Hyperlexis in the regulation of Australian funds management

The laws today are so complex that every funds management business is every day, at least inadvertently, almost certainly, violating some clause. The social problem which the regulation of funds management is intended to address is an agency problem. There are both public and private solutions to this problem.

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MANY COMMENTATORS AGREE that the regulation of funds management in Australia has created an unduly complex set of rules (laws/regulations/rules/determinations etc). In funds management (as in many other areas) Australia suffers from hyperlexis – 'the pathological condition of a state with an overactive law making gland' (Manning 1997). The 'rules' governing funds management span thousands of pages of laws and tens if not hundreds of thousands of pages of rulings, determinations, guidelines, compliance and risk management plans, etc.

It is useful to contrast two intellectual views of this complexity. A lawyer seeking to serve the community/advise clients/profit from hyperlexis will seek to understand its taxonomic intricacies. However, from a social science perspective, describing/analysing the impact of the complexity itself on behaviour (supposing decision makers treat the law as uncertain and clarification dubious and expensive) might be a more useful route to predictive understanding. These two approaches often compete as potential settings for discussions of future law reform.

Complexity over time – in general

Take some 'area' of public policy – funds management/banking/immigration /broadcasting – with a body of rules. Evidently, the complexity of that body of rules is multi-dimensional, but let's suppose that it can be mapped to one dimension so that a graph can be constructed of the complexity over time of the relevant body of rules in this particular area.

Many in the finance industry are inclined to the view that such a graph is always monotonic and increasing. It's not. By way of counter example, consider migration law in Australia. In historical (perhaps apocryphal) time, a single immigration official decided at the port whether a potential migrant could gain entry. This official had the capacity to set a language test in any European language (Gaelic was a favourite except for undesirable Irishmen). These rules were fairly simple. But this situation didn't last. By the mid 1990s Australia had about 1250 pages of migration law and regulations, frequent and expensive appeals etc.

The most significant 'regulatory signal' influence on behaviour isn't careful individual consideration of what the spirit or the letter of the law means in a particular situation. Rather it is the knowledge of the potential impact upon reputation of the ready possibility that some capricious regulator will exercise their statute-granted option to find a rule that has (in their opinion) been broken.

Much of the cost of this complexity was borne by the public sector.

The Government became concerned about the increasing number and cost of appeals against migration decisions and, in 1998, introduced a 'privative clause' (Section 474 of the *Migration Act 1958*) which severely restricts access to, and the exercise of, powers of review. When it is effective, administrative decisions under the Act or regulations are incontestably validated by this clause. There is no avenue for contesting capricious, random or corruptly negotiated decisions (Ruddock 1999, p. 8).

Complexity fell, so did the value of knowledge of the intricate details of the law.

Complexity in funds management

The social problem which the regulation of funds management is intended to address is an agency problem. It would be prohibitively expensive to write the manifold individual contingent contracts which would be required to deal with all the situations that those managing money on behalf of others deal with. There are private solutions to this problem. The historic extensive use of mutuals in the Australian finance industry is an example of a private solution and one state approach is to nurture private solutions. There are also public solutions (in a state with hyperlexis, like our own, these are the fashion).

Public solutions can be split twofold.

The first are founded in a rule of law/private contract setting. Rawls (1971, pp. 206–213) sets out the characteristics and rationale for 'the regular and impartial administration of public rules' as part of the conception of justice:

> A legal system is a coercive order of public rules addressed to rational persons for the purpose of regulating their conduct and providing the framework for social cooperation. When these rules are just they establish a basis for legitimate expectations. They constitute grounds on which persons can rely on one another and rightly object when their expectations are not fulfilled. If the bases of these claims are unsure so are the boundaries of men's liberties (Rawls 1971, p. 207).

Historically the regulation of trading company prospectuses exemplifies this approach.

The alternative public approach is to prohibit activity and then provide situations in which the state will grant or (not today) cancel a licence. Historically, regulation of privately owned Australian banks fell into this category.

In funds management in Australia today the latter approach, in terms of behavioural impact, is dominant. But far more significant than the pedigree of a particular subset of these rules is the labyrinthine complexity of the overall rule set. The rule set has evolved in such a manner that any competent regulator now has the option to enter the business of one of the regulated and trawl for some rule which has been contravened. The laws are so complex that every funds management business is every day, at least inadvertently, almost certainly, violating some clause.

In this situation it is, to my mind, mischievous to perpetrate and perpetuate the myth that the public solution to the funds management agency problem adopted in Australia effectively falls into 'the rule of law'/private contract category. The most significant 'regulatory signal' influence on behaviour isn't careful individual consideration of what the spirit or the letter of the law means in a particular situation. Rather it is the knowledge of the potential impact upon reputation of the ready possibility that some capricious regulator will exercise their statute-granted option to find a rule that has (in their opinion) been broken.

(References can be found in Pender, H. 2004, *Public Policy*, Complexity & Rulebase Technology, The Australia Institute, June, DP 67).