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CONTRIBUTION OF TRANSNATIONAL PRIVATE REGULATION TO REVISITING RISK REGULATION

by Colin Scott[1]

Introduction

When considering contemporary risk regulation approaches, one tends to think of how companies go about fostering and protecting innovation and reducing corporate risk and consequently about how governments support and affect the environment in which companies operate. A further dimension concerns the ways in which governments and their agencies assess and manage risk as a means to evaluate and implement regulation and other policy activities, with a view to achieving societal goals such as public safety or environmental protection. Governments and companies are closely intertwined in these activities since state action is constitutive of many corporate activities that range from incorporating a company and benefiting from limited liability, to offering the protection of intellectual property law where innovation is concerned, through to establishing regulatory regimes that both target and create risks.

Recently, scholars have emphasised the extent to which the emergence of multinational enterprises and the advent and prevalence of so-called "systemic risks" has generated governance gaps from the perspective of both the market and governmental actors (see also paper by Terry Yosie in this publication). On one view these gaps comprise an insufficiency of norms or rules to address matters that companies must address but which they cannot supply for themselves on their own and which governments cannot or do not want to develop. This largely explains the emergence, in the early part of the twentieth century, of technical standardisation bodies whose mission was to supply the specifications, which enabled companies to rely on standardised components, first in manufacturing and, more recently in management processes, thus facilitating business and trade. In this context, we can see technical standards as a significant, albeit private, component of the regulatory environment. Such standards typically provide clear specification as to requirements in the sector involved, even though, from a formal perspective, their adoption is voluntary.

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Private governance regimes now extend well beyond national and transnational technical standardisation bodies to areas such as the environment, employment, consumer markets, computer security and financial markets. In other words, the remit of the decisions by (and the mandate conferred upon) standardisation bodies has scaled up from affecting specific elements only of a normative regime to now shaping and determining entire regulatory (transnational) systems. They do not wholly replace public governance and there is frequently an explicit relationship between public activity and private rules.

This paper first addresses and explains the concepts associated with the emergence of transnational private regulation. Second, it explores the emergence and effects of transnational private regulation through three brief illustrations in financial markets, food safety and forestry that provide a rationale for the emergence of transnational regimes and/or innovative risk governance. The paper then investigates the various forms of relationship between transnational private regulation and governmental and intergovernmental actors. Finally, some conclusions are offered in respect of the relationship between transnational private regulation, innovation and risk. The paper does not seek to appraise the adequacy or effectiveness of any given regime. Rather the paper describes and outlines reasons for the emergence and functioning of such regimes, with a focus on how the latter can advance risk regulation in modern times.

1. Towards a definition of the notion of transnational private regulation

Transnational private regulation is a key example of innovative governance, which increasingly is shaping market practice. Indeed, the challenge is to explain why transnational private regulation has grown in importance and prominence in recent decades. This section elaborates on the three constitutive elements of the term "transnational private regulation".

1.1 The evolutionary regulatory context

The first constituent of the term relates to regulation. The concept has gradually established itself as a significant form of governance. An influential definition speaks of the sustained oversight of activities valued by the public by reference to rules (Selznick, 1985). For many, this classic definition conjures up the image of independent regulatory agencies of the kind that were developed notably in the United States during the twentieth century.[2] Canadian scholar John Willis noted that such agencies, popular also in Canada, were 'governments in miniature' because they had the capacity to make rules (a legislative task), monitor compliance with rules (an executive task)

[2] One might think, for instance, of the Securities and Exchange Commission and the Food and Drug Administration. The extent to which these agencies are "independent" of the Executive (the President) is a subject of considerable debate (Datla and Revesz, 2013).

and enforce rules (a judicial task) in such a way as to combine all the governmental functions (Doern and Schultz, 1998; Willis, 1958). The intrinsic lack of capacity by legislators to perform expert analysis and hence deliberate on many technical implementing risk regulations has been widely acknowledged in modern government. However, noting the rise of the regulatory state in Europe from the 1980s, it became clear that, contrary to US experience and practice, there was more caution elsewhere in delegating such extensive governmental functions to independent agencies. By contrast, agencies established in European states have typically more limited powers, because of both historical and legal restrictions on the delegation of regulatory powers.[3] Commonly, though not universally, rulemaking powers have been reserved to legislatures, and formal enforcement powers to courts.

