the requirement to adopt compliance systems or to develop industry-based codes of conduct, there is little consideration of the problems associated with successfully integrating these mechanisms of regulation into a system of self-regulation.

The main body of the article takes this general analysis further by focusing on two particular examples of the failure by CLERP 6 to adopt a systematic approach to self-regulation. The first is the tendency for the proposed regulatory framework to adopt a command style of regulation when specifying the relevant rule-making processes. There is a tendency to adopt a top-down approach to rule-making with the result that responsibility for rule-making is moved into traditional law-making forums and away from institutions which are closer to those being regulated. The second example focuses on the failure to make full use of those regulatory strategies that can be used to support a system of self-regulation. The proposal for the regulation of the information disclosure to wholesale investors relies on a form of de-regulation. It is a form of regulation where there is no *direct* regulation of what information should be disclosed to wholesale investors. As a result of reliance on this form of de-regulation, CLERP 6 missed the opportunity to use innovative approaches to the regulation of disclosure to improve the integrity and robustness of financial product markets.

There are a number of reasons why this failure to integrate the elements of the proposed regulatory framework into a system of self-regulation may be regarded as important. One reason is that it will increase the likelihood that the CLERP 6 proposals will be of limited effectiveness in achieving the overall goals of regulation. Perhaps more importantly, though, the failure to effectively integrate all of the elements of the proposed regulatory framework into a system of regulation highlights the key area in which CLERP 6 is a missed opportunity for innovative regulatory reform. This is the failure to accept and work within the limits of regulation. The recognition that there were real limits to the capacity of regulation to alter complex forms of human activity was one of the driving forces leading to greater reliance upon self-regulation. The failure to recognise and work within these limits represents a lost opportunity to foster and enhance discussion and analysis of the limits of regulation and of the role of self-regulation.