

The 2017 Max Watson Lecture

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Ethical Business Practice & Regulation: A Revolution in Regulation, Delivery, Enforcement and Compliance

I am deeply honoured to be asked to deliver the 2017 Max Watson Lecture. I did not have the pleasure of knowing Max, but his reputation for transformative thinking is legendary. Taking this inspiration, I aim to identify in this lecture how the evolution of various strands of policy and practice in regulation, compliance and enforcement have recently converged, to create a transformational opportunity. In short, I aim to show that where we have got to in enforcement of regulation opens up both the need and the means of doing things differently and doing them better. The resultant theory and practice has come to be called ‘Ethical Business Practice & Regulation’. It is basing human activities on ethical values, supported within social groups, and by regulatory relationships.

This need arises because we seem unable to stem the tide of major scandals in corporate behaviour (Enron, WorldCom, BCCI, Payment Protection Insurance, selling mortgages to those who would be unable to repay and selling bundled sub-prime derivatives, the 2008 financial crisis, LIBOR fixing, Tesco systematically paying farmers late, VW’s emissions ‘cheat device’, Rolls-Royce’s systematic bribery and corruption payments, recidivism in cartels, the Odebrecht bribery scandal in Brazil) and public life (MP’s expenses, phone hacking by journalists), and sport (FIFA, doping in professional cycling, Russia’s expulsion from the Olympics due to institutionalised doping). Traditional approaches to regulation and enforcement are simply not preventing these problems, or identifying them early enough. We need a fundamental review of how we do regulation and enforcement.

The inquiry ranges widely, over at least law and legal philosophy, economic theory and enforcement practice, socio-legal research into ‘responsive regulation’, human genetics, cognitive and behavioural psychology, and ethics. The amount of detail that one can look at in this area is enormous—witness my tome *Law and Corporate Behaviour* (Hart, 2015)—but here I will consciously simplify the argument. Many points of substantiation may be overlooked, but the argument should be clear.

1. The evolution of policy and theory on regulation

The basic purpose of regulation is for society to control *how* legitimate activities are performed so as to conform to the social and economic policies of the society, represented by its state authorities. The constitutional basis for businesses, for example, to be controlled in this way stems from their legal and social licence to operate within a state. Hence, the state imposes controls on economic and social aspects of how business operates.

I start by reminding ourselves of the familiar regulatory models, especially of two opposing approaches. First, the ‘command and control’ model under which those in authority impose their will on others. [‘Do what I say.’] It is a ‘top down’ model. The opposite is the ‘bottom up’ model of self-regulation, in which people voluntarily conform to the required norms, perhaps assisted by external effects such as the incentive to maintain market reputation. [‘My word is my bond.’]

Neither ‘command and control’ regulation nor voluntary self-regulation are ideally effective. The intermediary model between these two extremes is co-regulation, which seeks to combine elements of public control with voluntary self-regulation. Various models of co-regulation exist, such as involving trade sector codes of best practice, or third party certification (e.g. by auditors or notified bodies). A development of the co-regulatory model was firmly endorsed in January 2017 by the UK Cabinet Office’s *Regulatory Futures Review*, under the title of ‘regulatory self-assurance’ as the desired direction of travel for *all* regulatory systems in UK.¹ The basic idea of ‘regulatory self-assurance’ is that the regulatee is owner of the risk, and should assure itself that the risk is under control. It is the regulatee’s risk, not the regulator’s risk. The regulator’s role is to ensure that the regulatees are in control of the risk, primarily by assisting, but if the regulatee is not in control of the risk, the regulator’s role switches to supervisory policing.

The ‘regulated self-assurance’ model can be categorised as the co-ordination of activities in co-regulatory tiers involving a matrix of multiple stakeholders.

2. The evolution of policy and theory on enforcement

Those models of regulatory structures each have enforcement policies associated with them. The issue of *enforcement* has received comparatively little study. Enforcement is the ‘back end’ of regulation, and inherently unattractive to most regulators or theorists. Yet we find that understanding *how* and *why* people—individually or in groups—conform to rules or break them, is critical to designing an ‘enforcement policy’ and also to the ‘front end’ issue of the design of the regulatory system itself. If the system and its rules are not going to achieve the desired outcomes, it fails. If we understand more about why people observe or break rules, we may discover a great deal about how to design effective and efficient regulatory systems. That observation applies equally to regulatory systems that apply *inside* businesses, which are usually called ‘compliance systems’. That observation itself raises the question of whether external regulatory and internal compliance systems and approaches are aligned or unsynchronised, which would have consequences in relation to achieving desired outcomes effectively and efficiently.

