The International Adoption of Ethical Business Regulation

Christopher Hodges and Ruth Steinholtz
This Policy Brief is the latest in a series on Ethical Business Practice (EBP) and Ethical Business Regulation (EBR). It summarizes current thinking on these topics, based on a Conference held at Wolfson College, Oxford on 4 May 2018.1

EBP and EBR are built on firm scientific and empirical evidence, based on insights from behavioural psychology and economics to research into and experience with ethics and compliance and regulatory practice.

Elements of EBP and EBR can be found in diverse regulatory systems across the world, and the articulation of the EBP and EBR models is attracting wide-ranging interest and approval, including from OECD and various governments as an approach that offers firm foundations for future cooperation, growth, and enhanced compliance with rules.

The number of studies and developments are now proving various aspects of the EBP and EBR concepts. More volunteers for pilots aimed specifically at these concepts would be welcome.

The initiation of EBP has to come from businesses, individually or in sectors. More pilot studies are required to examine the operation of the full EBP approach and to determine training needs for regulators, as well as the best methods for implementing EBR.

EBP will be demonstrated by a combination of evidence of ethical practice based on the Framework. The approach cannot be ‘tick box’ or solely compliance-based. The exact type of relevant evidence will differ depending on the sector, type, and size of company, context, and state of maturity. It might include showing how feedback from staff, auditors, ombudsmen, suppliers, customers, regulators, and investors is collected and produces change.

Politicians should support an EBP/EBR policy. This means that they should not ask ‘Who’s to blame?’ when faced with major problems. Senior Scottish ministers have indicated that they will do this. Selected regulators in the UK and elsewhere should pilot the approach and write up the findings. With the strong support of officials in the Department for Business, discussions have been held with selected authorities regarding the implementation of EBP/EBR policy.
What are ethical business practice (EBP) and ethical business regulation (EBR)?

The key concept behind ethical business practice and regulation is a focus on ‘doing the right thing’ by creating an efficient, ethical culture based upon values, and consistent reinforcement and application of those values. Constructive inquiry through conversations to determine what is the right thing to do underpins the approach, as does fair, honest, and open feedback, without seeking to blame, for continuous improvement. The model also postulates full cooperation between ethical businesses and regulators based on a respectful, responsible relationship rather than an adversarial relationship or one focused on the attribution of blame.

Organizations can bring to life their commitment to an effective ethical culture by designing and implementing the cultural, leadership, and ethics and compliance frameworks to produce desired behaviours, all based upon core ethical values. This will make it possible for them to produce evidence that shows that they can be trusted — Ethical Business Practice. The components of a generic framework are suggested that will support EBP; however, different organizations will of course design and implement their own versions, depending on their particular values, situation, and risks. There is no one culture or set of values that will maximize compliance in every organization. The process of developing the frameworks themselves is an important contributor to the outcome, and will require a learning culture, where mistakes are viewed as opportunities for improvement. Relevant evidence should emerge holistically from staff, suppliers, customers, investors, society, and regulators.

Businesses that demonstrate EBP should deserve recognition, and have a cooperative relationship with their regulators — Ethical Business Regulation. Regulators should encourage and reward EBP through EBR. In many sectors, individual or collective protocols can be agreed that record parties’ expectations in relation to the commitment required, perhaps giving examples of relevant evidence, ethics-based relationships, and the tasks of different actors in co-regulatory arrangements (including assessors, certifiers, auditors, trade associations, ombudsmen, and others as well as businesses and regulators). Further work is being carried out on this aspect.

EBP can be seen as the next step for many business sectors, given the low levels of trust in business, increasing demand for transparency, and the need to maintain market reputations. The UK Financial Reporting Council’s Corporate Governance Code has been amended to stress that decisions should be taken in the interests of long-term sustainability of businesses, based on strong cultures. This is but one example of a well-consolidated trend towards focusing on culture as the main factor in compliance.

EBR is an approach to regulation that applies the lessons of behavioural science and ethics to traditional legal and economic approaches. It can transform not only the observance of society’s rules but also enlist powerful support for operating beyond the minimum standards of compliance (achieving consistent performance and improvement) — an approach that can drive business growth. There is now evidence from multiple sources concerning the effect of a strong, healthy ethical culture on performance. There is no longer any doubt that an organization can be both ethical and profitable.
The Essence of the Concepts

Ethical business practice
An organization in which the leaders consciously and consistently strive to create an effective ethical culture where employees do the right thing, based upon ethical values and supported by cultural norms and formal institutions. EBP requires people who can recognize ethical dilemmas, challenge constructively, speak up if they know or suspect unethical behaviour, and who use mistakes and wrongdoing as an opportunity to learn and improve. Engagement with EBR then requires the organization to be open with its regulators and provide evidence of EBP.

