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Reinventing regulation

DEEN SANDERS

Professional Standards Authority, Australia

The traditional tools of regulation have failed to effect change in financial services, necessitating a more coherent and substantive response to crisis. It is sobering to witness how quickly policy pure arguments for flexible, efficient regulation lose momentum in the face of crisis. With the death knell of principles-based regulation ringing out, it would only be reasonable to assume that its less government interventionist cousin of "self-regulation" is officially now a regulatory dead end. What has been missing from the debate about corporate failure and inadequate regulatory systems is a serious consideration of the individual ethical and professional obligations of those in positions of influence, expertise and authority inside *corporations.*

A. The context

It might be argued that it has become too clichéd for regulators and governments to publicly wring their hands over the conduct of financial services individuals and entities in recent years, joining the conga line of media and governments calling for wholesale new structures, for new laws and new regulators, and in some extreme cases, for whole new types of people to work in the industry.

Sometimes the sheer volume of noise overpowers a more quietly held discomfort from those in the front line of regulation and industry response. From such proximity there is more than a little unease about how difficult it is to navigate the complexity and the enormity of any radical reform task, especially when, as Drezner comments, these economic entities have now become embedded in the fabric of citizenry, permeating not only the economic but also the political and social construction of our world, intrinsically linked to everything aspirational regarding money and success.[1]

When the thing to be regulated has become so large as to create its own gravitational field, warping the orbit of economies, societies and even individuals, then it must hardly be a surprise that the normal tools of regulation falter. When the tendency of regulation to too narrowly circumscribe the issues it seeks to control is suddenly shocked into urgent reaction to crisis it tends only to increase the noise levels and inevitably distract the players (legislative, regulatory and industry) from the vital task of developing a more coherent and substantive response. Typically, the favoured of these "normal reaction" tools is the call for greater punitive controls accompanied by a clamour for increased ethics, often without a flicker of acknowledgement of the established contradictions of these two forces.

B. Regulatory options

Governments and industries naturally wrestle across the vague space between market interference and regulation. Indeed the "regulatory bright line" between them is rarely so bright as to prevent claims of over-reach (by government) or protectionism (of industry) and nor is the debate about regulatory options a new one. It is often surprising, though, to reflect how much of this "reactive policymaking" ignores the established protocols of government that, typically in calmer times, dedicates resources and deep consideration to the range of regulatory tools and options available to governments. Various regimes, including the UK (Better Regulation Taskforce), international (Organisation for Economic Co-operation and Development) and Australia (Office of Best Practice Regulation), have captured the typical regulatory options for government on common spectra. These options are relatively singular and simple in their dimensionality but for ease of reference they tend to range from "no regulation" at one end of the options spectrum to the assumed most interventionist position of prescriptive "statutory regulation" at the other (see Figure 1).[2]

Leaving aside the one-dimensional nature of this policy framework, it is primarily intended to provide for flexibility in policy and regulatory settings when responding to differing levels and types of community risk. Interestingly, it is frequently the case that the "self-regulation" (and "principles-based regulation") end of the spectrum is the most highly rated of these in the abstract environment of non-contested policy debate. It is understood that this conclusion usually reflects the established benefits of self-regulation delivering cost efficiency, market independence, and alignment of knowledge and oversight.[3] It is also important to note that this sort of considered policy debate usually occurs in a vacuum free of political and/or community influence. At the least it is sobering to witness how quickly policy pure arguments for flexible, efficient regulation lose momentum in the face of crisis, such as recently occurred for the global financial environments, where the public loudly cried for the pendulum to swing away from flexibility and towards stronger government controls, so as to save "the market system from its excesses and inadequacies".[4]

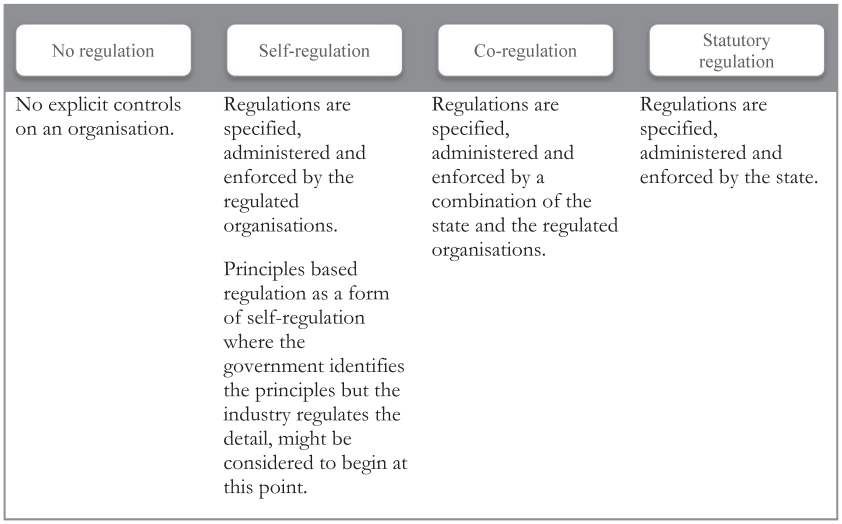

Figure 1. Bartle and Vass's summary of the regulatory options spectrum.

