



# Ethical Business Regulation

*Integrating Theories of Regulation, Enforcement, Compliance, Culture and Ethics*

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# The Questions

- Why do people conform to or break rules?
- Not: How do we increase deterrence

So

- How do we get people to conform to rules?
- How should we design enforcement policies and regulatory systems?

# The Evidence

- **Evolutionary biology**
  - The genetic mutation in *homo sapiens* of an ability to make moral judgments (an ethical gene) enabled our species to be able to collaborate
  - Collaboration is based on trust, which is based on evidence
- **Economics**
  - We achieve more by collaborating than working alone.
  - Incentives can generate good and bad behaviour – but social not just economic incentives
- **Regulatory theory**
  - Vertical ‘command and control’ and voluntary self-regulation are both not ideally effective
  - Co-ordination of activities in co-regulatory tiers and multiple matrix stakeholders can work well: ‘regulated self-assurance’
- **Regulatory practice**
  - Many effective regulators use ‘advice and support’ rather than aggression
  - Have a big stick, talk softly
- **Behavioural psychology and science**
  - We are ‘predictably irrational’, not the rational actors of economic theory
  - Good people do stupid things, usually not seriously
  - We are strongly influenced by social groups and by our concept of fairness

## Theories of Enforcement/Behaviour

Theory	Mode of action	Effectiveness
<b>Deterrence</b>	Fear	Traditional, ingrained, but very limited evidence or support
<b>Economic deterrence:</b> rational profit calculation	Disrupt the calculation, incentivise by cost internalisation	Widely applied, significant flaws
<b>Behavioural psychology &amp; genetics</b>	Human and group drivers, incentives and disruptors	Empirical findings, applied in some sectors
<b>Responsive regulation</b>	Advice, support, negotiation	Empirical support for psychology
<b>Ethical Regulation</b>	Open commitment to internal belief system	Very effective Being rediscovered! This is the fundamental concept

## Supportive

*Effective inspection and enforcement: implementing the Hampton vision in the Office of Fair Trading. A review supported by the Better Regulation Executive and National Audit Office* (Better Regulation Executive, Department for Business Enterprise & Regulatory Reform and National Audit Office, 2008).

*Toward Effective Governance of Financial Institutions* (Group of 30, 2012).

*Civil Aviation Authority Regulatory Enforcement Policy* (Civil Aviation Authority, 2012).

*Statement of consumer protection enforcement principles* (OFT, February 2012). *National Local Authority Enforcement Code. Health and Safety at Work. England, Scotland & Wales* (Health and Safety Executive, 2013).

P Lunn, *Regulatory Policy and Behavioural Economics* (OECD, 2014).

*Standards of Conduct. Treating Customers Fairly. Findings from the 2014 Challenge Panel* (Ofgem, March 2015).

*Competition Policy: A better deal: boosting competition to bring down bills for families and firms* (HM Treasury, December 2015).

*Corporate Governance and Business Integrity. A Stocktaking of Corporate Practices* (OECD, 2015).

*Better Business for All and Growth* (Better Regulation Delivery Office, 2015).

*Food We Can Trust: Regulating the Future* (Food Standards Authority, 2016).

*Consultation on Ofwat's approach to enforcement* (OFWAT, March 2016).

Scottish Government Response to the Working Groupon Consumer and Competition Policy for Scotland (March 2016).

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## Mixed – moving left

*The Bribery Act 2010. Guidance about procedures which relevant commercial organisations can put into place to prevent persons associated with them from bribing (section 9 of the Bribery Act 2010)* (Ministry of Justice, 2011).

*The Prudential Regulation Authority's Approach to Banking Supervision* (PRA, April 2013).

*Enforcement and Sanctions – Guidance.*

*Operational Instruction 1356\_10, version 2* (Environment Agency, 2014).

*Enforcement Guidelines on Complaints and Investigations* (OFGEM, June 2012).

*Economic enforcement policy and penalties statement* (ORR, 2012).