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

EBP and EBR build on modern scientific understanding of successful human behaviour. The EBP and EBR concepts are based on a mass of empirical evidence that includes behavioural psychology, research on the most effective practice by companies and regulators in achieving compliance and in ‘enforcement’, and evidence on what does not work, including enforcement based on deterrence theory. Extensive substantiation was published by Hodges in 2015. The EBP and EBR model has been explained by Hodges and Steinholtz in 2017.

Elements of EBR can be identified in the approach of a wide range of regulators, such as in food, pharmaceuticals, medical devices, health & safety, environment, energy, and the UK’s Primary Authority scheme. A number of pilot studies and other trends are currently underway, outlined below.

Official support for EBR
The Organisation for Economic Co-operation and Development (OECD) has focused recent work on regulatory policy and governance in the context of international regulatory cooperation and quality of regulatory activities. Nick Malyshev, Head of the Regulatory Policy Division at OECD, has identified a growing role for global private regulation and hence for cooperation between public and private actors, and on behavioural insights.

The ownership of business risk rests squarely with businesses themselves, as has been demonstrated in various contexts, ranging from workplace safety to employment conditions and human rights. Rob Brightwell of the Cabinet Office explained in the Oxford conference on EBP and EBR that the UK policy of ‘regulated self-assurance’ by businesses was set out as the goal in the UK’s 2017 Regulatory Futures Review.

In February 2016, the UK Department for Business, Innovation and Skills published a short paper on EBR that has been widely read across government and the regulatory community. The EBR approach has been cited with approval in the 2016 UNCTAD draft Manual on Consumer Protection. The Scottish Government adopted the idea as policy in 2016.

Aspects of ethical business regulation

Cooperation based on full communication and an open culture: The aviation safety paradigm
The aviation industry realized some decades ago that compliance-based regulation was not working, and that a radically different approach was needed. They have developed a ‘just, open culture’ based on open, honest conversations in an adult–adult relationship. The approach was outlined at the conference by Jon Round, Head of Airspace, Air Traffic Management and Aerodromes (AAA) at the Civil Aviation Authority and Captain John Monks, Head of Aviation Safety, Risk & Compliance at British Airways PLC. Those concerned with aviation safety need to know that they can have honest conversations that are not impeded by fear. A ‘just culture’ is built on processes and procedures that do not normalize deviance, and supports outcomes that can be deliverable.

A similar approach of constant open communication and mutual learning has developed over several years in the relationship between the Water Industry
Commission for Scotland and Scottish Water. This was explained by Alan Sutherland, CEO of the Water Industry Commission for Scotland and Douglas Millican, CEO of Scottish Water. They are currently involved in negotiating the pricing structure for water in Scotland for 2021–27, expressly adopting the principles of EBR.8 The previous regime of only revealing information that was specifically requested has been replaced by an agreed process in setting prices for the next decade based on full information that is deployed to address a wide range of issues, notably when to replace assets at end of life, and who is to pay for this. The architecture has been expanded to include a Consumer Panel and social media consultation of consumers.

A Local Authority–business pilot

The primary contact between local businesses, or local branches of national businesses, is with their Local Authority. Local Authorities are responsible for many regulatory areas, often acting as the primary contacts for national regulators such as the Food Standards Agency, the Health & Safety Executive, and many others. The UK has developed a highly successful structure for cooperation between Local Authorities and national or local businesses, through the Primary Authority scheme, which is supervised by the Office of Product Safety and Standards.

An EBP/R pilot study was undertaken in 2017 between the Neighbourhood Protection Service of Cornwall Council (‘Cornwall Council’) and the Rick Stein Group (‘Rick Stein’). Aspects of the study design and outputs were reported at the conference by Allan Hampshire, Service Director, Neighbourhoods and Public Protection at Cornwall Council and Ian Fitzgerald, Managing Director of the Rick Stein Group, who made the following main points.

- Current regulatory regimes are not as effective as they should be, because they are based on fear, and motivators are misaligned. The EBR pilot study was successful in building trust between individuals and parties, based on closer, meaningful relationships involving sharing and respect, which are now producing better outcomes. It enabled the participants to build on the opportunity for communication that arose from the Primary Authority scheme.

