



The Law Society

## **Regulation: the political context**

Speech by Professor Julia Black at the Law Society legal breakfast

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For most of my professional life, when people ask me what area I work in, my response 'regulation' has been greeted by a blank look, and, if at an event involving any kind of refreshment, a sudden need on the part of my interlocutor to go and get another drink. More recently, however, the response has been most often on the lines of – 'gosh, you must be busy', and although they may have gone off to get that other drink, they have at least come back, sometimes with one for me as well.

Regulation has usually been seen as part of that Whitehall world which has been described by Andrew Marr, in his book *My Trade*, as 'low politics'; a world of mundane technicalities, far below high politics of international diplomacy or national party politics.

But regulation has recently taken political centre stage, and the fact that there are articles in newspapers on 'regulatory philosophy' is quite startling to someone who is used to having their area regarded as pretty much a Cinderella subject.

The reasons for the increased political salience of regulation are many. The financial crisis has brought regulation into the spotlight recently, but the increasing political salience of the style and philosophy of regulation has been growing over the last 10-15 years. Political, media and indeed academic attention was initially drawn to regulation in the 1980s with the privatization of the nationalized industries and liberalization of their markets. It grew through the 1990s with an increasing focus on consumer issues and a heightened political and media awareness of risk regulation, and with calls for governments to recalibrate their relationship with markets, by moving from 'rowing' to 'steering'.

However, contradictory demands are made of regulators as to what regulation should deliver by firms, politicians, the media, consumers and the wider public. Whilst government expands regulatory remits, it also requires regulators to 'reduce burdens on business'. Complaints about 'regulatory creep, the 'nanny state' or 'health and safety gone mad' sit alongside criticism that regulators 'were asleep on the job' and demands that 'something must be done' whenever accidents or losses occur.

I've been asked to focus today on the changing political context of regulation and what implications that has for the regulation of the legal profession in particular. I thought I'd set the scene by outlining what's been going on in the regulatory world outside over the last 20 years or so, a world which the legal profession is now being brought into. It's a new and possibly strange world for you, so an idea of what its main characteristics are is probably useful.

## **The evolution of regulation**

The increased political attention to implementation, to what happens after enactment of legislation, has been reflected both in changes in the institutional structure and organization of regulation, and in changes in regulatory 'philosophy'.

### **Changes in Institutional Structures**

What follows is a very sweeping and over-generalised characterization of the development of regulatory agencies but in broad terms development has been thus:

Historically in the UK, as now, enforcement of regulation has been distributed between central and local government. Whilst local government still plays a key role in the enforcement of some regulation, notably food safety and trading standards, most attention has focused on developments within central government. Within central government, for most of the 20<sup>th</sup> century the structure of the executive was that of large, central Departments, and a number of separate inspectorates with relatively limited powers, for example for health and safety in factories or railways (many of which were established as part of the Victorian 'revolution in government'). Outside of the executive there were strong models of self regulation, notably in finance and the professions. The professions in particular had in effect a monopoly grant of power to be regulators. The 'governance bargain' that was struck between the state and the professions was in effect the same as that which applied to the guilds: the self regulating body was granted a monopoly in delivering a particular service or performing a particular function, and in return it was expected to maintain order within that sector.

The pattern started to change in the 1960s - 1970s. There was a growth in recognition of consumer issues, for example, and the Director General of Fair Trading was established in 1974, albeit with what appear today with extremely limited powers. The first 'mega-regulator' was also created: the Health and Safety Executive and Health and Safety Commission, which amalgamated the several inspectorates into one organization.

Regulation shot to prominence however in the 1980s, the decade of privatization, liberalization and the full-scale introduction of economic regulation. In financial services, we also had de-regulation and then re-regulation, with 'big bang' and the establishment of the quasi-statutory system of financial services regulation in 1986. For many academic and political commentators the 1980s saw the 'birth' of regulation and the 'regulatory state'.

The 1990s were, again in sweepingly general terms, the decade of the rise of 'risk' regulation and recognition that risk was an issue that needed specific forms of regulation. As we've seen, factory inspectorates had been established over a century ago, but it was arguably in the 1990s that task of various regulators became conceived in terms of risk. We had the BSE crisis and creation of the Food Standards Agency; in the EU the crisis led to the creation of European Food Safety Agency and a fundamental re-evaluation of risk regulation in this area. Returning to the UK, we had the consolidation of responsibilities and the formation of another 'mega' regulator in the creation of the Environment Agency.

