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Superregulation: Competitive Approved Private Regulators

Gillian K Hadfield

Superregulation: Competitive Approved Private Regulators (CAPRs)

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[Please see attached excerpt from my book *Rules for a Flat World* for description and background of the concept of competitive approved private regulators.]

Abstract

In this paper, I explore the potential for developing markets for regulation as a means of producing regulatory methods and technologies that are better adapted to the characteristics of a complex, digital, and global economy. This model expands the new governance concept of outcomes-based regulation, in which government monitors the achievement of established targets (such as an accident rate or release of toxins) but does not prescribe the means of achieving those targets. In standard outcomes-based regulation, regulated entities design their own approach to achieving regulatory targets. In the model I propose, private regulators compete to provide regulatory services to regulated entities; these private regulators, however, must be authorized (approved) by government, evaluated on the basis of their efficacy with which they achieve the regulatory targets. In this model, government becomes a regulator of regulators: superregulation. In this preliminary paper, I explore the possibilities and limits for such a model.

Introduction

As the complexity, speed, and global reach of modern economies and technology expand, traditional methods of regulation are increasingly hard-pressed to keep up. Legislation, regulations, and legal processes continue to grow in terms of volume, delay, and complexity, with the tripe negative effect of increasing the cost of regulation while simultaneously decreasing the predictability of legal treatment

and the efficacy of regulatory efforts.[1] Among executives in leading global companies, 70% identify regulation and government oversight as the leading sources of complexity they face as they try to manage their businesses.[2] Developing regulatory technologies—particularly those that go beyond the conventional reliance on text-based rules which require legal expertise to interpret and apply, enforced through public agencies and courts administering fines, awarding damages, and imposing injunctions—will require developing incentive systems that attract human capital, investment, and research which is deeply steeped in the complexities of particular regulatory settings. In short, developing regulation that can manage the complexity and speed of modern technologies and globalization will require recruiting the high-powered incentives available in markets, attracting private investment and attention through a combination of profit and non-profit (mission-driven) organizations.

In this paper I propose one such model: competitive approved private regulators. In this model, companies that are the target of regulation (producers of self-driving cars, for example, or operators of manufacturing facilities that pose potential risks to the environment or workers) are required by governments to purchase regulatory services from private (profit and non-profit) organizations: private regulators. To compete in this market, private regulators are required to maintain approval status with relevant governments, by demonstrating that they are achieving regulatory outcomes (accident rates, levels of workplace risk, environmental toxicity levels) that are set by governments. Governments also act to ensure that these markets are indeed competitive, with a sufficient number of suppliers and reasonably low-cost opportunities for switching regulators to provide regulators with the incentive to engage in research and development to produce more effective and less costly means of regulation. I call this superregulation.[3]

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[1] See Gillian K. Hadfield, *Rules for a Flat World: Why Humans Invented Law and How to Reinvent It for a Complex Global Economy* (2017), Chapter 7.
[2] KPMG International, *Confronting Complexity: Research Findings and Insights* (May 2011)
[3] Anthony Ogus introduced this concept in "Rethinking Self-Regulation" 15 *Oxford Legal Studies* 97 (1995).

Methods of Regulation

Although the idea of competitive approved private regulators may seem far-fetched at first, it is in many ways just the next step along several paths that regulatory systems are already on. This note provides an overview of the landscape of regulatory methods so we can see how CAPRs fit in.

There are currently four principal methods for regulating markets and industries.[4] The traditional, and most widely used, approach is *prescriptive*, sometimes called *command-and-control*. Prescriptive regulation supplies specific and sometimes highly detailed rules governing behavior, technology and/or processes; failure to comply with the rules generates penalties (fines, loss of authority to provide goods or services, criminal sanctions, etc.) Also traditional and widely used is *licensing* (which can also be thought of as a form of prescriptive regulation and is also called *prior approval*), the requirement of obtaining and maintaining authorization before providing goods or services in markets. Initial authorization can require completion of prescribed education, testing of individuals or products, or inspection and evaluation of facilities or processes.[5] Maintenance of a valid license can require ongoing compliance with regulations. Operating without a license is penalized.

In recent decades, these traditional forms of regulation have been supplemented with "new governance" techniques. *Performance-based* regulation (also called *outcomes-based or principles*-based) specifies results (sometime specific, sometimes expressed only as principles) that a provider has to achieve but does not specify how the provider has to achieve those results.[6] Failure to achieve

[4] See generally, Peter J. May "Regulatory regimes and accountability" 1 *Regulation and Governance* 8 (2007) and Christopher Carrigan and Cary Coglianese, "The Politics of Regulation: From New Institutionalism to New Governance" 14 *Annual Review of Political Science* 107 (2011). I am focusing here on mandatory regulation and not self-regulation through the adoption of voluntary standards, even if adoption of the standards alters expected legal obligations such as by shifting the risk of private liability or of the imposition of public mandatory rules. I discuss voluntary standards below.

[5] Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* Oxford: Hart Publishing (2004); "Morris M. Kleiner, "Occupational Licensing," 14 *Journal of Economic Perspectives* 189 (2000);

[6] Cary Coglianese, Jennifer Nash and Todd Olmstead, "Performance-Based Regulation: Prospects and Limitations in Health, Safety and Environmental Protection" 55 *Administrative Law Review* 705 (2003); Peter J. May

outcomes is penalized. *Management-based* regulation (also called *process-oriented, risk-based, or enforced self-regulation*[7]*)* requires firms to evaluate the risks generated by their business and to develop their plan for how those risks will be managed. Plans might need approval from government or a third-party certification agency. Failure to generate a plan as required and/or to abide by the plan is penalized.[8]

The move to new modes of regulation has been fostered by the perception that traditional approaches inhibit both efficiency and innovation in the achievement of regulatory goals. The theory of new governance approaches is that government should find ways to harness the expertise and cost-minimizing incentives of industry itself in the pursuit of politically-established outcomes such as a safe food supply, reduced pollution, or stable financial systems.

Private regulation

Although we think of regulation as a quintessentially public/state activity, private—non-state—actors have long played a role in regulation. This is especially the case if we include in our concept of regulation voluntary compliance with rules and standards established by private standard-setting

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"Performance-based regulation" in David Levi-Faur (ed) *Handbook on the Politics of Regulation* Cheltenham, UK: Edward Elgar (2011). Coglianese, Nash and Olmstead suggest that performance-based regulation is also a traditional form, dating back to Hammurabi's code—which specifies outcomes such as the obligation for a builder to make a wall firm. In this sense, performance-based regulation is like tort law, specifying liability for outcomes without specifying the means by which those outcomes are to be achieved. The literature however generally identifies performance-based regulation with new governance approaches—the more recent shift in government agencies from, for example, specifying the means for reducing pollution (installation of particular technology) to the obligation to meet pollution targets.

[7] John Braithwaite, "Enforced Self-Regulation: A New Strategy for Corporate Crime Control" 80 *Mich. L. Rev.* 1466 (1982).