- Both parties valued the EBR approach as it gave them the opportunity to understand the culture of their organizations in greater depth. They achieved a more accurate view of the values that are expressed in the organization and what issues might be preventing them from achieving their highest potential. They felt that this understanding facilitated better communication between them, and therefore deepened the trust that had been growing during the course of the Primary Authority relationship.

- Cornwall Council confirmed that the use of a cultural values assessment provided a good basis for understanding whether a business was committed to being ethical and expressed a view that further inquiry into the mechanism for entering into an EBR relationship was warranted.

- Further work should be done to explore how the existence of an EBR relationship would affect national inspection regimes. EBR could be interpreted as a form of earned recognition which may be a welcome benefit for businesses in the future.

Wide potential applications of EBP and EBR

Food and Primary Authority

The involvement of national regulators in a combined approach is an obvious next step, whether this builds on the Primary Authority scheme or regulators’ own initiatives. An example of the latter is the ‘Regulating Our Future’ programme of the Food Standards Agency (FSA), which was outlined by Yvonne Robinson of the FSA. The FSA has established a workstream to develop EBR, including to examine its own cultural values, recognizing that it has been doing some aspects of EBR for some time.

The ‘Regulating Our Future’ programme has been shaped through ‘open policymaking’involving all stakeholders, including a consumer panel. It aims to deliver behaviour change, and to use all available data, including the resources of businesses. It has four main platforms: enhanced registration (two-way exchange of information); segmentation (risk management, assessing all information on a business and the nature and intensity of its...
approach); assurance (enlisting businesses’ own assurance systems and data, more ways to show they are doing the right thing); intervention (recognizing when businesses do the right thing and coming down hard on those that don’t; moving towards a co-regulation approach; using root cause analysis).

Medical devices
John Wilkinson, Director of Devices at the Medicines and Healthcare products Regulatory Authority (MHRA) noted that the catalyst for change is being jeopardized by a raft of new regulatory requirements in the recent EU Medical Devices Regulation. Discussions on EBR are developing good historical engagement with manufacturers of medical devices and other healthcare products. These areas were covered by Phil Brown, Director, Technical and Regulatory at Association of British HealthTech Industries (ABHI) and Sarah Lepak, Director of Governance & Policy at the British Healthcare Trades Association (BHTA). BHTA had developed an ethical response around 2000 in response to bad practices by unethical traders in double-glazing and unregulated activities within the home. The association had developed a Code of Practice approach that had proved successful and they now wish to expand this beyond advertising and trading activities to all business activities by member firms.

Data and digital
Richard Thomas CBE noted that the appeal to ethical values will be fundamentally important in determining the regulatory and enforcement approach to data protection under the General Data Protection Regulation. His successor as UK Information Commissioner has said:

I have no intention of changing our proportionate and pragmatic approach after 25 May. My aim is to prevent harm, and to place support and compliance at the heart of our regulatory action. Voluntary compliance is the preferred route. But we will back this up by tough action where necessary; hefty fines can and will be levied on those organizations that persistently, deliberately or negligently flout the law. Report to us, engage with us. Show us effective accountability measures. Doing so will be a factor when we consider any regulatory action. … And when we do need to apply a sanction, fines will not always be the most appropriate or effective choice.

A major example of the need for a genuinely cooperative approach to making and applying ethical rules is the fast-developing digital arena. There is no time to wait for structures to emerge through legislation on regulation. People expect businesses and governments to simply observe ethical norms. Companies need to demonstrate that they get it right. In areas where there are no rules, and it would take too long to create legislation, it will be important to assemble an inclusive dialogue among all relevant stakeholders. The approach is effectively an extension of self-regulation through involvement of all stakeholders on an equal basis, and voluntary compliance, backed by social sanctions based on reputational risk.

Financial Services
All leading financial authorities identified that poor culture was a — if not the — major cause of the 2008 global financial crash and subsequent scandals. Various central banks and regulators are now returning to focus on culture in order to prevent the next crisis. As the UK’s Financial Conduct Authority has recently said:

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?

The Dutch Financial Regulator DNB has been focused on behaviour and culture for over five years, informed by the conviction that these aspects are key to successful regulation. There may be a sense of frustration among supervisors in wishing to create and supervise the culture of financial institutions. However, the critical step is to accept that organizations are responsible for their own culture, and this cannot be imposed or controlled from outside — although it can be supported or harmed.
**International extensions**

Businesses that have expressed an interest in EBR range from retirement homes, mining, transport, and food safety in Canada to various areas of safety and consumer trading in Finland. Srikanth Mangalam, Founder and President of the Public Risk Management (PRISM) Institute, Mississauga, Canada, noted that the concept of EBP is not new to Canada, where a responsible care programme was developed in 1985 after the Bhopal disaster. He outlined an example in which fines were first doubled and then tripled, yet compliance dropped rather than increased. This was contrasted with new regulation based on consultation, after which compliance improved.