The classic model prompted an understating of regulation as a governmental function exercised by public bodies: independent agencies, or a combination of legislature, agencies and courts. As interest in regulation has grown, it has become apparent that, whilst government regulatory regimes, however comprised, may exert important control over businesses (and also others, including NGOs and government itself (Hood et al., 1999)), the control environment in which all manner of organisations operate is not limited to government oversight (Scott, 2004). For many organisations, self-regulatory bodies constitute an important mechanism for setting and enforcing rules (Ogus, 1995). Less formal norms exerted through professional bodies and communities may be important, constituting a form of 'order without law' (Ellickson, 1994). We may even find market mechanisms exerting a form of regulatory control (Marx, 2008).

These insights about the diffuse forms of control which are exerted on organisations led scholars to reconceive regulation from its former rather institutional-specific formulation into a more generic and comprehensive notion. Accordingly, regulation has been defined as a mode of control which comprises not only norms, rules, standards or objectives, but also various mechanisms that supply feedback on compliance with the norms, as well as processes for correcting deviation in behaviour (Hood et al., 2001). Thus agency regulation is an example of where agencies not only set rules, monitor and enforce them, but also where they recognise a wide range of other modes for drawing up standards, providing feedback and correction, including both formal and informal social processes, and possibly market mechanisms. Taking this approach we can recognise that few environments are free of regulation in this broader sense, and a decision of government not to engage in formal public regulation is most likely to leave control to a mix of social norms and market mechanisms (such as contracts).

[3] What pertains the EU-level, reference can be made here to the reluctance by EU Member States to confer further regulatory competences to supra-national bodies (the EU agencies) and their preference to retain control over EU technical regulation through a system of committee-based governance. The so-called "Meroni doctrine" on non-delegation of decision-making powers to de-centralised bodies draws from that concern.

1.2
The nature and scope of private regulation

The second element of the term refers to its private character. Because of the evolving context mentioned above, private regulation assumes a more important role in contemporary governance than might previously have been expected. Companies create norms specifically for their own employees, which are monitored and enforced through contractual relationships (Parker, 2002). Such in-company regulation may often be quite informal in character, even though it has the 'capacity to harden', for example when addressing issues of underperformance or misconduct. Similarly, the measures taken by companies to address corporate social responsibility issues can be characterised as a form of in-company regulation, especially when they are orientated towards developing and implementing norms which address an aspect of company performance in respect to such issues as the environment or equality (Parker, 2007). Demonstrating a capacity for regulatory innovation, governments have become increasingly interested in how companies may contribute to meeting public objectives through corporate social responsibility programmes and have sought to encourage them, for example through mandatory reporting requirements.[4]

The scope of private regulation and its implications are not to be conceived narrowly. On the one hand, private regulation encompasses not only in-company regulation but also a wide range of mechanisms by which standards are set, monitored and enforced through private organisations (Scott, 2002). Self-regulatory or associational regimes emerge where a group of organisations agree to create an association with rules and feedback and enforcement mechanisms (Buthe and Mattli, 2011; Black, 1996). Professional bodies operate in a similar manner. Whilst associational regimes are founded on a form of collective contract that binds the members, bilateral contractual relations can also be used to embed rules set by the parties or introduced by a third party organisation. In practice, such contracts, operated through supply chain contracts and often with third party certification, are extremely important mechanisms for giving effect to rules set down by private organisations, including technical standardisation bodies, associational regimes, and others (Cafaggi and Iamiceli, 2014). We might, of course, expect such bilateral arrangements to reflect the interests of one or both of the parties to the arrangement. In some instances, such provisions are liable to reflect a wider public interest (for example contractual specifications that products are safe or that they should comply with a particular technical standard).

A key challenge for governments which might seek to depend on such contractual regulation is to recognise the conditions under which there is an alignment between public and private interests (with the consequence that no further public regulation is required) and the conditions where private and public interest diverge, requiring public intervention (for example on competition, environmental or consumer protection grounds).

[4] An example is the EU Directive 2014/95/EU on disclosure of non-financial and diversity information by certain large undertakings and groups.