[8] Cary Coglianese and David Lazer, "Management-Based Regulation: Prescribing Private Management to Achieve Public Goals *37 Law & Society Review* 691 (2003); Sharon Gilad, "Process-oriented regulation: conceptualization and assessment" in David Levi-Faur (ed) *Handbook on the Politics of Regulation* Cheltenham, UK: Edward Elgar (2011); John Braithwaite "Enforced Self-Regulation: A New Strategy for Corporate Crime Control" 80 *Mich. L. Rev.* 1466 (1981-1982); Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* Oxford: Oxford University Pres (1992); John Braithwaite "The Essence of Responsive Regulation" 44 UBC L. Rev. 475 (2011).

bodies[9], private third-party certification agencies[10], and by regulated entities themselves, such as when these entities adopt codes of conduct for their own operations. As I emphasize in *Rules for a Flat World*, there is an economic demand for legal infrastructure to make market (and other) interactions more reliable and productive and as a result private entities can in some cases find a profitable opportunity to supply rules to meet that demand; in other settings, private actors can meet the demand for legal infrastructure by collectively establishing industry standards and funding an oversight mechanism.[11] Voluntary submission to regulation can also go beyond voluntary compliance, as when voluntarily chosen standards are made enforceable through contract.[12] Publicly-enforceable standards of conduct are privately written into contracts both by parties to the contract, as when an online retailer sets out rules governing privacy and data usage in its terms of service, and by third parties, as when trade associations require their members to use the organization's contract terms.[13] Suppliers in developing countries with underdeveloped regulatory systems are increasingly subject to standards in areas such as quality control, environmental practices, workplace safety, and child labor established by purchasing

[9] For example, the International Organization for Standardization (ISO) provides standards in areas ranging from quality (ISO9000) and the environment to risk management, food safety, and anti-bribery.

[10] I discuss examples of private certification providers in the online environment, such as TRUSTe, in Gillian K. Hadfield "Delivering Legality on the Internet: Developing Principles for the Private Provision of Commercial Law" 6 *Am. Law and Econ. Rev.* 154 (2004). Online rules platforms continue to flourish online. eBay provides a set of rules to govern transactions and dispute resolution, for example, and Taobao is taking on this role in Chinese online commerce.

[11] A good example of this is the response of large retailers in the garment industry to the 2013 collapse of the Rana Plaza factory and the 2012 Tazreen Fashions factory fire, both in Bangladesh. American retailers such as the Gap established the Alliance for Bangladesh Worker Safety (http://www.bangladeshworkersafety.org/) which created a set of workplace safety standards for members to incorporate into their supply contracts and a monitoring facility to inspect factories for compliance.

[12] European retailers such as H&M, for example, went beyond the Alliance approach in response to the Bangladeshi disasters. They established the Accord on Fire and Building Safety in Bangladesh (http://bangladeshaccord.org/) which makes the achievement of workplace safety standards and commitments to fund safety programs in Bangladeshi factories subject to third-party enforcement (arbitration) and whose governing board includes union representatives and is chaired by someone from the UN's International Labour Organization (ILO).

[13] See e.g. Lisa Bernstein "Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms" 144 *Univ. Pa. L. Rev.* 1765 (1996).

companies (Nike, Apple, Walmart etc.) in their global supply chain contracts.[14] In many cases, supplier compliance with supply contract obligations is monitored and enforced by private sanctions (contract termination, fines) imposed by the purchasing company—which may outsource oversight to a third-party monitor.[15] There is a robust literature in political science examining these forms of "private regulation."[16]

But even if we limit the landscape to mandatory regulation—where regulation is imposed by the state—private entities have long been a significant presence. There are numerous examples of cases in which public regulation has piggybacked on systems initially developed privately[17] and this creates an incentive for industries to organize self-regulation in order to shape what is seen as inevitable public regulation.[18] Private actors also play an indirect role through their influence over government regulation.[19] Standards developed by private standard-setting bodies—membership organizations such as the Society of Automotive Engineers, for example—are sometimes incorporated into legislation.[20] Privately-developed rules (established and sometimes monitored by industry bodies or by individual firms such as insurers) can also be imposed by government as a condition of obtaining a government contract or permit.

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[14] Richard M. Locke, *The Promise and Limits of Private Power: Promoting Labor Standards in a Global Economy* Cambridge: Cambridge University Press (2013).

[15] See e.g. Jodi L. Short, Michael W. Toffel and Andrea R. Hugill, "Monitoring Global Supply Chains" manuscript, *Harvard Business School Working Paper* No. 14-032 (2015).

[16] See generally Tim Buthe, "Private Regulation in the Global Economy: A (P)Review" 12 *Business and Politics* (2010).

[17] Securities regulation originated, for example, in the private regimes developed by stock exchanges. See Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (3rd edition) (2003); Jonathan R. Macey and Maureen O'Hara "Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective" 28 *J. Leg. Stud.* 17 (1999), William A. Birdthistle and M. Todd Henderson, "Becoming a Fifth Branch" 99 *Cornell Law Review* 1 (2013).

[18] Braithwaite and Drahos, *supra* n. 14. Elinor Ostrom emphasized the capacity for groups to self-organize to supply rules governing common pool resources. Elinor Ostrom, *Governing the Commons: The Evolution of Institutions for Collective Action* (1990).

[19] This can occur both through lobbying and through the creation of epistemic communities of experts and policymakers. See, e.g., Peter M. Haas, "Introduction: Epistemic Communities and International Policy Coordination" 46 *International Organization* 1 (1992).

[20] See, e.g., 16 CCR § 3351.6 "Equipment Requirements for Automotive Air Conditioning Repair Dealers" (all automotive repair dealers engaged in service or repair of air conditioning systems in vehicles must have refrigerant identification equipment that meets or exceeds Society of Automotive Engineers standard J1771, " which is hereby incorporated by reference.")

Private membership organizations are sometimes delegated authority to regulate their members on behalf of government actors—examples include FINRA and bar associations. The demand for transnational regulatory standards in our increasingly integrated global economy has also resulted in increasing reliance on private actors to regulate. As with domestic regulation, there has long been widespread reliance on international standard-setting bodies to supply the rules governing goods and services sold in global markets. [21]

What's missing in private regulation?

Although there are numerous examples of private (non-state) entities supplying rules and standards to govern the behavior of other private entities, my current sense is that few of our existing regulatory approaches fit the CAPR model.[22]

I define the CAPR model as a regulatory approach that displays all of the following features:

1. The regulator is a private (non-state) actor (profit or non-profit).
2. Regulation is mandatory: regulated entities must choose and submit to the regime established by a regulator (and pay any fees charged by the regulator.)
3. In order to participate in the market for regulators, the private regulator must be approved by the state.
4. The market for regulatory services is competitive.
5. The regulator has the capacity to recruit the public enforcement apparatus of the state to sanction non-compliance with the requirements of its regulatory system (beyond contract enforcement.[23])

[21] John Braithwaite and Peter Drahos *Global Business Regulation* Cambridge: Cambridge University Press 2000; Tim Buthe and Walter Mattli *The New Global Rulers*: *The Privatization of Regulation in the World Economy* (2011).
[22] I am still in the process of surveying the landscape of current private regulation—and hope to harvest the collective wisdom in the room to this end.

I think we have examples of regulatory strategies that satisfy as many of three, possibly four, features of the CAPR model, but I have identified so far only one that displays all five. I'll set that example out first and then consider how other approaches fail in one or more dimension.

