



Ethical Business Practice and Regulation

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

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The Questions

- Why do people conform to or break rules?

So

- How do we improve compliance with what society wants (conformity with rules)?
- How can regulators/enforcers and company managers/compliance deliver compliance, performance, improvement, growth, innovation?
- How should we design enforcement policies and regulatory systems?

Models of Regulation and Compliance



Theories of Enforcement/Behaviour

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

Evidence

Behavioural psychology – based on extensive research

- 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

Genetic biology and its evolution

- Genetic mutation in *homo sapiens* from defensive (blame) to an ability to make moral judgments (an ethical gene)
- That enabled our species to be able to collaborate, which was critical to our success
- Because collaboration is based on trust, which is based on evidence

Regulatory practice: research (eg responsive regulation) and enforcement policies

- Many effective regulators use ‘advice and support’ rather than deterrence or confrontation
- ‘Have a big stick, talk softly’: still need effective powers
- UK policy of ‘Regulated self-assurance’ and ‘earned recognition’: *Regulatory Futures Review* (Cabinet Office, 2017)

Evidence of what does *not* work

- Empirical studies on whether there is any deterrent effect, and the unintended consequences of hard enforcement on good people

Deterrence/enforcement

- Two meanings of deterrence
 - Domination by fear in early societies: unacceptable in modern societies
 - 20th century economic theory: the basis is *theoretical* not *empirical*
- There is little empirical evidence that deterrence is effective in affecting future behaviour: it is a widely held myth
- Many regulators/enforcers have shifted to a response to wrongdoing that differentiates between
 - Unethical people/motivations and the anti-social (sociopaths): proportionate, deserved sanction
 - 'Ethical people': advice, support improvement

Annual FCA fines 2011/12–2015/16 £million (FCA, 2016)

	2009/09	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

“Culture in financial services is widely accepted as a key root cause of the major conduct failings that have occurred within the industry in recent history, causing harm to both consumers and markets.

The financial services industry, in particular, has demonstrated instances of rate-rigging, rogue trading and mis-selling in the last 10 years since the global financial crisis. Despite record fines, increasing investigations and an expanding compliance industry, misconduct remains. Why? What have we not learned?”

Transforming culture in financial services (Financial Conduct Authority, 2018)

Homo sapiens and the ethical gene

People will obey rules where:

1. *The rule is made fairly*
2. *The rule is applied fairly*
3. *The rule corresponds to the individual's internal moral values*

Implications for system design

- Process: predictable, fair, open, transparent, consultation, participation, democratic
- Enforcement policy and practice: occurs when required, predictable, consistent, even-handed, proportionate responses
- Agreed, shared ethical principles
- Substance of moral values is seen to be shared and applied

Regulators need a diverse tool box



Proportionate Enforcement: Scottish Environmental Protection Agency

Compliance and engagement spectrum



Shifts in Corporate Practice and Theory

Maximising shareholder value → maximising stakeholder value

Treating Customers Fairly, Corporate Social Responsibility,
Human Rights

Evidence of values-based businesses driving commercial
success

Social purpose and culture are central to Corporate Governance

A single model of Ethical Business Practice

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

Aviation safety case study

- *Open culture* of *questioning* decisions and sharing knowledge of mishaps – extensive free sharing of information
- *Just culture* of *accountability* without *blame* provided ethical intention
- 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

MISTAKE / WRONGDOING OCCURS

OPEN, JUST CULTURE



BLAME CULTURE



Regulator
Committed
to EBR

Ethical
Business
Regulation

Business
committed to
EBP

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.

CIVIL JUSTICE SYSTEMS

Law and Corporate Behaviour

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

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Better
Regulation
Delivery Office

Ethical Business Regulation: Understanding the Evidence

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CIVIL JUSTICE SYSTEMS

ETHICAL BUSINESS PRACTICE AND REGULATION

A Behavioural and Values-Based Approach
to Compliance and Enforcement

Christopher Hodges & Ruth Steinholtz



Hart · CH Beck · Nomos