On the other hand, increasingly, the in-company and contractual (collective and bilateral) modes of private regulation have an impact on a wider range of actors and organisations and not exclusively those who are, in a sense, volunteers to the regime. Where third parties are affected by such a private regime to which they are not party, this is potentially problematic as such third parties have no capacity to shape the regime or to decide whether or not to accept it (Scott et al., 2011). Thus many private regimes are established by industry or NGO actors or some combination of the two, with an identity which is autonomous from any particular organisation, and which determine rules and processes for organisations well beyond the scope of their own organisations.

Technical standardisation bodies provide a key example. Firms and other representatives may participate in the process, but many, perhaps most of those who adopt the standards, do not participate in the decision-making and need have no link with the standard-setting organisation. To an even greater extent those who benefit from the standards, such as those who purchase the products, have no involvement, whether directly or indirectly, in drawing up the standards. Increasingly, organisations addressing matters such as environmental protection, employment and human rights are autonomous from those for whom they create the standards, with distinct corporate identity and motivations, but also from those who benefit from the standards.

If such private institutions do not have legislative backing and are not contractually linked to those for whom they write the standards, the question then arises about the effectiveness and binding character of the rules these institutions issue. Answers are varied. In some cases, private standards are adopted by governments in their practices or through legislation (as with some technical standards and financial standards) (Scott, 2002). In other cases effectiveness is dependent on organisations deciding voluntarily to adopt the standards and implement them in-company and/or through specifying them in contracts. In practice, supply chain contracts are very important for giving effect to a wide range of technical and other standards (Cafaggi and Iamiceli, 2014).

1.3 The scale of application of the regime

The third definitional component of transnational private regulation is the transnational element. This concept is simply explained as describing a regime which crosses national boundaries in its effects but is not public or governmental in origin (Scott and Wai, 2004). Thus transnational activity is contrasted with international governance, the latter occurring between nations and engaging sovereign governments, for example in making and implementing treaties (Scott et al., 2011).

The scope of transnational private regulatory regimes is very broad, with prominent examples found in the many transnational technical standardisation bodies, food safety, advertising, financial markets and environmental protection. Equally, the form such regimes take is quite diverse. Some consist of associations of members (such as the group of national advertising self-regulatory bodies, the European Advertising Standards Alliance) whilst others originate from NGO activity and draw in industry and NGO members, such as with the Forest Stewardship Council. Each regime can be characterised as constituting a community of actors, and in each case the regimes face not only technical challenges in undertaking their mission, but also legitimacy challenges in justifying their governance actions and subsequent effects on members and third parties (Kingsbury, Krisch and Steward, 2005; Cassese et al., 2012).

2. Emergence and effects: three cases

This section presents brief illustrations in financial markets, food safety and forestry that provide a rationale for the emergence of transnational private regulatory regimes. In some instances, such regimes have emerged to address market coordination problems, where cooperation over standards facilitates market activity. A second rationale for the growth of private regulation lies in concerns about the adequacy and appropriateness of national public regulation for addressing (transnational) risks, especially those labelled as 'systemic risks', marked by international networks, complexity and cascading effects. In these cases, transnational private regulation seeks to impose standards on market actors that go beyond public law requirements, or aims to improve implementation. A third rationale for the emergence of transnational regimes is that of building community solidarity around social objectives at a level greater than that able to be adopted by national governments.

The first two of these rationales address what are primarily market-based concerns. The final one uses various forms of activism to promote adoption of social or community concerns in market settings. In each case the market is of fundamental importance in explaining both the reasons for, and modes of, adoption.

2.1 Market coordination problems

The first case presented in this paper lies in the development and adoption of standards to facilitate market activity. The development of technical standards processes from the early national standardisation bodies, established in the first quarter of the twentieth century, to the creation of an elaborate architecture involving thousands of standardisation bodies with hundreds of thousands of participants in their activities, is directed at providing the conditions for efficient trading and contracting for the supply of products where there is a high degree of specialisation and differentiation of tasks (Brunsson, 2000). Complex manufactured products, for example, may involve dozens of different producers in developing and producing components and manufacturers need to be assured that whoever they buy from, the components they purchase will meet their needs through compliance and a standard specification.