Regulation of the legal profession in England and Wales: CAPR

The U.K.'s Legal Services Act of 2007 (LSA) was implemented to increase competition and innovation in the market for legal services in response to concerns from the competition authority in the U.K., the Office of Fair Trading, that existing professional regulation was overly restrictive.[24] Prior to the passage of the LSA the English legal professional landscape differed from the American landscape in two key respects: 1) there were no restrictions on who could provide legal advice and drafting and 2) there were multiple distinct legal professions exercising a monopoly over specific legal services (most notably barristers, who had rights of audience in courts, and solicitors, who had rights to initiate and manage legal proceedings.) But it followed the American model in another key respect: regulation of legal providers (barristers, solicitors, etc.) was carried out by a trade association (comparable to our state bar associations) with a dual representative and regulatory role. The LSA made several sweeping changes. First, it designated six "reserved activities" as ones that could only be performed by "authorized persons"[25]: the exercise of rights of audience, the conduct of litigation, reserved instrument activities (e.g. conveyancing, licensing), probate activities, notarial activities, and administration of oaths. (Note this list does not include legal advice or the drafting of legal documents like contracts and wills.) It then created a regime in which all of these activities (with the exception of notarial activities) could be

[23] I mean here to distinguish a setting in which the regulator's power to compel compliance is limited to a suit for breach of a contract between the regulator and the regulated entity.

[24] For discussion of the regulatory regime in the UK and how it could be adapted to the US see Gillian K. Hafield and Deborah L. Rhode, "How to Regulate Legal Services to Promote Access, Innovation, and Quality of Lawyering" 67 *Hastings L. Rev.* 1191 (2016).

[25] This is in sharp contrast to the US approach which extends the monopoly of licensed providers across anything that bar associations and courts deem to be "the practice of law."

provided by multiple professions. For example, barristers, solicitors, and legal executives[26] can perform all reserved activities except notarial activities.

The LSA did more than create competition between professions, however. It also created (the potential for) competition between regulators. The Act established a Legal Services Board (LSB), which is an independent administrative body accountable to Parliament and operated out of the Ministry of Justice; it is composed of individuals appointed by the Lord Chancellor.[27] The Board appoints a Chief Executive; the LSA requires that the Chief Executive and a majority of the Board members be lay people, defined as people who have never been authorized persons. The remit of the LSB is to approve regulators of authorized individuals and licensing authorities for authorized entities.[28] There are currently nine approved regulators, largely tracking professional designations that emerged prior to the Act. These approved regulators are required to have established a regulatory body that is independent of the representative side of a professional organization: like the LSB, the regulators must be chaired by and composed of a majority of lay people. The Law Society, the former regulator of solicitors (comparable to our bar associations), for example, was required to establish the Solicitors Regulatory Authority as an independent agency in order to gain status as an approved regulator.

The LSA scheme satisfies all five criteria for a CAPR regime. Anyone who wants to be an authorized provider of reserved activities must be licensed and regulated by one of the regulators approved by a state super-regulator. The regulators are private entities (currently, operating within the framework of a membership organization but with important safeguards for independence from control by the

[26] Legal executives are generally people who have completed a community-college type of training, and completed an extensive period of supervised apprenticeship.
[27] Lord Chancellor is a post in the British Cabinet (the position is currently held by the Secretary of State); she is responsible for oversight of the judicial system. Prior to 2007, Lord Chancellor also served as the presiding officer of the House of Lords, the head of the judiciary, and the presiding judge of the Chancery Division of the High Court.
[28] I consider this to be the major promise of the UK reforms: the licensing of entities. Among the corporations now licensed to provide legal services in the UK are PriceWaterhouseCoopers, LegalZoom, Ernst & Young, and KPMG.

membership.) They charge fees for their services. They compete in the sense that those wishing to be authorized to perform reserved activities can choose which regulator they want (and with the exception of notarial activities there is more than one regulator than can approve someone to engage in a particular reserved activity).[29] And they have the state-backed power to sanction those they regulate.[30] In addition, it is interesting to note that the regulatory approach taken by the LSB is not command-and-control: the LSB has established performance criteria (largely derived from the regulatory principles established in the LSA) and regulators seeking approval have to demonstrate how they meet these criteria.

Close but no cigar

I haven't identified other examples of a CAPR regime. Here's my take on other prominent examples of regulatory regimes that fail on one of the five criteria:

1. "Regulatory competition" between providers of corporate law, contract law, labor, environmental standards, finance etc. [mandatory[31], competitive, state-backed sanction, may be mandatory but not private[32]]
2. Self-regulatory organizations (SROs)—such as FINRA and bar associations—that are authorized to regulate their members and the conduct of the SRO is overseen[33] by a government actor (e.g.

[29] The competition is not as effective as we'd like. Entry-level lawyers can choose which profession to enter but because the professional regulators have continued to rely heavily on high-investment education and apprenticeship requirements, switching regulators is difficult. But it's possible in theory and if I get a chance to advise them, they'll lower those barriers.

[30] The private regulators are authorized by the LSB to impose fines up to £250 million on a licensed entity, for example.

[31] Choice of contract law is mandatory in a weak sense: parties can choose but if they fail to choose, the law provides a default. Parties can't enter into a contract without being subject to some body of contract rules.

[32] For a recent review see Bruce G. Carruthers and Naomi R. Lamoreaux "Regulatory Races: The Effects of Jurisdictional Competition on Regulatory Standards" 54 *J. Econ. Lit.* 52 (2016). Eric Talley and I have a model of how competition between public providers of corporate law differs from competition between private providers. Gillian K. Hadfield and Eric Talley, "On Public versus Private Provision of Corporate Law" 22 *J. L. Econ. Org.* 414 (2006).

SEC, state supreme court) [private, approved, mandatory, state-backed sanctions, but not competitive]

3. Incorporation of standards from standard-setting organization (SSO) into legislation or government contracts (e.g. ISO, FASB) [private, mandatory, state-backed sanctions, approved, but not competitive)
4. Submission to enforceable private standards regime (e.g. code of conduct in global supply chain contracts, organic certification, insurance requirements for construction permits, arbitration, trade associations) [competitive, private, but some not approved (all examples except organic certification), some no state-backed sanctions (that is, beyond contract enforcement--contractual codes of contract, arbitration, trade associations), some not mandatory (contractual codes of conduct, arbitration, organic certification)]

When could CAPRs work?

I am not claiming that CAPR can work in all regulatory settings. I'm just starting to sketch out the factors that I think would influence the feasibility for a CAPR regime—ultimately the test would have to be whether CAPR improves regulatory outcomes relative to the set of regulatory techniques currently in use. I think these factors include:

1. *Potential for competition*—this is a big one. There has to be a sufficient number of regulated entities to support the viability (and in the for-profit context, profitability) of multiple private regulators. Health and safety regulation, for example, would seem to satisfy this requirement; nuclear regulation maybe not – unless the private regulatory market is global in scale (which is one reason I advocate exploring the feasibility of CAPR regimes—so that less-wealthy or

[33] At least ostensibly—there's an open question of how much oversight supreme courts exercise over bar associations, an issue made a live one by the recent decision in *FTC v North Carolina Board of Dental Examiners* 135 S. Ct. 1101 (2015) holding that a state regulatory board composed of active practitioners that is not "actively supervised" by the state cannot invoke state-action antitrust immunity.

advanced countries can free-ride on the regulation of regulators supplied by advanced wealthy countries.[34]) As William Birdthistle and Todd Henderson have emphasized in their analysis of FINRA, however, even an environment that is theoretically set up to encourage multiple private regulators may end up with just one for political reasons.[35] Competition may be blunted, as in any market, by excessive switching costs, as I suggested in my brief review of the UK Legal Services regime. And of course, as we see throughout the modern economy, the economies of scale and network externalities associated with a platform may lead to a monopoly.