Source: I Bartle and P Vass, "Self-Regulation and the Regulatory State: A Survey of Policy and Practice", Research Report 17 (University of Bath, Centre for the Study of Regulated Industries, October, 2005).

C. The public/regulatory dimension

The public outcry was hardly unjustified, as evidence of ethical failure, incompetence or outright criminal conduct piled up around the feet of the industry, even famously leading a regulator such as Hector Sants (CEO, UK Financial Services Authority) to declare that a "principles-based approach [to regulation] does not work with individuals who have no principles".[5] Such public and regulatory outcry is a seductive siren call for governments, and in Australia, the then Prime Minister, Kevin Rudd, famously responded to the call, making his case for increased governmental regulation in an essay titled "The Global Financial Crisis".[6] In that article he called for an end to the neoliberal model of capitalism and the establishment of a more socially responsible regime of financial markets, where governments are willing and committed to greater regulation. It has become apparent to many of us in various government and regulatory roles that the financial crisis not only exposed the limitations of the structures of financial markets and the behaviour of its participants, but also called into question some "critical aspects of international and national financial regulation".[7]

With the death knell of principles-based regulation ringing out, it would only be reasonable to assume that its less government interventionist cousin of "self-regulation" is officially now a regulatory dead end, pinned, as it always seems to be, between the "rock" of community distrust and the "hard place" of industry inadequacy, tarred by the assumption that self-regulation is the same as, or too close to, "no regulation".

However, any debate about "better regulation", rather than just "greater or more regulation" inevitably leans back towards that end of the spectrum, having to find a way to encourage greater industry involvement in its own regulatory structure. This is not only because industry possesses better information about the regulatory issues at stake,[8] or because, as Schumpeter long ago advised,[9] government is never the preferable determinant of a firm's health and is rarely as efficient as robust competition, but also because the public paradoxically call for industry's involvement,[10] perhaps distrusting the capacity of government.

If we accept, though, that "pure" perspectives of the self-regulation end of the spectrum do not meet the public or politics test, it challenges us as regulators and regulatory theorists to think more deeply about the best way to ensure safe, accessible, fair and efficient markets without presumably burdening government or the community with unacceptable risk or cost. If that task were not hard enough, there is also a growing government paradigm of "deregulation" in Australia, and elsewhere, "whereby new standards, new rules and new compliance burdens are never introduced as the default option by government".[11] Adding further complexity to the normal "reaction" tools of regulation, this then also comes on the heels of reduced resources for regulators and a warning to the populace that they need to take more personal responsibility because the "age of entitlement is over [and] the age of personal responsibility has begun".[12]

D. The industry dimension

From amongst these competing community, political and market paradigms there is the challenge to reinvent regulation in a thoroughly new way that balances these concerns. Picking at the thread of personal responsibility is the option that most appeals to the Professional Standards Council and is the underpinning paradigm of professional standards legislation in Australia, which emphasises the role of personal, "*professional*" responsibility as an expanded and underutilised tool of consumer protection.

In our view what has been missing from the debate about corporate failure and inadequate regulatory systems is a serious consideration of the individual ethical and professional obligations of those in positions of influence, expertise and authority *inside* the corporations. Indeed Jed Rakoff (a US District Judge for the Southern District of New York) persuasively argues that, in the US at least, over the last 30

years there has been a noted shift away from the prosecution of high-level individuals to a focus on prosecuting the corporate entity.[13]

Whilst it might be true that in most jurisdictions some individuals have been challenged regarding personal acts of fraud or illegality, the number is surprisingly low given the scale of global community affect arising from the financial crisis. More specific to our concern, though, is the fact that there has been surprisingly little substantive debate addressed to the professional *community* of lawyers, accountants, auditors, engineers, actuaries, investment experts and the many advisers that sat at the heart of much of the failure. Perhaps even more alarming has been the lack of outrage from their "professional" communities, as their professional brands presumably suffer the effect of association with ethical failure.