Two opposing theories of enforcement can be seen, which largely mirror the ‘command and control’ and ‘self-regulation’ models. Deterrence is the traditional enforcement policy under ‘command and control’. Deterrence has (at least) two meanings. The first meaning stems from relatively unsophisticated societies, in which the leader rules by fear, threatening to impose physical punishment of death on any non-compliance with his wishes, perhaps in an arbitrary fashion. The authoritarian instruction is accompanied by a threat: ‘Do what I say—*otherwise I will hit you.*’ Mediaeval lords and more dictators throughout history rule this way. But ruling by fear is socially and constitutionally unacceptable in a modern democracy.

The second meaning of deterrence stems from 20th century economic theory. It assumes that all decisions are taken by rational actors, based on an objective calculation of whether the benefits of an action outweigh its costs. The basis of this approach is *theoretical* not empirical. However, the ‘rational actor’ model of decision-making—even in relation to an organisation whose aim is to make profits—has been roundly undermined, especially by the scientific findings of behavioural psychology on how humans make decisions.

Nevertheless, deterrence is deeply engrained in legal theory. It stems from a philosophical focus on the *individual* as morally responsible for his or her actions. Its firm basis within classical economic theory, coupled with American political emphasis on personal individual freedom, is entrenched within legal positivism.

Deterrence is also found in some corporations’ internal compliance systems, and underlies the so-called ‘leniency’ policies of some regulatory or criminal sanctioning regimes on companies. There are three ideas here: first, that a corporation is able to control the activities of all of its employees, and second that an internal compliance system is the mechanism that will do this (traditionally involving a code of ethics, lecturing staff on their ethical responsibilities, and operating extensive compliance systems). Hence, third, companies should be incentivised to adopt compliance systems. These propositions have not stood up to scrutiny. Moreover, the result is that corporations seek to buy lower fines under a ‘leniency’ scheme by demonstrating that they have sophisticated compliance systems. Basically, the game is to demonstrate that the firm has extensive training, procedures and records. But training, procedures and records do not drive or guarantee human behaviour or corporate actions. Neither do fines or civil damages. Threat of sending senior executives to gaol will not affect most executives or staff, who believe they are doing the right thing, or have no choice, or will not be caught.

Many legislators, enforcers and judges seek to respond to wrongdoing by increasing deterrence. The truth, however, is that there is little empirical evidence that deterrence is effective in affecting future behaviour, certainly in the regulatory context: it is a widely-held myth.

If deterrence fits a ‘command and control’ model as its ‘enforcement policy’ or means of behaviour control, its opposite under a self-regulatory model might be called ‘spontaneous voluntary benevolence’. People are inherently good, and will ‘do the right thing’. Altruism certainly exists, but it is not universal. Selfishness, or the pursuit of commercial goals, may overcome acting in the best interests of

others. However, ‘My word is my bond’ is not just a personal commitment, but actions are supported by mechanisms of social communities and reputation built on evidence that a person can be trusted.

Further, my review of the enforcement policies of UK regulatory authorities² revealed, first, how few of them adopt deterrence as a headline policy (the leading examples are the Financial Conduct Authority and the Competition and Markets Authority), second, how many authorities adopt a supportive, responsive approach to improving business compliance and practice, and, third, that the economic regulators, as a group, have been moving away from deterrence and towards the supportive approach. These shifts are so marked that they raise the question of whether those authorities that still rely on deterrence are simply out-of-date. Many regulators/enforcers have shifted to a response to wrongdoing that differentiates between (a) unethical people/motivations and the anti-social (sociopaths), for whom proportionate, deserved sanctions are imposed, and (b) ‘ethical people’, i.e. people who are basically honest but who might fail but wish to improve and comply, for whom the response is to give advice, education and support improvement.

The supportive approach to businesses getting things wrong rests on assumptions like the following:

- 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.’³
- They might not know what to do, or how to do it, but could be helped.⁴ This is especially relevant for small businesses (SMEs) but could apply to ones of any size.
- 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.’⁵

Much of the regulatory approach is familiar to scholars from the ‘responsive regulation’ work of John Braithwaite and others. Enforcers should have a well-stocked toolbox of investigative and enforcement powers, but need to select which powers are used when (‘*Have a big stick, talk softly.*’) The aim should be to agree responses to problems, rather than engage in fighting through the courts.