2. *Optimal monopoly* Our modern approach to legal infrastructure emphasizes the value of a single, harmonized set of rules. This is one way of seeing the history of the evolution of our currently highly organized, hierarchical nation-state regimes.[36] A single set of rules reduces transaction costs—individuals and entities need only to comply with a given set of rules and the applicable rules is usually not in doubt.[37] Firms operating on a global scale face the challenge of having to comply with a diverse and potentially conflicting array of rules. In some cases, these considerations may make a single set of rules optimal. But I believe this is true less frequently than is thought. The literature on global private regulation frequently treats legal rules like technical standards necessary for interoperability.[38] But the optimality of a single set of standards is not foregone even in the case of technical standards. Even though there are clear benefits to a single operating system for computers and mobile devices, for example, we prefer the competitive gains generated by some incompatibility across systems. Moreover, even though there is value in a single set of technical standards in some (perhaps many) case (so that containers can be loaded up at factories in Chinese provinces, shipped by Chinese rail to a

[34] Hadfield, *Rules for a Flat World*.
[35] William Birdthistle and M. Todd Henderson, "Becoming a Fifth Branch" 99 *Cornell L. Rev.* 1 (2013).
[36] I tell this story in Hadfield, *Rules for a Flat World*.
[37] In our highly organized nation-state-based systems, conflict-of-laws rules help to resolve uncertainties.
[38] See e.g. Buthe and Mattli, *The New Global Rulers*.

Shanghai port, loaded onto a container ship operated out of Denmark, unloaded onto a truck at the port of Los Angeles, and ultimately unloaded in a warehouse in Detroit, for example) this is not uniformly the case with respect to legal rules. Businesses operating globally currently press for a harmonized set of rules governing accounting or GMOs or privacy because under our current state-based regimes they are required to comply with the rules of every state in which they operate. But with global recognition of multiple approved regulators, this demand for a single set of rules wanes. Just as it has with respect to laws governing corporate entities: the aim of a regime of multiple competing regulators is that multiple regulators are approved in multiple jurisdictions. Thus, a company can choose a single set of rules that apply to its products and procedures in many/all of the states in which it operates. We don't need a single global set of rules for individual companies to reap the benefits of a single set of rules. Nonetheless, there may be settings in which multiple competing rule systems generate more costs than benefits.

3. *Government's capacity to regulate regulators* A CAPR regime depends for legitimacy on the capacity of government to exercise effective approval authority. The fact that regulated entities are choosing a regulatory regime and paying for it creates powerful incentives for private regulators to design systems that serve the interests of regulated entities and not the beneficiaries of regulation. Our competitive systems for arbitration, for example, display this in the areas of consumer and employment arbitration. Private prison systems are a troubling example of how weak and distorted government oversight of private regulators can be. These risks may be higher in some settings than others.

Rules for a Flat World

Why Humans Invented Law and How to Reinvent It for a Complex Global Economy

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Contents

PART IV: *Global Legal Innovation*

10

Markets for Rules

AS I WRITE THIS in 2016, we don't have self-driving cars picking us up to deliver us to meetings and dinner dates. There are still no drones dropping off our packages. Why not? Most people think that the big obstacle is building the technology. But in fact we have a lot of the core technology, and researchers can see where this is headed. The technology that's proving really challenging to develop is the technology that can navigate not just physical space but also regulatory space.

The problem, as we've seen, is not that rules are evil. Getting rid of the rules is not the solution. We need rules to manage the risks of these technologies and handle the inevitable disagreements we will have about who is responsible for the inevitable problems and complications that will crop up—the accidents that will occur at pedestrian crossings and highway on-ramps, the drones that will crash into other aircraft and onto front lawns. It's magical thinking to imagine that we don't need rules, some rules, for how this all gets sorted out. That's what we need legal infrastructure for.

The question is, how are we going to build this legal infrastructure? In the increasingly complex world we inhabit, the difficulty of building that legal infrastructure is as least as challenging as building the technology in the first place. We're still stuck, however, on the idea that regulation is something produced only by politicians, policymakers, and civil servants. Produced using only the technology of written words on paper and costly arguments about what those words mean. Implemented primarily through the threat of government-imposed sanctions for those who ignore the rules or violate them. All this in a system that is increasingly costly, complex, and failing to deliver on the most fundamental thing we need legal infrastructure to do: provide a stable and useful platform for making things and coordinating economic life.

But it's hard to take seriously the belief that we can continue to regulate phenomenally smart and agile technology and systems without legal tools that are just as smart and agile. Think ahead to the perhaps not-too-distant future in which there are millions of artificially intelligent creatures in our midst—not just AI cars, but robots caring for people in nursing homes, robots diagnosing and treating patients, robots flipping burgers, and robots building the parts and software for building robots. Robotics pays off when robots are able to process more information and use data better than humans to make judgment calls. So why is it that we think that human brains, working even in the best of circumstances (and not under the enormously heavy weight of politically charged deliberative, bureaucratic, and adversarial processes), will be able to stay one step ahead of the robots? The 2015 Volkswagen scandal involving smart cars that could detect when they were being tested by regulators for allowable emissions and rig the test results is testament to the misplaced confidence in traditional regulatory technology. Regulating AIs, almost surely, will require almost as much or more AI than the AI targets of regulation themselves.

We already have good evidence that our conventional approaches to producing regulation, exclusively through governments and public officials, are increasingly unable to cope with the levels of complexity and scale of some of our new technologies. The European data protection law creating the right to be forgotten, for example, requires online search engines such as Google to delete, when requested, links to personal data when those data are "inaccurate, inadequate, irrelevant, or excessive."[1] Judgments about when the law requires deletion involve weighing public and private interests in complex ways. Regulators have delegated those judgments in the first instance, however, to search engines. In 2016 Google was adjudicating over 500 such claims a day, relying on a team of Google lawyers, paralegals, and other employees. But this is a purely private process. Unless they appeal to a court, claimants don't get hearings to explain their case. Although Google provides outline reasons to the claimants for the decisions made, the public—including the publisher of the information that's being deleted—can't get access to records, as they can with public regulators, to see what's going on in practice. Individual claimants who are unhappy with the result can appeal to state regulators—that happens in less than 1 percent of cases. So why are European regulators, having granted expansive data-protection rights, not adjudicating more of these cases themselves instead of leaving the bulk of the task to search engines? According to a 2016 *New York Times* report, it's because public regulatory agencies lack "the financial, technical and human resources" to do the job.[2]

Are these our only two choices: relying on public agencies with limited financial, technical, and human resources to regulate complex systems or relying on companies to regulate themselves?

In this chapter I argue that there is a third option: rules and regulation supplied by competitive private regulators that are overseen as necessary by public regulators. This approach harnesses the benefits of private regulators but without turning to self-regulation. Instead of Google adjudicating its right-to-be-forgotten claims, companies and other private organizations specializing in providing this service would compete to adjudicate them. Google would be required to choose a regulator from among these competing providers. Google's private regulator, however, would have to meet targets and follow rules set by government. That's why this is not self-regulation: the regulator is a third party. It's just not a government third party; it's a government-accountable third party.

This approach shifts the role of government from primary regulator to superregulator—a regulator of regulators—and it tracks the shift from central planning to markets that we've already seen underlies the basic transformation in the global economy over the past several decades. This isn't an approach that's right for all types of regulation, but it is an approach that we can add to the options available to confront the challenges of complexity.