Challenging the professional community is a distinctly different approach to the issue of prosecuting individual duty and accountability and goes instead to the role that professions play as collective embodiments of ethics and standards. It queries the moral high ground they occupy in foundational education and modelling of norms, the influence they have over ethical versus conflicted decision-making, the position they hold as exemplars of public duty, and ultimately their role in policing professional misconduct.

Judge Rakoff's reasoning in his *New York Review of Books* article potentially provides a substantial clue as to why there has been such a shift away from professional values and obligation. If, as he argues, government and prosecutors have increasingly chosen to ignore the role of the individual and instead pursued prosecution of corporate entities with the goal of transforming "corporate cultures",[14] then individuals are only ever guilty by association with the incorrect culture, rather than for any overt, deliberate or personal failure of professional obligation.

This type of approach, which elevates the corporate entity over the individual, has a potentially more corrosive and widespread effect than might first appear. It not only subsumes individual responsibility, it erodes the very fabric of professional value and recognition by suggesting that the corporate entity brand is valued more highly (even if only as a scalp) than that of the profession that arguably gives the individual their career and commercial relevance.[15]

There is certainly evidence for this in the way that young graduate professionals are drawn to the brands of financial services for work that does not apparently reward or reinforce their education about professional obligations. A recent report from the intelligence unit at *The Economist* noted that 45% of Harvard MBAs who graduated in 2008 were lured to Wall Street and the City of London by generous pay packages where extreme risk-taking and knowingly inappropriate selling was the norm.[16] This might be dismissed as blindingly obvious but the fact that the same report goes on to say that even today more than 60% of financial services industry executives think an improvement in ethical conduct of employees would *worsen* their firm's financials suggests that the internal view of the brand and the role of personal ethics has been surprisingly resistant to change.

It is this sort of "cultural ignorance" that leads theorists to conclude that it is the culture of organisations that needs reform and so they set about trying to imbue organisations and entities with ethics and moral function by creating stronger, clearer rules, and complex governance and compliance frameworks for reporting[17]. However, this too is a trap, not only because rules always fail in the face of ever more sophisticated transactional capacity of the players, but also because they create the disturbing illusion of change.[18] The "optimistic" anthropomorphising of organisations that informs the perspectives of governments, academics and, it should also be said, some regulators on corporations appears to misunderstand the essentially fractured nature of most corporations. Often made up of wholly separate siloed businesses with no sense of common purpose,[19] there is never a "single" culture to fix and rarely an individual who is responsible or even cognisant of what everyone in the business does. Regulating a cultural fix in such an environment is almost impossible, and certainly so from the outside.

This is not to say that these organisations are without standards; in fact, in the language of professions, "norms and standards" frequently exist in each of these silos, and, just as in professions, adherence and excellence is rewarded with financial benefit and career progression. The only issue is that these "norms" have been created within a thoroughly abnormal environment, free from expectations of public duty or other [external] community principles, and allowed to metastasise into behaviours that ultimately betray any sense of community norms. The particular way these "employer norms" interact and compete with the pre-existing professional norms of individuals is insufficiently understood, but it is reasonable to assume the strength of employer brand, status, authority and remuneration are sufficiently corrupting to result in primacy of employer over profession. Finding ways to restore professional primacy is no doubt challenging, but experience shows that the least assistance would come from creating stronger organisational-level technical, compliance or reporting rules that create further barriers between public/professional concepts and private ones.

E. Potential solutions

In promoting the role of professions and standards we would argue instead for a modern reworking of the age-old principle of the "sunlight test". Encourage a system that brings in greater transparency and professional contest, rather than greater rules-based complexity. Allow and encourage professional expectations of public duty to trump internally constructed expectations designed to protect the siloed club and the organisation. Establish formal support for, *and obligation on*, professionals to exercise their duty in whatever role they play in corporations, which in turn allows the inoculating power of community norms to be injected directly into the core of organisations, carried through the agency power of professionals. Rather than create thicker barriers of rules that create ever better compliance engines, open up the windows and encourage a debate about the public expectation of duty in the daily decisions of employed professionals.

Inverting the regulatory model this way opens up interesting new options for revitalising the essence of professional responsibility. Rather than calling for more papering over of the issues with layers of organisational or market rules that

encourage rule transacting and discourage personal obligation, we can increase the porous nature of organisations and allow long-established professional norms to influence decisionmaking.

Structurally this is not a call for "self-regulation", and it certainly does not throw open the doors to blind trust of the corporation; this is instead about engaging, and rewarding, a different form of moral agent that is already in place through the empowerment of public and professional expectations. Harnessing this agent works to enliven the external regulators' perspective (by accessing superior expertise) and sharpen the internal corporation perspective (by requiring absorption of external public norms). On the regulatory options spectrum this is about expanding the vague space between "self-regulation" and "co-regulation", to open up what Bartle and Vass call "subsidiarity"[20] and what the Professional Standards Council calls "meta-regulation".