The case of financial markets

Equally, in the area of financial markets, there is a need for reliable standards. A prime example is that of the market for derivatives that emerged as a mechanism for hedging financial risks and which, over time, became a source of systemic risk to the financial system. The issue of reliability with derivatives transactions concerns the terms on which they are written. The parties require certainty concerning what they have agreed; what events will trigger payments contractually; what the effects will be under interlinked agreements; and, in particular, whether the intention of the parties to net the effects of their agreements will be honoured. In the absence of any public regulation of such agreements, the parties write their own contracts. Starting from scratch is both costly and full of uncertainty. The International Swaps and Dealers Association (ISDA), comprising the major dealer banks, was established in the 1990s and amongst its core activities has been drafting the standard terms on which derivatives contracts are made, the ISDA Master Agreement. It is not compulsory to use the Master Agreement, but ISDA is very active, in a number of ways, in ensuring that through drafting, usage and interpretation, its terms should, as far as possible, be predictable for the parties. ISDA may imply that they are not a regulatory body since the standards in the Master Agreement are not mandatory, and implementation and enforcement are matters for the parties. However, it has progressively become clear that the Master Agreement is the de facto in terms of business. Its effects on third parties, including states (for example in respect of derivatives linked to sovereign debt), are such that the role of ISDA goes beyond that of simple setter of technical standards. Indeed, it has an overview of the entire life of transactions and of their terms and enforcement (Biggins and Scott 2012).

2.2 Lack of adequacy and appropriateness of national public regulation: the case of food safety

If technical standardisation is more concerned with market settings where the state has no significant role in drawing up standards, there is another set of conditions where state involvement is significant but inadequate. When, due to insufficient standardisation, public regulatory rules are inadequate or badly implemented, producers run the risk of damaging their reputation and losing sales because of diminished confidence in their products. As from the 1980s a series of scandals involving food products, such as the BSE crisis in Europe in the 1990s or the outbreak of E.coli infection in Germany in 2011, left major food retailers in Europe feeling that the food regulation regime in the member states of the EU, some of which has EU components, was insufficient to create confidence in food products. The industry response was for larger retailers and other key stakeholders to establish a number of standardisation bodies which initially imposed safety standards on producers, wherever they were located within or beyond the boundaries of the EU. These standards are implemented through supply chain contracts and processes of accreditation for producers (Fuchs et al., 2011).

A key example is provided by GlobalGAP[5], established in the 1990s by major European retailers, a forum for setting detailed standards for food products and agricultural practice. If, initially, the group was rather informal, it has progressively constitutionalised itself and drawn into its decision-making a wider range of affected parties, notably food producer representatives. Additionally, it has introduced certification procedures to ensure compliance (Casey, 2009). Thus, over time, the regime has progressively increased its share of those affected by its decision-making as a means to bolster legitimacy through a more democratic structure. In recent years, its reach has been such that GlobalGAP is regarded as jointly empowering producers and retailers. This contrasts with some other regimes which remain retailer dominated (Fuchs et al., 2011).

For retailers who impose GlobalGAP standards on producers, compliance is a condition of contracting and thus a prerequisite for trade. Accordingly, the scope of GlobalGAP activities affects not only supply chain contracts but also trade in general. The appropriate treatment within the global trade regime of private standards, not just in respect of food, but also in respect of other social matters such as the environment and labour rights, is controversial. For some, the solution is to seek to regulate private standards in the same way as public legislation would be controlled if it constituted a barrier to trade. For others, socially constituted standards, though they may affect trade, are a product of community and market actions, and should be accorded a separate space, distinct from the trade regime which regulates attempts by states to protect their producers (Bernstein and Hannah, 2008).

2.3
Building community solidarity around social objectives: the case of forestry

A third case concerns the conditions where market actors are content with public standards and, broadly, seek to comply with, but not exceed them. However, social actors such as environmental NGOs and trade unions strive to adopt more stringent standards on a transnational basis. Given the importance of companies in implementing voluntary standards, these conditions appear unpromising for effective transnational private regulation (Bartley, 2007). However, it has proved possible for NGOs and other social actors to develop both the more stringent standards and market salience for them, to the point that companies have felt it in their market interests to adopt them. By doing so, companies are able to preserve or enhance reputation and thus strengthen their market position (Cashore, 2002). Under pressure from civil society actors, such an exacting adjustment of standards by market actors can be defined as a form of community solidarity.