Getting to smarter regulation will require markets. Markets that can suss out information and alternatives using multiple lenses and perspectives. Markets that can underwrite the risk of innovation and rope in the investment needed to fund costly experiments with regulatory schemes, systems, and technology by dangling the prospect of profit and, for the philanthropically minded, social impact. Markets that are responsive to the feedback from both the targets and the beneficiaries of regulation about how well things are working. Without a greater role for markets in the production of legal infrastructure, we are fairly doomed to see the gap widen between what our complex economy is up to and where we want to be. That's not just a problem for the potential victims of technology and systems gone awry. It's a problem for everyone who wants to build the technology and systems of the future. Unless some of the money, energy, and intensity of focus that powers the Silicon Valleys of the world is also directed to building better legal infrastructure, the prospects for spectacular innovations like the self-driving car—not to mention transformative goals in energy, biotechnology, finance, logistics, communications, and more—recede further into the future.

Markets for Legal Rules: The Easy Case

Think back to the thought experiment we conducted in Chapter 4. You are an entrepreneur working to build a new web-based company. We saw there that, maybe surprisingly to you, you will need a lot of law to get your project off the ground and into profitable skies. Most basically you and your partners need some rules to govern the deal you have worked out between you about how you will share the costs of starting up your new business, decision-making authority about how the business is run, and how you will divvy up profit, in the hopeful scenario in which you make a profit. You will want those rules, and expect that everyone expects that everyone expects (etc.) that they will be enforced, so that each of you can make fairly reliable predictions about how each of you will behave in the venture. If you agree that you'll share profits equally, that the partner who came up with the original business idea does not have to put any money into the venture, that any business decisions will require a majority vote, and that none of you will participate in a competing venture, then you want comfort that this is how profits, decision-making, capital contributions, and competition will in fact play out in the future.

The way things work now, you and your partners can all expect that if any of you reneges on the deal, the others can, if they're so inclined, file a lawsuit and sue for breach of contract. And if the court agrees that there has been a breach of the contract, after applying the rules that determine whether your agreement is legally binding and whether it was breached, the court will order some kind of remedy. What the remedy will be will depend on other legal rules. The court might order the person who breached to pay damages or it might order the person who breached to do something—stop competing with the venture, for example.

The rules that will operate in this case, and the courts that can decide the case and provide a remedy, will be the rules and courts that other legal rules deem to be the relevant jurisdiction. If all the partners are in California, for example, and the business is in California, then the default is that the rules and courts will be the ones developed and run by the State of California. That's because there are fairly clear legal rules that say that the relevant jurisdiction is the one with the closest connection to the deal. If one of you tried to get the rules of, say, New York applied to the case, neither California nor New York courts would go along with that.

But those same rules also give you and your partners an option at the outset. If you don't like California's contract rules, then you can all agree up front that you want your deal governed by the rules that New York's legislature and

courts have developed. You can agree to go into California courts and ask the California court to apply New York law—which it will do if it agrees that you have a binding agreement to apply New York law. Or you can agree to go into New York courts and ask them to apply New York law, even if none of you otherwise has anything to do with New York. And here's the beauty of this scheme: even if you ask the New York court to decide your case using New York law, you can still go to California and ask those courts to enforce the judgment of the New York court. In fact, this is what you'll want to do if the partner you're suing has no contact with New York: he or she has no assets or wages there to seize. That means one government—California—is allowing its power to seize assets or wages to be used to enforce rules it didn't write and doesn't control. California doesn't get to weigh in on whether it thinks New York used the right rules or good rules. Under the US Constitution, each state's courts are obligated to give "full faith and credit" to the judgments reached by other states' courts.

The government of each state thus allows you to pick some other state's contract rules and courts to operate its enforcement machinery. In a sense, New York is competing with California for the business of providing legal rules governing contracts and operating California's enforcement machinery. New York might even make some money from this, in the form of filing fees if it attracts business. And lawyers in New York might make more money because their expertise in the set of rules chosen by the market is more valuable as demand for those rules goes up—which makes their professional monopoly over New York legal work more valuable. The benefits of winning the competition for the business of providing rules might explain why New York's legislature, for example, passed a law in 1984 authorizing people with big deals (over $250,000) to choose New York law to govern their contract even if their deal has no relationship to New York whatsoever—meaning the New York judgment is practically unenforceable by New York's own enforcement machinery. New York lawyers and courts, apparently, wanted the business.

So the next question is obvious: is there any reason private companies shouldn't be able to compete for the business as well?[3] Suppose I see a demand for simpler, less expensive contract law, a demand not being met by either New York or California. I set up a company—let's call it unimaginatively Simple Contracts Inc.—and charge people to use my rules. Because I know enough about how courts can take a simple set of rules and make them complex, I also provide adjudication services—using judges I train and procedures my company determines. And because I know that lawyers

trained in conventional contract law might behave in ways that make even my simple rules complex and expensive to use, I also train and provide lawyers who are experts in my system and who agree to charge for their services in a way that controls the cost. In fact, let's suppose I come up with a workable business model where all of these services—the production and maintenance of the set of rules, the provision of a judge and procedures, and the supply of legal assistance—are included in the package price or subscription fee paid by the people who choose my system to govern their contracts. (That's also a business model to help protect my investment in the intellectual property of developing the system, since my rules will be hard to keep secret.)

In order to be truly competitive with the states that are offering their contract rules and courts to venturers such as yourself, I'm going to need to be able to guarantee that the decisions my system makes in contracting disputes can be enforced with the full power of the state. If all the assets that could be used to make your partners pay up if they breach their agreement with you are in California, you're not going to use the law I'm offering to govern your agreement unless decisions in my system are as effective at reaching those assets as the ones coming out of New York or California state courts. So the question is: should my company, Simple Contracts, be recognized as a provider of contract law for your business venture, competing with New York and California for business, and authorized to operate the enforcement machinery of the California government?

A first possible worry here is that if Simple Contracts competes in a market for contract law, the rules might be bad for the people who choose them. I'll admit it. There might be lots that I get wrong in my design and management of Simple Contracts. The rules I choose might be too simple—missing too many of the nuanced details of what the contracting parties really expected would happen. Or I might advertise my rules as simpler and cheaper to use, but they might turn out to be much more complex and expensive than I promised. Maybe my judges will develop a bias in favor of the wealthier party, or the little guy. So you and your partners may find that when it comes to a dispute about managerial authority or profit-sharing or what counts as "competing" with the business, the result under the Simple Contracts system isn't what you wanted. (Of course, it is in the nature of disputes ruled on by a third party that the final result in any system will not be what at least one person wanted—but the question is, was the result what all of you would have said you wanted at the outset and did you think the process by which even a result you don't like was reached was fair and unbiased?) And maybe I'll

be too successful and gain too much market share and manage to extract an outrageous fee for my company's services from you.

Of course, that makes the legal rules and services you buy from Simple Contracts no different from what you buy from anyone else in a market economy. The food may be bad, the car of faulty design, the accountant dishonest or wrong, the internet service overpriced. What protects you in those markets is competition and regulation.

If a market is competitive, companies are working hard to capture business by delivering products that are in fact a better match with the features and quality people want, at a better price. If a market is competitive, then a business that sells goods of a lower quality than promised or that charges too high a price gets a bad reputation and loses customers. The internet, in fact, has made this basic protective mechanism a much more protective one—by amplifying the capacity for people who have had good and bad experiences with a product to broadcast that to just about anyone. That's the power of Yelp, Amazon reviews, rankings, ratings, and hashtags. The capacity of customers to protect themselves by choosing a different provider is a major source of protection against bad deals. (It's a mode of protection that people living in centrally planned economies with low-quality goods would dearly love to have.) That's a primary way in which you and your partners will be able to protect yourselves against buying a bad product from Simple Contracts.