Post-2000 saw the advent of a new generation of regulators, what I term the 'new millennium' regulators. Regulators such as Ofcom, the Financial Services Authority, and the re-vamped Office of Fair Trading were created along with new criminal regulatory offences. These 'new millennium' regulators had far broader powers to formulate policy, write rules, and in particular to impose sanctions than earlier regulators. The latter trend, giving regulators a wider range of powers to impose sanctions directly rather than simply relying on statutory notices and prosecution, has been expanded recently in the Regulatory Enforcement and Sanctions Act. We also saw the appurtenances of specialist consumer panels and ombudsmen being established alongside the regulators for that particular regulatory regime. At the same time, there has been an increasing role of the state in regulating areas that were previously the stronghold of self regulation, notably financial services, the professions, and, as seems increasingly likely, MPs. The creation of the Legal Services Board, and the range of powers that it has, can therefore be seen as part of these continuing trends.

## **Changes in regulatory 'philosophy'**

Changes in the institutional structure have been accompanied by changes in regulatory approach. In particular, as the function of regulation became increasingly distributed away from central government and out to the independent regulatory agencies, central government has increasingly sought to exert control over the manner in which regulation is performed.

Again, the trends are depicted here in overly-generalised terms, but broadly the evolution was thus. Initially, almost uniquely regulation took the 'command and control' (CAC) model of laws backed by criminal sanctions imposed by the courts. The Health and Safety Executive was a notable exception, as it introduced the notion of 'enforced self regulation' of firms, an invention of Robens which was decades ahead of its time. (Its organizational structure was also ahead of its time. It had a corporatist model (membership of unions, firms and government) which was an early precursor to today's

mixed membership boards (though unions been replaced by consumers, reflecting a broader shift in the balance of power between these groups within the economy).

The 1980s saw the advent of economic regulation, which opened up debate on whether the way regulation was conducted in other sectors could also adopt a more market-based form. Through the 1990s-2000s there has been increasingly political and academic discussion of the limits of 'CAC' regulation, and both governmental and academic publications were appearing on 'alternatives to regulation'; 'smart' regulation; and 'co-regulation'. Ofcom, for example, was a great proponent of co-regulation, outsourcing some of its functions to the Advertising Standards Agency; in financial services, 'co-regulation' was attempted in the SIB-SRO model, though through the 1990s that was certainly creaking.

In addition, the 'de-regulation' rhetoric of the 1980s moved in the 1990s-2000s to the rhetoric of 'better regulation'. It is through the 'better regulation' agenda that we have seen the marked 're-centring' of government control. After the dispersal of regulatory functions out to the independent regulatory agencies, and the increasing political salience of regulation, central government realized it wanted to exercise control over the manner in which regulators regulated; not over the substance necessarily, though that has and is happening in particular instances, but over how they went about their task.

So we began to see the introduction of principles of 'good' or 'better' regulation emanating from central government. This phenomenon was not just confined to the UK. Australia, Canada, the US - all saw central governments seeking to exert greater control. On a transnational level, the OECD issued its first set of principles of 'good regulation' in 1995. In the UK, the 'PACTT' principles of proportionality, accountability, consistency, transparency and targeting were adopted by central government's better regulation unit as exhortations for regulators to follow. I've been told by the HSE that the principles emanated initially from them, but there are many who claim authorship of them.

In the last few years, what we have also seen is the increasing 'juridification' of principles of better regulation. From beginning as self-imposed guidance for one regulator, they are now statutory duties for the Legal Services Board and the ARs. This is itself part of a gradual move to give legal force to a number of 'better regulation' principles, either in the individual statutes creating the 'new millennium' regulators or through cross-regulatory instruments such as the Compliance Code, introduced under the Regulatory Reform Act. As an aside, this increasing 'juridification', is also, in my view, providing new, statutory grounds of judicial review of regulatory actions, a fact as yet unremarked upon by public lawyers.

There have been other developments in the 'better regulation' model.

First, the use of cost benefit analysis (CBA) and regulatory impact assessment (RIA). These have now become central to all 'better regulation' agendas in those countries that have one, including, though rather tardily, the EU.

Added to this in the UK in particular, but also in countries such as the Netherlands, has been 'deburdening'. Sir David Arculus, as head of the Better Regulation Taskforce issued a report, *Less is More*, which emphasized the need for 'burden reduction', to reduce the burden on business of regulation. This 'light touch' regulatory approach still features prominently in BERR's rhetoric. Departments are strongly feeling the BERR requirement that they satisfy the demand for a reduction of 25% in the 'burden' regulation imposes on business, though the independent regulators are a little more insulated.

What the independent regulators are feeling is the demand from central government that they move to risk based regulation or 'RBR'. A handful of regulators had been developing RBR, but the movement was given considerable impetus by the Hampton Review of Inspection and Enforcement. This recommended that all regulators move to RBR, a requirement introduced in the Compliance Code formulated under the Regulatory Reform Act (another example of the 'juridification' of better regulation principles). RBR is the 'new kid' on the better regulation block.