Incidentally, the EU does not in fact have any coherent enforcement policy. A major reason for this arises out of the principle of subsidiarity, which has left the EU creating laws and regulatory systems, whilst completely failing to focus on how they will be operated in practice in the different contexts of the Member States. National variations have not been studied, mapped, compared, or harmonised. EU legislation is typically restricted to repeating the policy mantra that Member States are responsible for implementing the substantive provisions of EU legislation, and for its enforcement, and that sanctions should be ‘effective, proportionate and dissuasive’. This produces an ‘EU regulatory system’ that is incoherent and dysfunctional. Only the UK and the Netherlands have made much attempt to focus on ‘regulatory delivery’. There has been virtually no academic or policy work on EU enforcement or how to affect business behaviour.

3. Comparing the approaches

The competing approaches can be strikingly illustrated from recent examples.

FCA

In response to the raft of wrongdoing that emerged from the 2008 financial crash, Parliament and the Financial Conduct Authority imposed massive ‘deterrent’ fines (£3.38 billion since 2008), put in place a huge mass of new rules, and made ‘Senior Managers Regime’ (SMR) under which senior individuals must be allocated particular responsibilities,⁶ so they could be held accountable and prosecuted.

Annual FCA fines 2011/12 – 2015/16 £million⁷

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Number of Fines								
Individuals				40	19	22	24	15
Firms				23	26	27	27	17
Total				63	45	49	51	32
Aggregate Fines (£m)								
Individuals				19.9	5.0	3.9	7.1	16.2
Firms				58.9	422.2	416.9	1,403.1	874.0
Total	27.6	33.5	98.7	78.8	427.2	420.8	1,410.3	890.2

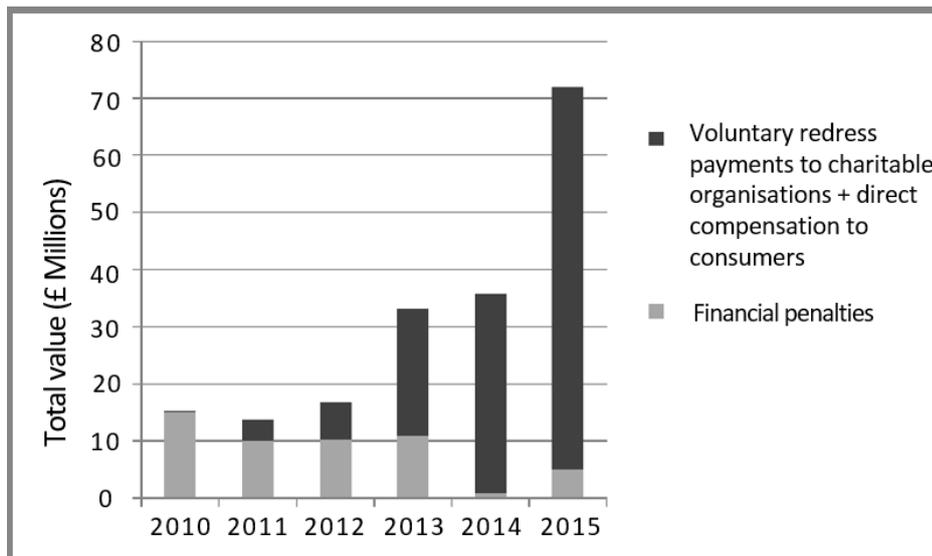
The theory is that large fines change behaviour. Where is the empirical evidence for that, or studies that show mechanistic cause and effects?

Although both the FCA, the City of London Corporation,⁸ the Financial Reporting Council⁹ have stressed the importance of culture in financial services and investment, they stop short of calling for *ethical* values. OECD has emphasised business integrity.¹⁰ There are signs that economic incentives that distort ethical behaviour are being changed, such as reductions in massive bonuses, changing the criteria for awarding bonuses from financial performance alone. However, it will take some time for things to change in the financial services sector. It is no surprise that the Banking Services Board's 2017 report, reporting the views of 28,000 staff in 22 UK banks and building societies, found 'many examples of good practice' but also identified 'areas where change is needed, and where deep-rooted attitudes and behaviour detrimental to the interests of customers and clients' as well as workers.¹¹ It highlighted that 'responsiveness, accountability, personal resilience and openness are all areas where ... progress needs to be made'.

Ofgem

The change in Ofgem's approach to sanctions is truly dramatic. Its enforcement notices typically set out detailed arrangements on what businesses are going to do in generating change in their behaviour, usually with specific targets, which can be monitored. There has also been a transformative shift between imposing fines to overseeing payment of redress from 2010 to 2015, as shown in Figure X.¹² In 2014/15, redress represented 92.5% of the volume of remedies imposed, with £26.4 million being paid or made available to customers, £15 million in penalties, and £19.3 million in payments to charities or other third sector organisations in lieu of financial penalties.¹³ The increase in redress begins to build consumer satisfaction.