From this solidarity perspective, transnational private regulation regimes may also address risk, both to companies and to broader society alike. Whilst national governments may be inhibited to adopt more stringent standards for environmental protection and labour rights by fear of national competitiveness, transnational regimes are able to persuade multinational enterprises to take up such standards across their enterprises, thus raising standards transnationally above public norms.

[5] www.globalgap.org/uk_en

A key example of such a phenomenon is provided by the growth in importance of the Forest Stewardship Council (FSC), whose standards on sustainable forestry have been taken up by many larger retailers and applied throughout their transnational supply chains. This is a central example of such socially driven private regulation. A number of regimes have developed over the past two decades, some led by NGOs and others, responding to the NGO regimes, that have a more substantial industry involvement. The FSC, which the World Wildlife Fund (an international environmental NGO) helped establish, provides a significant case (Cashore et al., 2004). The FSC developed standards during the late 1990s and sought to have retailers join their scheme and to sign up to incorporating its standards in their supply chain contracts.[6] The key issues for the FSC regime, similarly to GlobalGAP, concerns how it manages decision-making processes over standards and their implementation and the distributional effects of its regime within the forestry sector (Taylor, 2005).

3. Evaluation of transnational private regulation in relation to risk and to public policy

Risk is a major organisational concept, both for contemporary business and for society at large. Risk is not straightforward to define since it is the combination of the probability and the impact of an adverse outcome. In a recent guide to the vocabulary of risk, the International Organization for Standardization (ISO) offered a simple definition of risk as 'the effect of uncertainty on objectives' (ISO, 2009). Increasingly, organisations of all kinds seek to identify the risks they face so that they can reallocate them (for example through contracts), manage them (for example eliminate them) or, when they cannot be reallocated or eliminated, insure against them.

Regulation is used both for curbing risky activity (for example nuclear power, factory safety and so on) (Hood et al., 2001), and for deploying risk-based analysis to determine the appropriate allocation of resources, for example in considering frequency and stringency of inspections (Baldwin and Black, 2010). For businesses, regulation may be classed as a source of risk that, over and above the detection of breaches, is far more centrally concerned with mandated changes to the operating environment faced by business as, over time, regulatory objectives change in response to changing social or political preference.

Increasingly, regulation is concerned as much with the oversight of risky activities as with the efficient operation of markets. Contemporary risk challenges, for which regulation forms a significant part of the response, include the management of systemic risk – for instance in relation to the adverse effects of anthropogenic climate change; of potentially catastrophic accidents in nuclear power production; and the complex interdependencies in financial markets within a globalised economy.

[6] Similar experiences can be found in other sectors, such as the fishery industry in the form of the Marine Stewardship Council.

A core feature of some modes of transnational private regulation is that businesses and other actors may take on a central role in defining both the objectives and the implementation of the regime. Real world observation suggests that many regimes are centrally concerned with addressing risks. These can include those activities that are inherently risky such as food production; they can arise from activities which generate climate risks, such as forestry; and from those which generate risk because of uncertainty and market imperfections (e.g. in the financial market sector). Thus the numerous private food standards regimes, of which GlobalGAP is a key example, provide a core supplement to public risk regulation over food. Equally, regimes targeted at sustainable forestry constitute a core part of the measures taken to address risks associated with climate change. The ISDA Master Agreement provides a core example of addressing uncertainty. It puts the central focus on being able to establish and test the standards that govern derivatives instruments so that they may be reliably and predictably deployed.

The private regimes that target risky activities also generate risk for businesses. At the extreme, businesses that do not participate, or do not participate effectively, in socially driven regimes concerned with matters such as employment rights or climate change may find they are not able to participate in the market at all, or that reputation and sales suffer as they are identified as a cause of the problem rather than constituting part of the solution. Hence, there is a strong incentive to enter into collaborative agreements among private actors, as also argued by Terry Yosie in this publication. Much of the contestation around socially driven regimes of private regulation is concerned with creating a situation where, due to reputational and market damage, the risk to business in adopting a progressive (and perhaps costly) regime concerning environmental issues or labour rights, is lesser than that of not participating. The Forest Stewardship Council provides an example of a campaigning regime which has progressively persuaded more companies to take on its standards through direct action. It highlights the adverse effects of poor forestry practices (Meidinger, 2003). Facing such campaigns, companies have concluded that the less risky option is to adopt the regime.