*Enhancing consumer protection, reducing regulatory restrictions: Summary of responses to the discussion paper and decision document* (Legal Services Board, April 2012).

*The future of retail market regulation* (Ofgem, December 2015).

*Enforcement policy* (Care Quality Commission, 2015).

## Deterrence

*The Financial Conduct Authority: Approach to Regulation* (Financial Services Authority, June 2011).

*OFT's Guidance as to the appropriate amount of a penalty* (Office of Fair Trading, 2012), OFT423.

*Changing Banking for Good: Report of the Parliamentary Commission on Banking Standards: Volume I: Summary, and Conclusions and Recommendations HC Paper No.27-I, II* Parliamentary Commission on Banking Standards, 2013.

*The FCA's approach to advancing its objectives* (FCA, July 2013).

FCA's Decision Procedure and Penalties (DEPP) Manual ("credible deterrence").

*Prioritisation principles for the CMA.*

*Consultation document* (Competition & Markets Authority, 2014).

Serious Fraud Office.

U.S. Department of Justice Memorandum, "Individual Accountability for Corporate Wrongdoing," September 9, 2015.

*Penalty guidelines. s.392 Communications Act 2003* (Ofcom, December 2015).

# Assumptions

- Most people want to do the right thing most of the time

“We believe that most businesses aim to treat their customers fairly and comply with consumer protection law and that OFT aims to enable and encourage them to do so, and to take enforcement action only where there is no better route to securing compliance.”

*Statement of consumer protection enforcement principles (Office of Fair Trading, 2010), OFT1221.*

- They might not know what to do, or how to do it, but could be helped

*Lightening the Load: The Regulatory Impact on UK's Smallest Businesses (Department for Business Innovation & Skills, 2010); Consumer Rights and Business Practices (IFF Research, March 2013)*

- A small number of people do bad things

“An important finding from criminology is that the vast majority of crimes are committed by a small minority of people. The evidence tells us that there is nothing inevitable about criminality – no one is doomed to be a criminal by their upbringing. But there are some circumstances, like low levels of self-control, which are associated with a higher likelihood of offending. And we know that those characteristics can be influenced by what children experience growing up. So if we are to reduce the likelihood of future criminal behaviour, we need to build positive characteristics and resilience, particularly in young people at risk of harm or offending.”

Speech by Home Secretary Theresa May launching the Modern Crime Prevention Strategy at the International crime and Policing Conference 2016, 23 March 2016

# Cognitive and Behavioural Psychology I

1. People will *not break* rules where they perceive that the risk of being identified is high.
  - contrary to economic theory, the effect will not be much affected where penalties are increased;
  - social embarrassment and reputation are important;
  - constant surveillance (and enforcement), if practically achievable, would have huge economic and social costs
  - Constitutional objections to ruling by fear
2. There are many reasons why people will *do the wrong thing*: the brain's two systems, heuristic patterns, inertia and procrastination, framing and presentation, social influences: Compliance is socially constructed, little feedback, difficulties in assessing probability and under-appreciating risk, risk taking: under-assessment WYSIATI.

TR Tyler, *Why People Obey the Law* (Yale University Press, 2006)

D Kahneman, *Thinking, Fast and Slow* (Allen Lane, 2011)

D Gentilin, *The Origins of Ethical Failures. Lessons for Leaders* (Abingdon and New York, Routledge, 2016)

R Barrett, *The Values-Driven Organization* (Routledge, 2013)

# Cognitive and Behavioural Psychology II

3. People will *obey* rules where:

- i. The rule is made fairly
- ii. The rule is applied fairly (and that includes evenly, and with a proportionate response, so there should be serious consequences for serious wrongdoing)
- iii. The rule corresponds to the individual's internal moral values.