Figure X. Financial penalties and voluntary redress resulting from enforcement actions by Ofgem 2010-2015



Health and Safety Executive

In response to stubbornly high accident rates on construction sites (comprising 35% of the national worker fatalities (nearly 900 men) in the 1990s), the Health & Safety Executive (HSE) decided on a new approach: to make it those involved *own* it as their problem. Traditionally, inspections had been used to intervene on a site-by-site basis, but it was realised that inspections alone by tens of inspectors would never be sufficient to tackle the scale of poor standards across the industry with tens of thousands of construction sites. The HSE adopted a new approach, which was:¹⁴

‘to leverage influence within the industry supply chain in high risk areas, engaging and forming partnerships with parties able to effect widespread change (such as company directors or strategic bodies focused on particular interest groups or sectors).¹⁵ HSE’s role was as a catalyst, utilising its unique overview from official data of the harm being caused industry-wide and expertise in understanding reasonably practical controls (but explicitly relying on those who created the risk ultimately to control it).

.... The new approach centred on influencing or triggering changes, reliant on the action of others. For the theory to work in practice it was crucial that the risks to be addressed could be recognised by industry as being significant (what), and that the parties engaged with (who) were relevant and influential.’

The HSE created an Influence Network (IN) involving four layers of Environmental, Strategic, Organisational and Direct influence on construction health and safety. The most significant improvements in the IN factors were observed in Organisational and Strategy factors, which relate to the management of both companies and sites.

The approach was a significant success. From 2000/01 to 2012/13 the combined rate of fatal and major injury accidents in construction fell by 38%, and the number of fatal and major injury accidents fell from 4,410 to 2,161 (49%). Florentin Blanc has compared the enforcement policies of various countries on workplace health and safety legislation, which all have the same laws, and illustrated clearly that the difference in effectiveness lies not in the rules but in how the authorities approach the people who have to apply them.¹⁶ The UK’s approach noted above has permanently reduced the incidence of serious safety incidents, and that approach was later followed by Germany, with the same outcome. The approach in France, however, relies on inspections and identification on non-compliances, for which penalties are imposed, irrespective of the context. The ‘name of the game’ in France is for businesses to pass inspections, not to make workplaces safe. Thus, the workplace safety record of France has remained one of the worst in Europe.

Equality and Human Rights

The Equality and Human Rights Commission identified extensive legal infringements in the meat and poultry processing sector after an inquiry commenced in 2008. The sector employed 67,500 people.

The Commission had a choice between adopting traditional ‘hard’ enforcement, prosecuting some offending companies, or a ‘softer’ approach aimed at achieving more widespread and permanent change across the sector. It chose the latter. Reviewing results in 2012, it reported significant progress:¹⁷

‘Rather than taking expensive and confrontational enforcement action, we decided to work with, and support, the industry to improve their recruitment and employment practices. We began by writing to processing firms setting out the main findings of the inquiry, relevant recommendations and encouraging them to draw up an action plan to tackle the challenges the industry faced. We also set up a representative industry taskforce chaired by the Ethical Trading Initiative. The aim of the taskforce was for the industry to take the lead and work together to tackle the challenges it faced, supported by the Commission. The solutions for business came from business. The supermarkets and industry bodies identified and agreed management practices and key performance indicators (KPIs) to deal with many of the problems identified in our inquiry. These have already been adopted by meat and poultry processing firms supplying most of the major supermarkets.’

The Commission continued to work with the industry to embed good practice. As with the similar approach adopted by the Health & Safety Executive, a sea change in attitudes occurred across the sector. Supermarkets and other major influencers were enlisted to support and procure good practice. The Commission has adopted the same approach in relation to other issues, such as employers’ attitudes to maternity rights. The basic approach is to work *with* people rather than *against* them.

4. Taking a Fresh Look

If we have abandoned the two extremes of ‘command and control’ and ‘self-regulation’ regulatory models, and are now relying on a hybrid (regulated self-assurance) that seeks to combine but transform elements from both, we also need a theory and policy on enforcement and compliance that is appropriate and effective.

An approach based entirely on ensuring compliance will fail, as it does not give sufficient emphasis to improvement and risk. It also erodes trust, since it sends a message that those subject to regulation are being unduly monitored, measured, observed, and judged.