That brings us to PBR, or 'principles based regulation'. Of the various regulatory approaches, PBR has had the strongest role in political rhetoric, indeed it has been used as a key weapon in the political battle for market share in financial services between New York and London.

The reason for PBR's political attractiveness lay in its rhetorical invocation of a 'regulatory Utopia'. In this 'regulatory Utopia', regulation is targeted and focused (and preferably harmonized across jurisdictions), regulated firms are given the flexibility they need to get on with running their business, and consequently regulatory outcomes are achieved with no undue cost to business. The rhetoric of PBR thus invoked a re-framing of the regulatory relationship from one of directing and controlling to one based on responsibility, mutuality and trust.

That's not a bad vision, and it may be one which still exists for many, but in the wake of the financial crisis, PBR is no longer seen by many as the means of achieving it.

This is a shame, as PBR was always more complex than being 'light touch' regulation (for example, the FSA's Treating Customer Fairly initiative, which was used by FSA as an exemplar of its PBR approach but was far from light touch). But PBR was always

'oversold' by the government as 'light touch' regulation, and the FSA itself arguably 'over-bought' into this interpretation of the notion, at least in its regulation of the wholesale markets.

PBR was a multi-faceted strategy, and is one which is more complex than the label 'light touch' suggests. Unfortunately, the FSA invested so much reputational capital in PBR, particularly since 2006-7, that after the crisis it had no choice but to withdraw the brand from the market and to have a re-launch of a slightly different model under a different 'strap-line'. PBR is not in vogue; for the FSA it has been replaced by 'outcomes based regulation' or OBR, a strap-line also used by the Financial Reporting Council.

But more fundamentally there has been a shift in the philosophy of regulation within financial services regulation in the UK, a shift in philosophy which is based on severe destruction of trust. The previous philosophy of the FSA, at least towards large banks, was based on trust (they never trusted anyone in the retail market); now it is based on lack of trust. The attitude of the FSA, exemplified in the Turner Report, now is that they cannot trust the market, and they cannot trust firms: in that notorious phrase of Hector Sants, chief executive of the FSA, principles based regulation is no good for people who have no principles.

So the implicit or explicit assumption that firms, especially large firms, will have strong internal governance processes because it is in their interests to have them, and therefore the regulator does not need to monitor them so closely, has disappeared.

Instead, there is now a strong focus on outcomes not just processes; and in scrutinizing individuals not just for their probity but for their skills.

This shift in regulatory attitude makes Nick Smedley's suggestion (in his report on the regulation of large firms) that the Solicitors Regulation Authority be the large corporate firms' 'critical friend' somewhat out of step with current political climate. The emphasis in the current political climate is more on being critical, and less on being a friend.

So where to next in the regulatory movement? We still have all the better regulation initiatives that I mentioned above: CBAs and RIAs (though there is less emphasis in the case of the LSB than there is for other regulators); de-burdening; RBR.

We also still have talk of PBR, though it is more muted. As I said, I think that's unfortunate, as there can be a great deal of value in setting out the core principles that all regulated persons should be following. In the context of legal regulation, these principles should extend to all within the scope of the Act, not just to an 'elite' few, as

Lord Hunt is perhaps suggesting in his review. There is a lot of value in the professional ethics that lawyers have traditionally upheld, and I'm wary of solicitors keeping their 'professional' ethics to themselves, as I fear they could be used effectively as a marketing tool to show that they are superior to the great unwashed – those 'mere' providers of legal services. All should have to adhere to a common set of high level ethical principles, though the detailed rules may have to differ between groups.

Yet PBR may still survive in some form under the strap-line of OBR in that both try to shift the regulatory focus from systems and processes to outcomes achieved.

In turn, I predict that if the current climate continues, that we will see two more acronyms appear in what is already a crowded better regulation landscape.

The first is HLR, or 'hard look regulation'. We see the FSA moving to 'intensive supervision', and it won't take a huge leap to see moves to 'HLR' appear elsewhere, at least in regulatory rhetoric.

The second is that we will gradually see the emergence of a move to EBR or 'evidence based regulation'. There has been an increasing shift of emphasis in some regulators and in the National Audit Office to assessing regulatory performance in terms of the longer term outcomes that it produces, not just in terms of inputs and outputs (numbers of inspections performed or convictions obtained). We have seen evidence based regulation growing in risk regulation, but the evidence emphasized there is scientific evidence. What I predict will be the next 'new kid' is EBR of a different nature: the evidence will be that different regulatory techniques being adopted are actually working; for example a greater attention to how and whether inspections improve compliance, or on whether RBR itself produces the desired outcomes.