# Implications for System Design

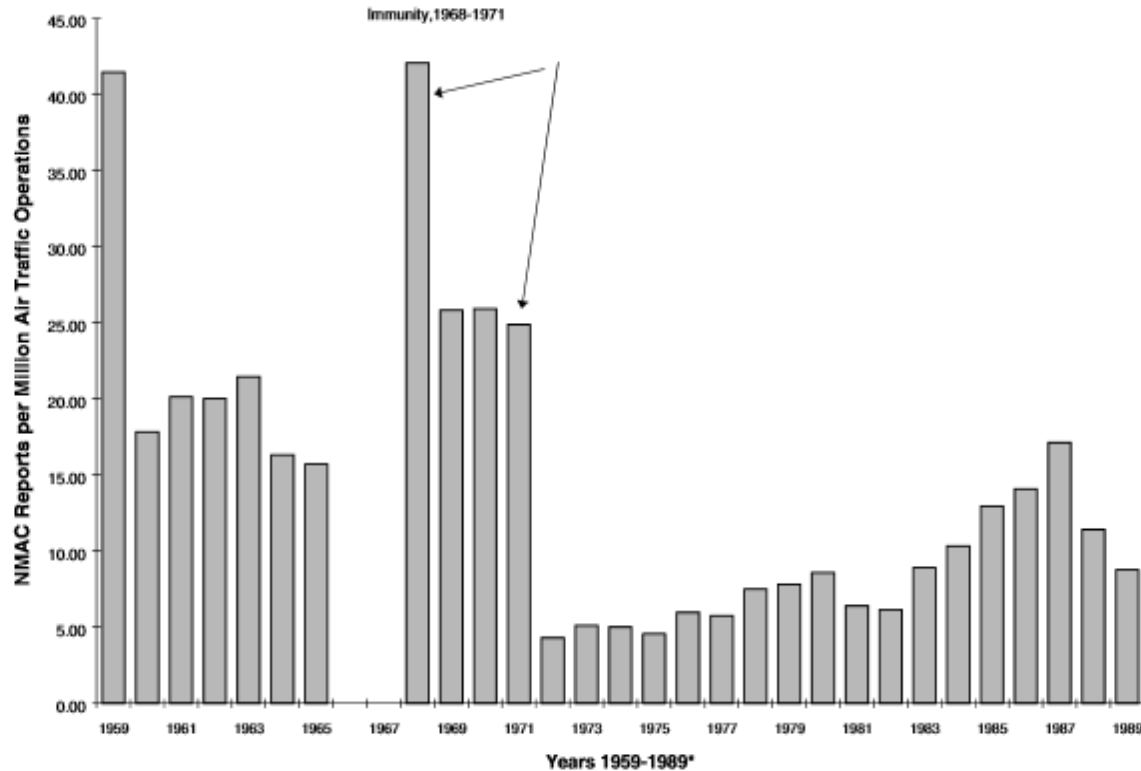
1. *The rule is made fairly*
  - Process: predictable, fair, open, transparent, consultation, participation, democratic
2. *The rule is applied fairly*
  - Enforcement policy and practice: occurs when required, predictable, consistent, even-handed, proportionate responses
3. *The rule corresponds to the individual's internal moral values*
  - Agreed, shared ethical principles
  - Substance of moral values is seen to be shared and applied

# To achieve data flow, you need a no blame culture

## *Aviation safety case study*

- *Open culture* of *questioning* decisions and sharing knowledge of mishaps – extensive free sharing of information
- *Just culture* of *no blame*, non-punitive environment and response
- Maintain *accountability* by constantly, visibly *contributing*
- Aims
  - constant monitoring of *performance*
  - constant learning and improving the *system* and its human operation.
- ‘No blame’ must operate in every context: system regulation, professional regulation, employment discipline, liability for harm, social

FAA NMAC introduced an offer of immunity from prosecution: pilot reporting increased dramatically (from 559 in 1965 to 2,230 in 1968); when retracted immunity in 1972, reporting dropped (to 231 in 1987) and remained low.



**Figure 2: Pilot Reports of Near Midair Collisions (NMACs) (1959 to 1989) and Under Federal Aviation Administration Grant of Immunity (1968-1971)**

SOURCE: Adapted from U.S. Federal Aviation Administration, Office of Aviation Policy and Planning (1999), and U.S. Federal Aviation Administration, Office of Aviation Safety (1987).