If we want to know how to increase compliance with law, we need to start somewhere else—by asking how and why people observe rules or break them. That means we need to look not at economic *theories* of how behaviour is affected, but at the relevant *science* of how humans behave.

5. Lessons from Behavioural Psychology

A great deal of learning about how humans think, make decisions, and act has been assembled in the past century. This is a short summary of some key points.¹⁸ Humans make many decisions quickly, and by gut feel, especially if the brain thinks that it has encountered the decision before (heuristics, ‘fast’ and ‘slow’ brain). We can take a decision and then immediately seek to rationalise it, even when it is obviously wrong. We are ‘predictably irrational’, suffer from inertia and procrastination, and are not the rational actors of economic theory. Good people often do stupid things, and break rules, usually not seriously. People think they comply, even if they (obviously) do not. We are strongly influenced by social groups and by our concept of fairness. We follow what we perceive to be ‘group culture’. How decisions are presented and framed can affect us.

People will *not break* rules where they perceive that the risk of being identified is high. This means that one might control some behaviour by affecting not the risk or likelihood of being identified but the perception of people who are at risk of breaking the rule. Social embarrassment and reputation are important. However, this line of control could not be universal: constant surveillance (and enforcement), if practically achievable, would have huge economic and social costs, and be socially divisive.

This science has been applied (under the title of ‘behavioural economics’ or ‘nudge’) by governments to influence actions by citizens and consumers (paying tax on time, not exceeding road speed limits, eating more wisely, sensible consumption).¹⁹ What I have tried to do is apply the same science

to decisions by people in business organisations (compliance) and to the relationship between the state and businesses (regulation). To do this, we need to add a new dimension.

6. Genetic Evolution, Collaboration, and Trust

We usually achieve more if we work together with others, using the combined power of our efforts and brains. How and when do we cooperate with others? The species *homo sapiens* is unique in having an inherent sense of morality—of right and wrong.²⁰ We use this sense to distinguish whom we can trust and whom not, and hence whom we should cooperate with.

Philosophers help here. Hawley concluded that to be trustworthy, a person has to demonstrate evidence of a non-self-regarding motivation and other-regarding commitment.²¹ Onora O’Neill considers that the benchmarks for intelligent accountability are *informed* and *independent* judgment of performance, complemented by *intelligible* communication of those judgments. She suggests that we have to know both *who* and *what* we are being asked to trust.²² Francis Fukuyama says that ‘People who do not trust each other will end up cooperating only under a system of formal rules and regulations, which have to be negotiated, agreed to, litigated, and enforced, sometimes by coercive means.’²³ Accordingly, this legal apparatus, serving as a substitute for trust, necessarily produces ‘transaction costs’. Fukuyama also said: ‘A high-trust society can organise its workforce on a more flexible and group-oriented basis, with more responsibility delegated to lower levels of the organization. Low-trust societies, by contrast, must fence in and isolate their workers with a series of bureaucratic rules.’²⁴

If we want to expand cooperation and hence economic health, we should be looking for ways in which individuals and businesses can signal that they can be trusted, and encourage these. (Imposing deterrent sanctions, of course, will destroy trust.)

Drawing on the proposition by celebrated psychologist Abraham Maslow, that the ultimate stage of human development is ‘self-actualizing’,²⁵ Fernand Laloux suggests that we are currently shifting to a new consciousness of collaboration between people and between peoples.²⁶ He suggests that as we develop our ideas and social, economic and political needs, we develop different ways to collaborate—a new organizational model. He argues that the most recent stage has developed features of meritocratic empowerment, values-driven culture and inspirational purpose, a multiple stakeholder perspective with no hierarchy among stakeholders and the family as the guiding metaphor.

These ideas have echoes in scholars’ idea of a regulatory system in which multiple influencers or stakeholders influence behaviour (regulatory pluralism), such as Gunningham and Grabosky’s concept of ‘Smart Regulation’,²⁷ Black’s ‘decentred regulation’,²⁸ and Parker’s ‘open corporation’.²⁹

Trust is increasingly regarded as critical by many regulators³⁰ and by companies,³¹ and has become about more than merely stopping people and businesses from engaging in bad behaviour, now to include helping people to act ethically. I note here that in 1944 the economic historian Karl Polanyi said that the basis of compliance with rules and regulation is in fact strongly based on social relationships.³² However, he noted that the industrial revolution had displaced social arrangements in favour of economic considerations, and that we needed to embed economics back within its social context.