Whilst transnational private regulation is defined by its non-governmental character, governments and inter-governmental organisations may be involved in such regimes. Many regimes may be characterised as hybrid, in the sense that public bodies engage in observing and, in some cases, either delegating the making of standards, or adopting standards that have been drawn up through a number of mechanisms. Governmental and inter-governmental organisations are increasingly involved in observing environmental, food, consumer and financial standardisation regimes that operate through private regimes. The European Commission, for example, has taken a close interest in private advertising regulation regimes in the EU and has sought to bolster their standing within national settings so that they may, at least implicitly, hold a place in key regulatory delegations (European Commission, 2006). As a result, the European Commission has set up a 'community of practice' concerned with self- and co-regulation as a means to engage all the stakeholders involved in support of both the legitimacy and effectiveness of such private regulation across a wider range of policy areas.

Conclusion

The purpose of this paper was to provide an overview of transnational private regulation, why and where it can be relevant. Whilst private regulation has emerged as an important component of contemporary regulatory governance generally, and risk regulation in particular, there are clear limitations associated with it. First, in some areas, such private regulation may lack the legitimacy to command wide support from market and social actors. Equally, there may be a lack of effective capacity in some transnational private regulatory regimes. There is increasing evidence of these issues being addressed, for example through umbrella organisations such as ISEAL-ALLIANCE (Loconto and Fouilleux, 2014) which offer both capacity and legitimation.

The question of the contribution of transnational private regulation to risk regulation yields a variety of answers because of the wide range of regime types and of their differing origins. Within the coordination type regimes, market issues around risk and innovation could be addressed effectively since the coordinating standards are designed to reduce risks through standardisation. This issue is reflected in debates over standards that regulate matters such as mobile phone networks, video players and computer operating systems. Research on standardisation suggests that a successful standard may not be the most innovative, but rather one which, for reasons other than innovation and effectiveness, secures wide take-up or rewards performance without creating lock-ins to existing technologies or practices. The classic example is the standardised QWERTY typewriter keyboard, which was not ever necessarily the most efficient layout, but has survived into a period where its rationale is long gone because of its ubiquity and the costs of re-learning that would be associated with adopting what might only be a marginally more efficient layout (David, 2001).

The case where public rules are deemed inadequate and are supplemented presents greater challenges for risk. In some cases, transnational private regimes may address risky activities, driven by market actors, to supplement inadequate public regimes. Where well constituted, such regimes may permit market actors to engage their concerns, possibly tackling issues effectively with greater efficiency than could be achieved by public regimes. However, there are always likely to be concerns that such private regimes derive from the market power of key companies, and that they may be used to further enhance market power of these key companies over other actors, whether suppliers or competitors. Thus they represent competition risks to which, increasingly, national competition authorities will need to be attentive.

Socially driven regimes have gradually emerged to address risks associated with environmental issues and with employment rights in transnational settings. These regimes have varying degrees of company involvement in their founding, but they all provide an opportunity to address substantive risks and to engage with important reputation-associated market risks of a social nature. Such regimes represent both a risk and an opportunity. Recognising this factor, competing companies have entered and shaped regimes across a variety of social issues. Such competition between NGOs- and company-led regimes, for example in forestry and labour rights, is likely to be a source of regulatory innovation, as the various organisations learn what kind of standards are most able to meet the policy objectives and be readily capable of implementation by the firms involved. In this context, because of the more direct participation and market testing of the regime whether in its origin or its implementation, private regulation has the potential to better fit the requirements of innovative markets than traditional public regulation. As it will be apparent in further contributions to this publication, the interaction between private sector actors and NGOs can evolve from (constructive) competition into a more comprehensive joint action. Whatever shape it takes, the question of the effect and impact of private regulation as compared to public regulation is becoming more important both for public and private organisations. If we are to address the problems that contemporary risk management poses us, it is time to devote to this under-researched agenda the full attention it deserves (Loconto and Fouilleux, 2014; Radaelli and Fritsch, 2012).

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