NOTE: Data missing for 1966 to 1967.

# Principles for System Design

1. **A policy of supporting ethical behaviour.** The regulatory system will be most effective in affecting the behaviour of individuals where it supports ethical and fair behaviour.
2. **Ethical regulators.** Regulators should—self-evidently—adopt unimpeachable, consistent and transparent ethical practice.
3. **Ethical businesses.** Businesses should be capable of demonstrating constant and satisfactory evidence of their commitment to fair and ethical behaviour that will support the trust of regulators and enforcers, as well as of employees, customers, suppliers and other stakeholders.
4. **A learning culture.** A blame culture will inhibit learning and an ethical culture, so businesses and regulators should encourage and support an essentially open collaborative ‘no blame’ culture, save where wrongdoing is intentionally or clearly unethical.
5. **A collaborative culture.** Regulatory systems need to be based on collaboration if they are to support an ethical regime, and to maximise performance, compliance, and innovation.
6. **Proportionate responses.** Where people break rules or behave immorally, people expect to see a proportionate response.

See Annex to *Striking the Balance. Upholding the Seven Principles of Public Life in Regulation* (Committee on Standards in Public Life, 2016)

CIVIL JUSTICE SYSTEMS

# Law and Corporate Behaviour

*Integrating Theories of Regulation,  
Enforcement, Compliance and Ethics*

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Hart · CH Beck · Nomos



Department  
for Business  
Innovation & Skills

Better  
Regulation  
Delivery Office

## **Ethical Business Regulation: Understanding the Evidence**

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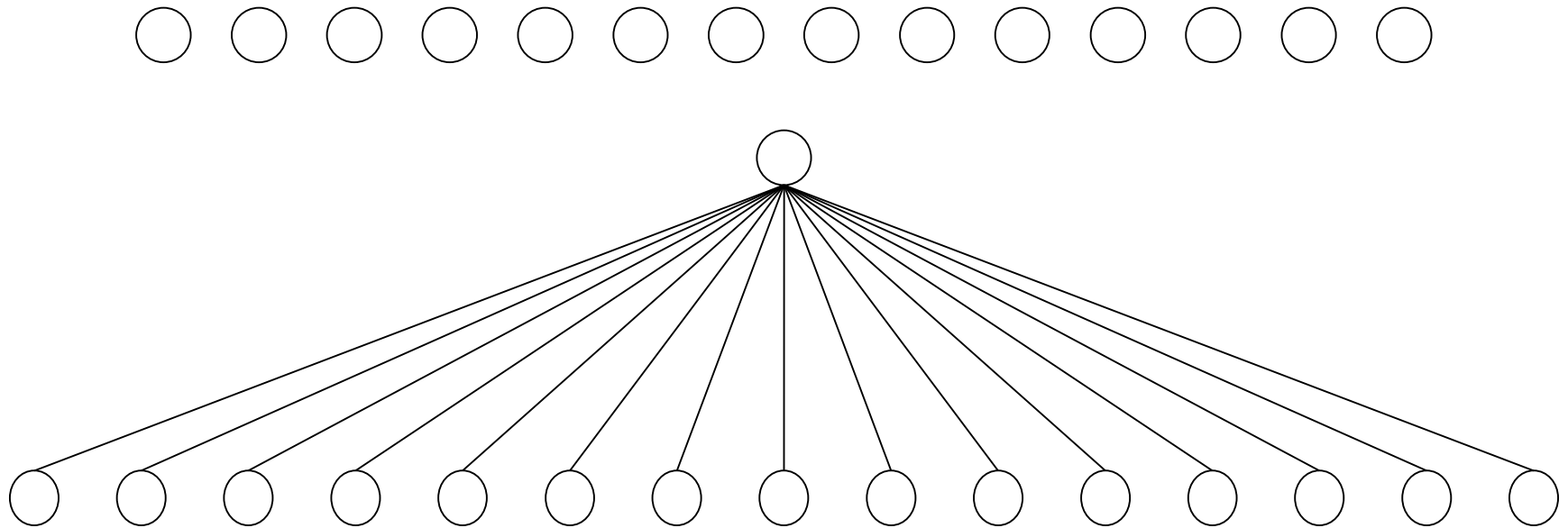
Professor of Justice Systems, and Fellow of Wolfson College,  
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February 2016