There has recently developed a new term, and a new expertise, of ‘regulatory delivery’, in which the UK is a global leader. Regulatory delivery looks beyond the traditional assumption that rules that are enforced will be observed, and engages with *how* rules are received and applied by businesses and others whose behaviour those regulations seek to control, and hence the manner in which they are enforced so as to achieve maximum compliance and performance.

7. Adding the Ethical Dimension

Looking at the scientific findings, it seemed to me that they point to the conclusion that people *will* obey rules where:

1. The rule is made fairly. That involves fair process: predictable, fair, open, transparent, consultation, participation, democratic.

2. The rule is applied fairly. That includes an enforcement practice that occurs when required, is predictable, consistent, even-handed, and involves proportionate responses. Hence, it requires serious consequences for serious wrongdoing.
3. The rule corresponds to the individual's internal moral values.

The critical component running through these three elements is that of fairness. It is interesting that fairness as a concept has spread in European consumer trading and regulatory law. (We ban unfair contract terms, and unfair commercial practices,³³ and we require banks and energy companies to 'treat customers fairly'.³⁴)

It is interesting to reflect that Christianity has formed the backbone of behaviour and relations in Western Europe for at least the past millennium, but some of our societies are now secular (and feel threatened). Might compliance increase if a sense of shared relationships and ethics were strengthened?

8. From Shareholder Value to Ethical Business Practice

The classic economic model is that companies should concentrate exclusively on 'maximising shareholder value'.³⁵ From the 1980s,³⁶ this theory and its associated 'agency theory' that one should incentivize managers to achieve profit maximisation, has been blamed for driving excessive pay for senior executives and a series of corporate scandals and disasters where there has been no institutional break on profit-maximising behavior. John Armour of Oxford and Jeff Gordon of Columbia argue that the shareholder value norm creates incentives for firms systematically to undermine the efficacy of regulatory internalization mechanisms, thereby failing to avoid the significant externalities that were thought to be avoided.³⁷ Harvard scholars Joseph Bower and Lynn Paine have recently attacked the traditional theory head on, arguing that the goal of pursuing shareholder value is flawed in its assumptions, legally confused, and damaging in practice.³⁸

In contrast, some companies place great emphasis on their efforts to put customers first, to treat staff well, to pay suppliers on time, not to source from chains that include child labour or destroy the environment, not to pay bribes, not to enter into cartels, to adopt Corporate Social Responsibility programmes, observe the UN Business and Human Rights requirements, and so on. These behaviours may have been produced individually through external forces, such as competitive markets and reputation (bad publicity), or legislation such as the U.S. Foreign Corrupt Practices Act (leading to adoption of the 'Responsible Care' programme by the US Chemical Manufacturers Association), but they are real. The question now is how to combine all the individual behaviours into consistent and simple holistic practice.

Since around 2003, case studies have appeared describing companies that have adopted a values-basis as their central strategy for doing business.³⁹ John Kay observes that the most profitable businesses are not the most profit-oriented and argues that happiness is not achieved through the pursuit of happiness ('Happiness is not a red Ferrari').⁴⁰ Similarly, Mayer points out that shareholder value is an outcome, not an objective.⁴¹ Sisodia, Sheth and Wolfe's 2014 analysis of 57 US public and private companies, and 15 companies from other parts of the world, which they identified as operating as 'firms of endearment' that adopt a comprehensive approach of delivering the needs of *all* their stakeholders, showed that cumulative shareholder returns over 15 years were 1681% and 1180% respectively, as against the Standard & Poor 500 companies' rate of 117%.⁴² They call culture the secret ingredient, and society the ultimate stakeholder.

Northern Gas Networks, for example, used to be a status-oriented organization, but created a customer-focused and safety-focused organization. It found that internal culture developed quickly, from one in which individuals expected to be told what to do to one in which trust was established, based on honesty, transparency, and authenticity. Like various other companies,⁴³ it found that a rigid hierarchical structure prevents trust among employees. Their workers who dig up holes in pavements and roads were found to love the idea that their most important corporate value is *love!* ('We're digging up your road with love, love!')

9. The Ethical Business Practice and Regulation Model

My idea of Ethical Business Practice (EBP) simply attempts to bring all these ideas together, and to incentivise EBP within a structure and a relationship—Ethical Business Regulation.

The Essence of Ethical Business Practice

1. Do the right thing.
2. Always ask, check, discuss if other people you trust think you are doing the right thing, or if you're not sure.

Ethical Business Regulation

A relationship between a business, or a group of businesses, and a regulator, or group of regulators, in which the business side produces evidence of its ongoing commitment to EBP and the regulatory side recognises and encourages that commitment.