Minna Päivinen, Director of Research at the Safety and Chemicals Agency (Tukes) of Finland, said that the ethical and fairness approach fits well with the approach of Tukes, and they plan to develop it in further pilots. The Finnish legislation gives a good framework for EBR. They are constantly trying to find the balance between advice and guidance. The key challenge is to build an environment to foster trust, for which good channels of communication are paramount.

**How to change culture**

The EBP model challenges an organization to consider all aspects of its governance, functioning, and operations in order to create an effective ethical culture, and in so doing, to produce consistent evidence that it can be trusted — and why.

Businesses that operate in regulated sectors, such as those that involve quality systems, can draw upon much relevant information, however, there are numerous other sources of evidence regarding the culture of an organization that can be produced.

For example, the Barrett Cultural Values Assessment (CVA) tool reveals the collective top personal values of an organization’s staff, and assesses how closely aligned these values are with the values that are perceived to in fact exist in the organizational culture, and those values deemed to bring the organization to its full potential. Ruth Steinholtz, Founder and Managing Partner of AretéWork LLP, demonstrated that the result is a very powerful diagnostic of the level of dysfunction (cultural entropy) in the organization, identifying issues that will tend to diminish ‘cultural capital’ and employee engagement. Low cultural capital is an indication of high-risk culture because employees will be more likely to rationalize bad behaviour and will be less likely to speak up if they observe others behaving unethically. Therefore, cultural capital is a useful indicator in this context. Over 6,000 organizations have used the CVA tool as part of a cultural transformation programme, with considerable success. Its other benefits include that it is easy to administer and the results are easy to work with, as was demonstrated by both Cornwall Council and Rick Stein in their pilot.

In addition to discussing the importance of measuring and understanding culture, Ms Steinholtz briefly introduced some of the elements of the Cultural and Leadership Framework, in particular the importance of defining an inspiring social purpose and a belief that ‘ethics is everyone’s responsibility’.

Data can be used to demonstrate improvement in culture. An innovative example was cited by Marcus Rink, Chief Inspector of the Drinking Water Inspectorate (DWI). From the extensive water testing data that is regularly produced, much of it by companies themselves, the DWI has developed a Compliance Risk Index (which examines the effect of a compliance failure, and what the company has done about it) and an Event Risk Index. The data has been used to confront the riskiest companies with the need to move to a transformation programme, and to assist in making decisions on the proportionate responses to breaches of the law.

**Challenges**

Transparency is an important element in supporting trust, but it can raise problems. The aviation safety system does not burden the public with complete transparency about all relevant data, for the simple reason that it would cause anxiety among the public. The enterprise of flying is not without risk, and the information can be concerning, but the results are what the public needs to see and to rely on. The aviation sector finds that it has to fight to maintain its operational values of openness, because they are not valued by the public, which remains attached to a blame culture. The involvement of the media,
politicians, the police, and criminal justice system poses a real challenge to maintaining success. Public tolerance for failure is declining, and this must be tackled in order for EBR to be widely adopted.

Is there a risk that a close relationship between businesses and regulators might become too cozy and complacent? The conclusion of the Committee on Standards in Public Life was that the best way of countering this risk is to accept that it may occur and to take steps to guard against it, for example through governance, transparency, and periodic circulation of individuals to bring fresh insights.12

EBR offers an opportunity for further discussions but may need resource, or resource of a different type. Regulators may need to spend more time with business on a proactive basis, however, because fewer incidents and issues will result from an EBR approach, the overall time commitment should be less in the long term. It is undoubtedly better to prevent problems before they emerge than to try to fix them later. Furthermore, certain aspects of supporting an ethical culture can be assisted by other private sector organizations, such as trade associations or auditors.

Investment in EBP should generate better overall results for an organization, since it enlists the support of all staff, suppliers, customers, investors, regulators, and so on. As staff are more likely to bring their discretionary effort to work, and not rely on obtaining business through bribery, an effective ethical culture will support innovation and growth. Investment in EBR should, over time, reduce the regulatory burden by transferring some existing elements of legal regulatory systems to less formal mechanisms, such as guidance, best practice, codes, and standards.