Markets can only protect against bad deals, however, if they are in fact reasonably competitive. We want the driving force of markets but, like a wild horse, without a harness that force doesn't necessarily take us where we want to go. And that's where a good legal framework—the superrules—comes in. A competitive market is one where you know what you're buying and you get what you thought you were buying when you decided to plop down your money. So we have basic laws that combat fraud and misleading advertising and require companies to pay compensation if they sell faulty products or products different from what was promised. Those laws will apply to Simple Contracts too. A competitive market is one in which there are enough buyers and sellers to ensure that good information flows and that when signals of bad outcomes emerge—such as poor quality, inadequate features, or excessive prices—a competing seller can jump on the opportunity to provide a better product at a better price. Getting to this result requires a slew of laws—antitrust laws that control the creation and behavior of monopolies, financial regulation that ensures access to capital for start-ups, maybe even internet rules that ensure small businesses have as much access to critical communications

infrastructure as established ones. Those laws will apply to Simple Contracts' market as well—making sure that if I supply a poor product, competitors with better rules and better ways of delivering them will be there ready to steal my customers away. It's possible that special features of the kind of legal product I'm offering will require special rules to ensure competition can work reasonably well. Maybe providing a legal system requires durability over a long period of time, much like providing, say, insurance does. So maybe Simple Contracts will be subject to special rules, like insurance companies are. These rules allow regulators to make sure that the company will have the resources it needs in a distant future to live up to its promises, a reasonable plan for transferring obligations to another provider in the event it goes belly-up, or a mechanism that minimizes the likelihood that the company simply won't be around to deliver when needed—such as requiring contracts to expire after a short time.

The point is that if what we're worried about is making sure that you and your partners are getting a decent product from a competitive legal rules provider like Simple Contracts, that challenge is really no different from the one we face in making sure that you get a decent product from all the other businesses that compete to provide you with what you need to run a profitable business of your own. And remember: the alternative to what Simple Contracts offers is not perfect affordable law. It's what you can get from entities that rely on planning, political mechanisms, and state-to-state competition—state legislatures and courts—to protect your interest in good legal rules. If New York and California are today competing for your business, what is your protection against bad quality and high cost? If you choose California law and courts, and you are a California voter, you might be able to get the politicians and judges (who, in this state, run for election) to respond better to your needs. But that's a blunt instrument at best. And if you choose New York law, you have no recourse as a voter at all if you live in California. You may be able to lobby legislators or contribute money to their campaigns. But by and large your main source of protection against bad law out of New York or California is the same as it would be if Simple Contracts were on the scene: if you don't like it, don't choose it. Indeed, you have more recourse against Simple Contracts if it doesn't live up to its promises than you do against New York and California. You can't sue New York or California if they fail to fund their courts adequately and it takes a year to get a court date or if the simple procedural rules on the books get so bollixed up in practice that it costs you millions in e-discovery costs to litigate your case. You can sue Simple Contracts if it promises something different and it doesn't deliver.

The case for competitively provided commercial contract law is probably the easiest case for market-based legal rules that we can identify. For one thing, you and your business partners are probably not the type of people we worry about not being able to protect themselves in ordinary market settings—people with poor education or who are marginalized or vulnerable. And for another, we're not talking life and death here. No one's going to jail if the rules are badly written or wrongly enforced; people are not at risk of being degraded or abused. The interests are pretty much limited to money and job satisfaction: are you going to make as much money and get as much personal fulfillment out of this venture as you would have if the rules were done right? The cost of bad law here is in the same category as what you're risking when you buy a house, invest in a retirement fund, agree to work for a new employer, or choose a college. These are risks that we all routinely manage through markets operated within a good legal framework.

What about risks to people other than you and your contracting partners? Here's another reason that the commercial contracting case is an easy one. Even if the business venture you are putting together with your partners might pose a risk that it will harm people—generating pollution, producing defective products, failing to protect customer data, treating employees in discriminatory ways—the rules governing your deal with your partners have no impact on those risks. No contract rules do. Your business has to comply with the regulations governing pollution, defective products, data privacy, and employment discrimination—the rules protecting other people's interests—regardless of how you decide among yourselves to share profits, decision-making authority, and capital contributions. So this is an easy case because the only people affected by the choice to use Simple Contracts' rules are the people making the choice. In economist lingo, there are no direct externalities from your choice of a system of commercial contract law.

There could, however, be indirect externalities. It's possible for a state to have an opinion—that is to say, policy—about how even the private arrangements you reach with your partners are structured. The state may have an interest in protecting your interests—such as by requiring that any deal you reach must be in writing to make sure you really know what you're getting into or that you can cancel without penalty within a few days if you have a change of heart. Or the state may have an interest in how the ecosystem of business deals works. California, for example, unlike many other states, has a strong public policy that refuses to enforce private agreements, known as noncompete agreements, that prevent an employee or entrepreneur from going to work for a competitor once the job or partnership is

over. There are lots of reasons for the California legislature to have decided to put this policy in place: people may do a poor job of protecting their own interest in continuing to work in their field when they change jobs. Noncompete agreements might limit the quality of the pool of workers available to other businesses. And they may restrict the free-flowing mobility of the labor force, mobility that can promote innovation and faster, smarter adaptations to market changes. Some believe, for example, that California's policy on noncompetes is part of the explanation for the success of Silicon Valley: engineers and entrepreneurs have been free to move around from company to company, start-up to start-up, and this has created a vibrant community for innovation, as engineers and entrepreneurs cross-fertilize expertise and experience from place to place. California believes that legitimate trade secrets can be adequately protected through legal means other than preventing employees and entrepreneurs from switching employers or partners.

Now, California may be wrong about this. But that's what the political system is for: to make those kinds of policy decisions. Suppose you and your partners are all located in California, you opt for Simple Contracts, and my legal system treats your noncompete agreement as fully enforceable. Then your choice of my system could undermine the power of the California legislature to implement the policy chosen by the elected officials of the state.

This is a legitimate concern. It's also one that is already addressed in the legal framework for our existing system of state-to-state competition in contract law. Right now, people can choose the contract law of any state to govern their contracts, even a state they have no other relationship with. If you and your partners choose New York law and New York courts, you may be able to run a business in California that doesn't follow the California rule against noncompetes—because New York thinks enforceable noncompetes are dandy. If enough California businesses did this, it would make it hard for California to achieve its policy goals. That's why the legal framework governing choice of law already puts a limit on choice: courts deciding whether to honor a choice of law take into account whether doing so would compromise important policies in the state that, but for the choice, would have its rules in play.

Introducing Simple Contracts into this framework does change the shape of this problem. The way things work now, if you and your partners choose New York law and you go to New York courts to enforce your not-valid-in-California noncompete, it will be up to the New York court to decide which law to apply. You will be arguing New York law

applies—respect the choice-of-law clause!—and the partner who is trying to work for a competitor will be arguing California law applies—respect California policy! As you might imagine, New York courts might be a little biased toward their own law. But even so, New York judges will by and large work hard to live up to their professional obligation to respect the law of other states—their peers in the constitutional system—and to decide in a good faith way how much weight to put on California's interest in achieving its policy goals.

The tone of this solution changes if we just substitute my for-profit corporation and my judges for New York's publicly accountable courts. It may work in a constitutional system to leave protection of California's policies somewhat in the hands of New York courts. To some extent, that's part of what giving full faith and credit to the courts of other states in a constitutional democracy means. But California's citizens can't have the importance of their policies judged by a private corporation like mine. I'm in the business of producing a good product and making money, not upholding constitutional relations. California doesn't owe me and my business full faith and credit. Simple Contracts may develop great market legitimacy, but it will never have political legitimacy. And that seems important here.