The approach re-balances the economic licence (maximising shareholder value) with the social licence to operate (doing the right thing, fairness). It aims to build an holistic collaborative approach involving all stakeholders—business, staff, suppliers, customers, communities, investors, regulators, legislators, society.

The approach has been adopted in the UK Government's *Regulatory Futures Review*, which said:

‘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.

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.’

How does business behave ethically? A business should have a clear socio-economic purpose, defined ethical values embedded throughout the organisation, and transparent production of evidence supporting trustworthiness.

10. Examples of Regulation through Relationships

One can identify numerous examples of cooperative relationships in the regulatory space. I will note three: civil aviation, the Primary Authority scheme, the approaches of the Food Standards Authority and of the Water Industry Commission for Scotland.

Civil Aviation Safety

Aeroplanes would simply not fly safely without a close working relationship between authorities and airlines, and the people involved. ‘Simply stated, a regulatory ‘compliant’ airline is not necessarily a safe airline.’⁴⁴ Relevant information is constantly shared and checked, to achieve the outstandingly good safety record in civil aviation.⁴⁵ This could not be achieved or maintained without a culture that is open. The essential point is that the culture does not include blame, since people who are afraid of attracting blame will not openly and swiftly share important information. The approach is not to blame an individual for making a mistake, but to identify why any human in a similar situation might make the same mistake, and so as to be able to reduce that risk. Aviation talks about maintaining *performance* rather than compliance.⁴⁶

The aviation safety world has redefined the concept of ‘accountability/responsibility’. Accountability is maintained by constantly, visibly contributing to the group.⁴⁷ The worst thing a pilot, engineer, air traffic controller or other person can do is to fail to be open and sharing. Rather like the City’s ‘my word is my bond’ mentality, the trust is essentially social, rather than imposed or produced by sanctions or threats. The enforcement policy of the Civil Aviation Authority clearly differentiates responses to operators.⁴⁸

The Primary Authority Scheme

The Primary Authority model is based on a shared approach between Local Authorities and participating businesses, in which responsibilities are defined in agreed protocols.⁴⁹ Above all, the formal structure has created *relationships* between regulators and businesses, and between authorities themselves. The scheme supports development of consistent good practice. A critical component is the ability of businesses to seek clarification of what they should do to comply with the rules. The resultant assured advice brings the consequence that compliance with it would not trigger enforcement action.

The model has been an outstanding success. At February 2017, there were over 16,000 businesses in Primary Authority partnerships with 183 local authorities. From 1 October 2017, the scheme will be extended to include five national regulators and trade associations, benefiting an estimated 250,000 businesses in UK. It reduces the need for inspections or enforcement action against trusted businesses, and instead supports communication within an established relationship so as to identify and swiftly resolve issues as they arise.

The Regulatory Delivery Directorate of the Department for Business, Energy and Industrial Strategy, which oversees the Primary Authority scheme, published its service standards in 2017 on what businesses can expect of it, which emphasise that it carries out all its activities ‘in a way that supports those we regulate to comply and grow’, and includes the following statements (which, it will be seen, are a long way from an approach based on deterrence):⁵⁰

‘Helping you to get it right

We want to work with you to help your business to be compliant and successful and it is important to us that you feel able to come to us for advice when you need it. We won’t take enforcement action just because you ask us a question or tell us that you have a problem. ...

Responding to non-compliance

Our aim, when dealing with non-compliance, is to deliver fair and objective enforcement in a manner consistent with the intentions of the legislation and the necessity of delivering a robust and credible enforcement regime. Where we identify any failure to meet legal obligations, we will respond proportionately, taking account of the nature, seriousness and circumstances of the offence, including taking firm enforcement action when necessary.’

Some success stories from PA are:⁵¹

- At a Northamptonshire local authority, savings to businesses in 2014–15 were estimated to be £80,000, with improvements in business compliance and satisfaction.
- Imperial Cars’ partnership with Portsmouth City Council reduced complaints to Trading Standards by half and increased turnover by £27 million.
- Savings for a care home group (HC-One) of £1 million as a result of agreeing single best practice that was applied consistently across its multiple homes in different geographical areas across the country.