The importance of selecting the right enforcement practice

The traditional approach to enforcement relies on the theory of deterrence. However:

- There is little empirical evidence that traditional theories of deterrence affect future business behaviour. The scientific findings of behavioural psychology research support a positive approach to improving behaviour. For most people, adherence to rules can be voluntary, based on their internal moral sense, supported by what they see of others’ behaviour. (‘Compliance is social!’)

- Traditional policy on encouraging private enforcement of law is based on deterrence, and approaches to enforcement and hence regulation produce an adversarial culture. However, evidence demonstrates that such an approach will merely be costly, and high-profile failures will drive calls for increased deterrence, which will itself fail. A more productive culture for all is one in which business and regulators operate as adult collaborators.

- While some public regulatory and enforcement authorities cling to deterrence as their sole policy, a number of authorities in some countries (led by the UK) have moved to a supportive approach, as a result of practical experience and the impact of Better Regulation policy.

- These systems rely on the continual circulation of data and its assessment in order to identify root causes of problems and reduce the risk of reoccurrence. As civil aviation has found, an open, just (no blame) culture is essential if performance is to be maintained.

EBR does not mean that regulators never use sanctions. But it needs to be understood that sanctions are not a primary driver of behaviour, as case studies are increasingly showing.13 Regulators should understand the drivers of behaviour and use the right tools in the appropriate situations. Applying the wrong enforcement tool can cause less rather than more compliance!

These points were illustrated by Dr Florentin Blanc, who described his study of occupational health and safety enforcement regimes in France, Germany, and the UK. The study showed that a high incidence of inspections (Germany) does not necessarily produce greater safety outcomes, and that the supportive approach of the UK’s Health and Safety Executive has produced significantly better outcomes than the enforcement-based approach in France, save in relation to transportation safety, where the HSE does not have jurisdiction.
Dr Blanc concluded that:

- There is no correlation between ‘more control’/‘more sanctions’ and ‘better outcomes’;
- An absence of active ‘regulatory delivery’ activities also under-performs so it is not just about ‘less is more’!
- Meaningful engagement with regulated sectors — risk-focused and risk-proportionate, using a range of instruments adapted to various issues, situations, and behaviour profiles — appears to deliver significantly better results;
- Occupational Safety and Health data allows us to make comparisons relatively easily — and should be replicated in other sectors.

Christopher Hodges’ recommendations are that regulators should have a wide toolbox of enforcement tools, and should apply the appropriate tools in responding to particular people who have breached the rules. This responsive approach requires flexibility, discretion, and accountability.

It is important that public confidence is maintained in the exercise of discretion in enforcement. An important means of achieving this is through publication and transparent operation of a written Enforcement Policy that lists mitigating and aggregating factors that will be taken into account in setting enforcement responses and sanctions. Such factors should include the extent to which a business and its staff have demonstrated EBP, through evidence of having an inherent ethical culture, identifying and remediying failures, cooperating with authorities, remediying those harmed, and taking effective steps to prevent future risk.

Conclusion

EBP and EBR offer transformative opportunities for regulation, behaviour, and economies. These mechanisms are a different paradigm from traditional regulation, enforcement, and compliance. Elements of EBP or EBR can be seen in many sectors, and conference attendees have reported that the comparisons between different sectors have stimulated new ideas for many. More EBP pilots should be done by companies, especially based on a Barrett Cultural Values Assessment, and more EBR relationships should be explored.

Notes

1. See: http://www.flys.org/content/policymakers-business-leaders-and-regulators-assess-shift-deterrence-values-based-ethical
10. Transforming Culture in Financial Services (Financial Conduct Authority, 2018).
11. Supervision of Behaviour and Culture (n. 74).

8 • THE INTERNATIONAL ADOPTION OF ETHICAL BUSINESS REGULATION
The Foundation
The mission of the Foundation is to study, reflect on, and promote an understanding of the role that law plays in society. This is achieved by identifying and analysing issues of contemporary interest and importance. In doing so, it draws on the work of scholars and researchers, and aims to make its work easily accessible to practitioners and professionals, whether in government, business, or the law.

Christopher Hodges is Professor of Justice Systems, and head of the Swiss Re Research Programme on Civil Justice Systems, Centre for Socio-Legal Studies, University of Oxford. He is a Supernumerary Fellow of Wolfson College, Oxford, and a Fellow of the European Law Institute.

Ruth Steinholtz is the Founder of AretéWork LLP, an international lawyer, management board member, General Counsel and business ethics catalyst, speaker, and author. Ruth speaks authoritatively on values-based ethics and compliance, and is a creator of change in both mindset and culture, with a focus on prevention. She developed the first ethics ambassador network; an approach which is now adopted by companies globally.