So, neither "self-regulation" nor "co-regulation" but instead a form of "delegated regulation" where government still maintains the rules and expectations at a public/legislative level but delegates specific functions and powers to appropriate (ie approved) professional bodies, each with line of sight over the conduct of relevant individuals and the way those individuals are required to operate in employer-agnostic environments. Essentially this type of professional regulation in a corporate context is a direct application of Grajzl's argument that "good regulation" best utilises the superior information of the industry it regulates.[21] There is no more superior information than that of the "professional" insider who knows the organisation and who, through authorised professional identity, also owes duties to the public, their profession and their employer – just in differentiated ways. Obviously a delicate balance is to be struck and one that ensures liability is not merely shifted to the individual professional and away from the corporation.

It is also worth emphasising that, just as this is not about blindly trusting corporations, it is also not about blindly trusting professionals and their associations either. Governments have been increasingly sceptical and untrusting of the self-interested nature of professions, seeing them as a form of private monopoly.[22] While there is some truth in that proposition, the opportunity to improve and expand the public protection resources (both as gatekeepers and gate-openers) by encouraging and, most importantly, rewarding shared responsibility would likely generate a profound shift in that trust dynamic. The evidence would suggest we could hardly worsen it, where, as vehicles for expertise and superior industry knowledge, these organisations and the individual experts they represent are seen by the public as having greater credibility than government officials or even regulators.[23]

This form of *delegation of powers* approach relies both on government delegating aspects of regulation, but also importantly, on the establishment of clearly defined mechanisms for the justified, easy withdrawal of delegated powers. A delegated regulation model still maintains the central integrity and authority of government whilst functionally expanding the reach and expertise of government. Whilst subtly different in language, this is nonetheless in distinct contrast to the current models of co-regulation, where an essentially pseudo-government body is constructed for the singular purpose of policing regulation, which then gives rise to potential dilution, confusion and competition of authority.

Finding ways to safely work with professions, and their professional members, as an additional but distinctly non-governmental moral agent is likely to expand the intelligence and resources pool of both governments and regulators. Such an approach is also likely to allow governments and regulators to change the way in which they engage their own regulatory tools, powers and finite resources, focusing more on the communities' loudly stated expectations of enforcement and external supervision, especially where that type of action can be better informed by access to superior information and early warning systems of risk or error. Indeed, prioritisation of regulatory effort and resources is one of the greatest challenges regulators face when the market they regulate is constantly growing in speed and complexity. This author's own work on developing a regulatory prioritisation tool has become reliant on a clearer assessment of the role that expertise, information asymmetry and risk play in pointing to urgent regulatory interventions. It is no accident that each of these elements are determinant characteristics of professional environments.

F. The opportunity

Putting such a model of *professional* regulation in the centre of a newly conceptualised *markets* regulation model also invites a more considered approach to the way we regulate professions, encouraging a more mature deliberation about the regulatory spectrum to be applied there too, and further testing the options of "subsidiarity" and "meta-regulation".

Australia's professional standards legislation is predicated on just such a concept. As a meta-regulator, the Professional Standards Council is empowered to regulate professional bodies (as distinct from the individual professionals), ensuring their systems of professional regulation are intact and functioning properly so as to ensure consumer protection. In exchange they are afforded formal recognition and legal protections regarding limitation of liability. Australia's systems of regulation already incorporate substantial and complex elements of oversight, uniquely tailored to the specific expertise and conduct expectations of the professionals being regulated, drawing the superior knowledge of the regulated into partnership around the promulgation and enforcement of legal rules. It would be a relatively minor exercise to expand this framework to incorporate new obligations about transparency and oversight of "employed professionals", and so long as appropriate recognition and benefit were afforded to the subsidiary regulators (ie the professional bodies and the individual professionals), we have confidence that they too could be supportive of such a role for professions in a new regulatory environment.

The challenge and the urgency to reinvent our approach to financial services regulation is very real. In an environment where no clear answers about structural regulation are emerging, professional standards, as regulatory tools and not just rhetoric, are worth revisiting. The structures required for a more efficient, publicly aligned set of professional behaviours that would be supported and rewarded as enlivening elements

of corporate life are already being modelled in systems such as ours and the Professional Standards Council is uniquely positioned and eager to progress that project through further regulatory theorising and expanded application. ■

Dr Deen Sanders is Chief Executive of the Professional Standards Authority, Australia. The Professional Standards Authority is the independent regulatory agency for the Professional Standards Councils, with responsibility for Professional Standards Legislation in all States and Territories of Australia.

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