The solution? Leave the decision about the extent to which California parties can depart from California contract law when they choose a private provider of contract rules up to California. This could happen in the same way it can happen now: the party trying to get the California rules applied can go into a California court and ask for a court order prohibiting the parties from proceeding in the system the parties chose by contract—whether New York or Simple Contracts. Sometimes these cases end up with dueling efforts to get one state's courts to order that the parties stay out of the other state's courts. Of course, that could eat up all the benefits of my system—if people using my system still have to deal with a really slow and expensive public courts regime to resolve their contracting disputes. But if I'm really smart in running Simple Contracts I'll figure out a better solution than this. I could make arrangements with the California courts to get quick rulings on which law applies—and pay the courts for that fast-track service. I could lobby the California legislature or put an initiative on the ballot for clear guidelines on when my system's rules will be allowed to rule and when they won't in cases like this. I could modify my rules so that these cases don't arise much—by conforming my rules to California policy, for example, or by offering killer mediation services that get these issues reliably settled without anyone getting the California courts involved. And

better entrepreneurs than me, no doubt, could come up with even better solutions.

The point is: this is a problem with a solution. This is the kind of solution we need to develop all the time—creating the right legal framework to ensure that markets work to produce the kinds of outcomes we want.

There's one last objection that seems pretty powerful, but isn't. On first take, it sounds rather shocking to think that private parties could order government enforcement agencies around—telling courts when they have to use their public authority to order the sheriff to seize assets or to order a former employee to stop working for a competitor, for example. But in fact this is how our entire civil (that is, not criminal) justice system works. It sits there sleepily, not doing anything, unless and until some private party gins it up by starting a lawsuit. This is true in just about every civil legal system in the world. Courts don't act in noncriminal matters unless private individuals or organizations ask them to act. (For purposes of civil litigation, governments are like any other private party with a right to sue or be sued.) In systems like we have in the United States, England, Canada, and the rest of what's known as the Anglo-American legal world, the role of private parties in operating the levers of the government's enforcement machinery goes even further. The parties to a lawsuit determine what issues will be decided, what evidence will be presented, and what remedies sought. They do this by playing a type of tennis: one side serves up the issues it believes should be decided by the court; the other side returns the serve and either agrees those are the issues or proposes to throw some out or add some on. The court then decides who wins the point, based on the rules, and proceeds to structure the litigation to decide the winning issues. The same volley is exchanged on what evidence to hear and what remedies to consider. The court does very little on its own say-so. In some systems around the world—in what are confusingly known as civil law systems or, misleadingly, inquisitorial systems such as those in Germany or France—judges play a more active role; they can decide for themselves what issues they think should be explored or what evidence collected. But even so, the whole process doesn't get underway unless a private party calls "Game on."

The extent to which private parties are empowered to call the plays for a government enforcement authority is pretty much at its maximum in our easy case of private contracting between business partners. The defining feature of contract law in advanced market economies is that the parties are free to put into their contract just about anything they want. They decide, by agreement, what legal obligations will be created for each of them. Because they are in a

world where courts enforce (most of) those obligations, they are effectively telling the government enforcers what to do: make him pay damages if he doesn't deliver the goods on time; make her cough up the money she promised to contribute to our venture. Failing to live up to those privately crafted legal obligations is a wrong against the contracting party. Before the contract is written, the state doesn't care when goods are delivered or who contributes money to your venture. It just puts its enforcement powers at the disposal of private parties: if private parties care about these things and they put them in a valid contract, the state will show up, adjudicate, and enforce.

Even this connection to the state's power to enforce against assets is shrinking, at least for private contracting. This is the potential of blockchain technology, which underlies the development of digital currencies like Bitcoin. Blockchain technology operates like a huge publicly accessible peer-to-peer web-based spreadsheet or ledger, a massive list of who owns what. The things on the list are assets only identified by a string of characters; the owners are identified only by a private ID, also a string of characters. The ability to change the name attached to an asset is controlled by the owner through the use of a private encryption key, another string of characters. Bitcoin works by enabling someone who owns coins—has her private ID associated with entries on the ledger—to transfer those coins to someone else's private ID. That's just the way money works: inherently worthless pieces of paper change hands, and because everyone is willing to agree that paper with a particular set of marks on it is worth a fixed amount ($10 for a ten-dollar bill), we can use those pieces of paper to exchange value: work for wages, for example. Bitcoin works so long as people are willing to accept uniquely owned strings of characters in exchange for things of value like goods and services.

Using blockchain technology for contracts involves layering a contract enforcement mechanism on top of this basic system of asset ownership. And that's where Simple Contracts gets interesting. California's public legal system is now offering two separate services: adjudication of contract claims together with the capacity to send out a sheriff to make people hand over stuff like physical assets, bank accounts, and wages. We've been looking so far at how Simple Contracts might compete with California for adjudication services, relying on California for enforcement of Simple Contracts' decisions about who owes what to whom when the assets that can be used to pay up are located in California. But with blockchain technology, Simple Contracts could potentially enforce its own decisions, without the need to ask California to go in and seize assets located in California. To do this Simple Contracts

would just need to get the parties who want to use its contracting system to store enough assets to keep everyone feeling secure in blockchain—entries on the great spreadsheet in the cloud—and then give Simple Contracts the ability to switch assets from one party's ID to another if needed to satisfy a ruling in a contract dispute. California sheriffs might still need to get involved—to evict someone from a home that is no longer listed with his or her private ID in the blockchain or to arrest a bank officer who draws on an account to pay the bills of someone who no longer owns the account—but now we've shifted from the role of the state in contract enforcement to the role of the state in enforcing basic property rights. The buck stops there, but there are a lot of bucks on the way down.

Markets for Legal Rules: The Harder Cases

The easy case of commercial contracting can help us think through the harder cases of how to build markets for legal rules by pointing to the dimensions we need to pay attention to. A key part of the easy case, for example, is the extent to which the people affected by the rules can protect themselves by opting out if rules are inadequate, too costly, or unfair—that is, the nature and extent of externalities. As we've seen, we need to think both about direct externalities on third parties and indirect externalities on policy and systemic goals that are, quite properly, under the control of politically accountable people and institutions. The other dimension we need to consider is the potential for creating a regulatory framework that ensures that markets for the production of legal rules and procedures are reasonably competitive and that market outcomes do a reasonable job, relative to law produced through legislatures and public courts, at achieving our social goals. Let's think through some examples.

Business Organizations

Could private companies offer corporate law on a market? This is the law that allows you and your partners to create a distinct legal entity that can sue and be sued, own assets, settle debts, and be regulated in its own name. The rules of corporate law determine what it takes to bring this legal entity into existence and govern the relationships among different participants in the organization. Corporate law rules determine how the corporation is to be managed, what role shareholders have, what duties corporate officers owe to the corporation and its shareholders, and so on. These rules also govern the

relationships between shareholders, protecting minority shareholders from being taken advantage of by majority shareholders, for example.

As with commercial contracting, people setting up corporations already are allowed in many cases to choose between state providers of corporate law. In the United States, companies can decide to incorporate under the law of any state they like, regardless of where they are doing business. Most choose either their home state or Delaware, a small state that has captured a large market share. A corporation established under Delaware law enjoys status as a distinct legal entity in the courts of any state: it can sue and be sued in those courts, it is entitled to limited liability, its ownership of assets that are not available to the personal creditors of its owners is respected, and it is taxed and regulated as a corporation and not as a bunch of individuals. Most countries now also recognize a corporation formed under the laws of another country as a distinct entity, allowing them to sue or be sued in their courts.