# Trust

- 1. The confidence to overcome risk**
- 2. Trust is based on evidence**
- 3. Build evidence that authorities/regulators/enforcers can be trusted**
- 4. Build evidence that businesses can be trusted**
- 5. Convincing evidence has to demonstrate ethical behaviour, applying ethical values**

# The Primary Authority Scheme (1)





## UK Regulatory Futures Review, January 2017

Regulators should move towards (and report on):  
'Regulated self-assurance' and 'earned recognition'

Effective regulatory delivery models should focus, as far as possible, on outcomes, rather than on a rules-based approach. Organisations should be able to find the best way to self-assure that they are meeting their legal responsibilities, and earn recognition that they are doing this. Where this occurs, the role of regulators should be mainly to provide information and advice to ensure that organisations assure themselves effectively and reliably, and intervene when they do not.

Potential public sector savings of £620 million pa  
Influence of EBR:

In practice this means that businesses who 'do the right thing' should be regulated with a very light touch. As part of this, regulators should encourage more ethical business practices. However, where regulated entities do not 'do the right thing' and do not follow ethical business practices, redress should be sought.

# Implementing EBR

## Building evidence for a relationship of trust

Actions for Government	Actions for Regulators/Enforcers	Actions for Businesses
<p><b>Support EBR</b></p> <ul style="list-style-type: none"><li>- Mandate EBR</li><li>- Promulgate and defend EBR</li></ul>	<p><b>Encourage EBP; not discourage it</b></p> <ul style="list-style-type: none"><li>- Incentivise: EBR protocols</li><li>- Responses to issues raised by EBs</li><li>- Enforcement/sanctions policies</li></ul>	<p><b>Implement Ethical Business policy</b></p> <ul style="list-style-type: none"><li>- Leadership, culture, training, reminders, feedback, checking, actions</li><li>- Build means to <i>demonstrate</i> consistent EB culture and outcomes</li></ul>

# Implementing EBR

Civil aviation	Medicines and medical devices	Workplace Health & Safety	Environment	Trading Standards: Primary Authority
Equality & Human Rights	Gambling	Water	Food standards	Genetic materials
International money laundering	Energy	Care Homes	Lawyers	Timber

# An Ethical Organisation

1. Full commitment to ethical values
2. The role of leadership; styles and effectiveness
3. The organisation has a clear social purpose
4. Establishing the organisation's core ethical values; and measuring them throughout the organisation;
5. Making the values relevant for everyone at all levels (eg through discussion of examples from daily practice)
6. Code of ethical practice and record of decisions (assured advice)
7. Ethical decision making models; recognising ethical issues and conflicts ....
8. Consistent systems and messages
9. Employee engagement in fostering ethical behaviour
10. Promoting an open culture, speaking up, checking and asking questions
11. Fail safes: whistleblowing
12. The need for enough time
13. Working together with all stakeholders in open trusting relationships
14. Responding ethically when under stress
15. Instilling the ethical approach; change of emphasis

# Barriers to EBR

1. The values are not real and realisable by people throughout the organisation
2. Inconsistent messages
3. Failure to recognise that an ethical issue/conflict arises
4. Incentives that drive unethical actions (eg remuneration and bonus practices, the wrong targets, and short-term expectations in reporting)
5. The values are ignored in decisions/actions, eg crowded out or ditched by other seemingly more pressing values (eg meeting financial or numerical targets, time)
6. Unethical sub-cultures
7. Too many managerial layers: messages become simplified, and the top does not know what is going on at the bottom
8. Stress
9. Focusing on compliance and rules, rather than on values and outcomes