Food Standards

The Food Standards Agency (FSA) has adopted a strategic goal of ‘Food We Can Trust’, and published the following five principles that form the core of discussions with stakeholders in 2016 (emphasis added below):⁵²

1. *Businesses are responsible* for producing food that is safe and what it says it is, and should be able to demonstrate that they do so. Consumers have a right to information to help them make informed choices about the food they buy - businesses have a responsibility to be transparent and honest in their provision of that information
2. FSA and regulatory partners’ decisions should be tailored, proportionate and based on a clear picture of UK food businesses

3. The regulator should take into account all available sources of information
4. *Businesses doing the right thing for consumers should be recognised; action will be taken against those that do not*
5. *Businesses should meet the costs of regulation, which should be no more than they need to be.'*

Studies published in 2017 have shown that audit data collected by two major food businesses could be used by local authorities to check food hygiene standards and decide ratings.⁵³ In other words, the businesses knew their business, and were doing the right thing, therefore they could be trusted. A collaborative programme between the major retailers and processing plants and the Food Standards Authority reduced laboratory reports of the campylobacter bacteria on chickens by 17%, with a direct saving to the economy of over £13 million in the cost of days off work and NHS costs.⁵⁴

Water in Scotland: Prices and Wider Issues

In Scotland both the water regulator, the Water Industry Commission for Scotland (the Commission) and the sole undertaking, Scottish Water, are publicly owned. The principal focus of the regulatory function is to control prices and levels of service for customers. In setting out its methodology for the next regulatory control period in 2021-27,⁵⁵ the Commission expressly accepted the principles of EBR set out in *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics*.

The regulatory philosophy of the Commission is that Scottish Water should 'Seek Trust but Expect Verification', and that 'the onus is on Scottish Water to demonstrate both now and on an on-going basis that its customers and other stakeholders should trust it to deliver the right levels of service for an appropriate price.' The Commission accepted that 'embedding trust among stakeholders will be a key enabler to improving the quality of decisions taken in the Scottish water industry and driving benefits for customers', as this is the 'principal foundation' of the concept of EBR.

11. Taking EBP&R Forward

Future regulatory structures are moving towards 'regulated self-assurance', in which businesses are expected to take responsibility for getting things right. A new approach to the regulatory relationship is needed. Regulated self-assurance will not succeed on its own: it is just a description of a structure. It must be infused with an approach to behaviour, and that behaviour can only logically be based on society's ethical values (EBP). Regulated self-assurance requires a relationship between regulator and regulates. Such a relationship is easiest to establish, manage and grow when it exists within a structure. An excellent example of such a structure is the Primary Authority scheme, which is based on partnerships, agreements on allocated responsibilities, and the expectation of that issues can be raised and will be answered without allocating blame.

The essential step of initiation has to come from business. It is an individual business that will decide if it wishes to adopt EBP, and then to produce sufficient evidence that it can be trusted. For some businesses, removing false incentives may present some challenges. But this it has to be accepted that some incentives can generate good and bad behaviour. Some examples are placing short term business needs above social or other considerations, having large pay differentials between senior and junior workers, and paying bonuses based solely on financial targets. Firms will need both a Cultural and Leadership Framework and a Values Orientated Framework.⁵⁶

Regulators should respond fairly to businesses who produce evidence of their EBP, and desire to enter into an EBR relationship. Regulators should be consistent between themselves in adopting this new approach. It will not be fair if some work with businesses to solve problems and others impose large fines. The relationship should, of course, guard against complacency and capture, but it is inherent in EBR that the roles and authority of all parties is respected.

EBR presents some challenges in adapting to a new approach. It is not susceptible to a 'tick box' approach in which criteria are satisfied, as is the case with satisfying standards. As the Institute of Business Ethics has noted, *'The conclusion that culture matters is a problematic one for regulators because it involves a qualitative approach. They cannot force companies to have a 'good' culture because they cannot define exactly what that means and measure compliance on an objective basis.'*⁵⁷

For this reason, a number of pilot studies are now under way, to learn if and how EBP works best in different settings.

It needs to be emphasised that only those entities that demonstrate that they operate on an EBP basis that they deserve a ‘no blame’ response in their EBR partnerships when things go wrong and they break the law. Entities are free to continue as now—operating outside such trusted relationships—in which case they remain exposed to harder enforcement.

EBP&R is a vision of how things should be. It will need political leadership, not least to establish that the reaction to an adverse event by asking ‘Who’s to blame?’ would prevent sharing vital information, learning or improved performance. The Scottish Government has adopted EBR as a consistent core policy in delivering its political goal of a fair Scotland.⁵⁸ Interest has been indicated by UNCTAD,⁵⁹ OECD,⁶⁰ the European Commission,⁶¹ and regulators from Singapore to Ontario. I commend the EBP&R approach to wider support.

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