## **Political climate - competing demands**

But life is never simple for a regulator - the political climate is fickle, and there are tensions and contradiction in the demands made of regulators by firms, consumers and politicians. Only one thing certain for a regulator, bound to fail at some point as far as some are concerned.

Politically, for example, on the one hand we have Turner, and on the other we have Arculus. As chair of the BRTF, as I mentioned earlier, Arculus put out the paper 'Less is More'. He reiterated this message in his report for Tory party published last week (The Arculus Review: Enabling Enterprise, Encouraging Responsibility). Yet the message of



Turner, chairman of the FSA, is, in effect, that 'more is more': the FSA's model of 'intensive supervision' of banks which it has adopted over the last few months.

We can also see these contradicting demands in risk regulation. As I mentioned at the start, there is a deep rooted contradiction between the requirement for 'individual responsibility' in managing risks and complaints about the 'nanny state' or 'health and safety gone mad' - and on the other hand if risk does crystallize the cries are that this 'should never happen again'.

And there are contradictions between calls for regulators to 'trust business', to have 'grown up' conversations with regulated firms, and to trust and rely on firms' own internal governance systems, and yet warnings, and evidence, that such reliance is ill placed at best, and, from Turner again, calls for regulators to have a 'braver approach'.

## **Implications of the political climate for the LSB and regulation of the legal profession**

How will these contradictions play out? How is the political climate likely to shape the approach the LSB takes or should take?

The challenge for the LSB is that it has been given a system which is a combination of financial regulation Mark I (the SIB-SRO) model, albeit an enhanced version, with elements of financial regulation Mark II (consumer panel, ombudsman, greater powers of direction and sanction).

Being an 'uber-regulator' is not an easy task, and even though the LSB has a better framework of powers than the old SIB had vis à vis the ARs, it is still going to be a difficult task to find right balance between oversight and duplication.

But that dynamic, between LSB and the ARs, although critical, is not what I want to focus on. Rather, I want to look at where developments leave public and political expectations as to what regulation should deliver, and how it should deliver it.

Those expectations are probably pessimistic at the moment as to the success of any government intervention. We're operating at the moment, in this area as well as others, in a climate of a significant lack of trust, of everyone of everyone else.

Lack of trust is critical, as without it the regulatory Utopia can never come. The title of this morning's session is 'Effective Modern Regulation - What Law Firms Want, What Clients Need and What the Public Expects'. In truth, they all want, need and expect different things.

What they have in common is that loss of trust is not good for any of them, including the regulators.

It is not good news for firms, in particular large City firms, because the argument that 'we're good because we're big' will not hold. Banks have shown that 'regulatory capacity' does not just equal having the resources to be able to put systems in place but also requires a willingness to comply at the highest level, and, critically, to forgo business where is counter to ethical / regulatory principles to engage in that business.

It is not good news for regulators, for several reasons.

First, the days of box ticking are over (not that any regulator ever admits to being a box ticker, or at least only does so in the past tense).

Secondly, there is a need for new skills and a new approach to supervision. Re-skilling is costly and challenging, as the FSA is finding out and as the SRA is being urged to do. But there is a shift in approach in financial regulation, which may well spill over to the legal context, which is that regulators have to be 'brave'. One Australian regulatory organization epitomizes this change in the training course it has run for its new recruits: they are first shown a picture of a cute dog, followed by one of a rottweiler – the message is clear, it is the latter type of 'watchdog' that they are meant to be, not the former.

Thirdly, the financial crisis has revealed starkly what regulators always knew, which is that regulation is politically a highly risky business. Regulators have to decide in particular instances whether they prefer to err on the side of assuming something is safe when it is risky (the 'light touch' approach which runs the risk of criticisms of being 'asleep on the job' when risks crystallise) or whether they prefer to err on the side of assuming something is risky when it is safe, in which case they are likely to be accused of 'overregulation' when risks don't materialize: it's not an enviable choice.

Loss of trust is also not good news for self-regulators and the professions. The days when the public and politicians thought lawyers were 'special' have long gone. The legal profession's image of itself as being the upholders of semi-mystical principles of ethics and a commitment to the 'rule of law' is one which is unrecognizable to most consumers.

Professional self-regulation as an acceptable model of regulation is in rapid decline and in the current political climate there are no sacred cows. If this new regulatory system for the legal profession doesn't work, if you don't make it work, then statutory regulation will swiftly follow. The question will be not whether it will come, but when.

Finally what about clients and consumers, is loss of trust good news for them? Well, we hope that the aim of the new regulation is to benefit them. But the sting in the tail is that whatever shape the regulatory system takes, and whatever regulatory approach is adopted, consumers will end up paying for it. So perhaps the most we can hope for is that the cost will be worth it in the end.

Thank you.