Many of the rules of corporate law are ones that the people affected can avoid if they don't like them. The original owner-founders make the initial choice of which corporate law to use. People who come to the corporation after it is formed—new shareholders, directors, officers—can stay away if they don't like the legal rules the founders chose to govern protections for minority shareholders, establish the duties of directors and officers, or determine how and when shareholders can act.

But once an entity is formed, decisions about how the corporation is operated, including what rules it is operated under, can be made without agreement from everyone who is affected. Majority shareholders can, for example, vote to merge the corporation into a new corporation that leaves out some of the original participants, in what is known as a squeezeout. (A squeezeout is what happened to one of the founders of Facebook, the story told in the movie *The Social Network*, which pulled off the fairly amazing feat of making a corporate lawsuit that doesn't involve murder or toxic chemicals compelling.) People who are owed money by the corporation can be harmed if the corporation chooses a body of corporate law that lets the corporation pay out dividends to its shareholders that leave it without enough assets to pay its debts. Personal creditors might be harmed if a borrower can easily form a corporation and put his or her assets in the corporation to keep them out of creditors' hands. Employees, even entire communities, can be affected by decisions to sell or merge the corporation. People at risk of being harmed by the rules under which the corporation operates can take some steps to protect themselves—requiring collateral for debts, for example, or refusing to buy from or work for a corporation that can too easily be stripped of the assets it

needs to pay its bills. But this market mechanism will not do everything that every state would want it to. Many consumers, employees, and investors will have little knowledge of the minutiae of corporate governance and how they might affect their interests. And there will be people affected by the actions of the corporate entity that have no choice they can make to protect themselves—motorists or pedestrians injured by an automobile that loses control due to defective steering, for example.

The question is whether a market for private corporate law systems can be placed within a regulatory framework that allows states to continue to exercise control over policy. The answer is that in many cases, it can. States with the power to regulate and control access to their public courts can retain the power to set the rules governing what can, and what cannot, be chosen through a choice of corporate law. If there are concerns about adequate capitalization to protect consumers or creditors, for example, states can require adequate capitalization—essentially moving rules about capitalization out of the body of corporate law and into a body of public regulation. This is, for example, what happened over the course of the twentieth century with respect to some aspects of corporate disclosures to shareholders. Originally only corporate law and the private stock exchanges on which companies wanted to list their stock imposed disclosure rules. After the stock market crash that triggered the Great Depression of the 1930s, however, securities statutes passed by legislatures imposed new disclosure obligations to protect investors and support efficient and liquid capital markets at a national level.

What would be the benefit of introducing private rule providers into the market for corporate law? The benefit would be market incentives to develop systems that work better for shareholders, directors, and officers—within whatever regulatory framework the state decides it needs to put in place to protect the interests of those who don't participate in that market directly. That may mean simpler rules and procedures. It may mean new mechanisms of disclosure, ones that take advantage of the potential to bundle legal rules with other mechanisms such as data-sharing systems that don't rely on reams of small print that few can parse. (Corporations may not want to give the state authority to directly access corporate information, but they may be willing to participate in private systems, including blockchain systems, for voluntary data-sharing with investors. We see this phenomenon today in the different reactions people have to knowing that Google's computers are combing through emails and search engine results and knowing that government security agencies are doing the same thing.) And it may mean the development of business entities that are better tailored to different circumstances, rather

than one-size-fits-all. My coauthor Eric Talley of Columbia University and I have shown as a matter of economic theory why we should expect competition between private profit-motivated corporate law providers to do a better job than competition between state legislatures to produce a range of options suited to different kinds of companies.[4] The reason is that profit-oriented companies will keep innovating until they have reached the point where the marginal benefit of a new system is equal to the marginal cost. State legislatures are just not likely to keep at the innovation in the same way: all they want to do is a good-enough job to stay in office. There's no big insight here: it's just the basic fact that competitive markets, regulated properly, can harness information and ingenuity in ways that politically based centrally planned systems—even when they are competing with other planned systems—cannot.

Employment and Consumer Law

We only want to put our faith in market mechanisms when they are in fact competitive, when the people affected by the rules have a meaningful capacity to opt in to good law and opt out of bad law. Meaningful choice requires that people have a good understanding about what they are choosing and that there are fairly good alternatives to choose from. One of the reasons the commercial contracting case is fairly easy is that we imagined a scenario in which the people doing the choosing—you and your partners—are likely to be relatively sophisticated, to have only business interests at stake, and to probably face a lot of other reasonable options: other potential partners and investors, and a decent job if the prospects for the business don't pan out.

But these conditions are less likely to be met when the contracting takes place between a large organization and an individual with little market clout acting alone. These are the conditions under which many employment and consumer contracts are struck. In fact, in those settings we tend to see organizations that offer employees and consumers a standard-form contract on a take-it-or-leave-it basis. You know these types of contracts: we met them already in the form of "Click Here" online agreements that everybody clicks and nobody reads. They are also the way in which a whole slew of the contracts that we enter into every day are structured. We take a job and sign on to the rules in the organization's standard employee handbook. We rent a car and sign a dense agreement that determines the terms of the rental. We lease an apartment and initial page after page of small print.

The failure of the assumptions of competition here are twofold. First, we doubt that many people "agreeing" to these contracts really know what they

are agreeing to. It's just too complicated, particularly for ordinary individuals without legal advice. A recent study found that fewer than nine percent of people shown a standard agreement to arbitrate in a cellphone contract—with the arbitration language in bold, italics, and capital letters—knew that the provision was an "arbitration" agreement and that if they signed it they would have no right to take a dispute with the credit-card company to court.[5] I find confusion between mediation and arbitration is widespread but the difference is fundamental: mediation can't result in any outcome you disagree with; arbitration means you've given up your right to disagree with the result.

Second, in most cases where people are being asked to agree to standard consumer or employment contracts there just aren't good alternatives to saying yes. Apple is not going to negotiate the terms of the contract with you. If you want one of Apple's products, then you have to agree to its terms. These are called contracts of adhesion: because you're stuck with them. Of course, you do have a choice. You can choose not to take the job, rent the apartment or car, buy the iPhone. But, in most cases, that's a big, lumpy choice—the differences between this job, this apartment, this phone, and the alternatives are significant to you. It's not the kind of close substitute that the economist's perfect world of perfect markets assumes. Moreover, even if there are reasonably close substitutes—not much difference to you whether you rent a car from Hertz or Avis, for example—because almost nobody reads or understands the standard terms anyway, neither Hertz nor Avis is likely to bother competing by offering the same car with a better contract. So you don't see an option in the market to get essentially the same product or service but with different contract terms.

Our legal infrastructure appears to be of two minds about contracts like these. On the one hand, we have some regulation that wraps around these contracts, much more so than in the commercial contract setting, limiting the extent to which the terms written by the large organization end up being the law of the relationship. Consumer law often gives people a few days to change their mind about a deal and in some cases prevents a company from getting consumers to agree that they will never sue the company or that the company is not obliged to follow laws requiring products to be safe, for example. Employment law and industrial regulation can limit the power of the employer to require employees to agree to work in unhealthy or harassing environments or to allow the employer to use discriminatory criteria when giving out raises and promotions.

But although we have some, we don't have very much regulation that wraps around these contracts. By and large, they are enforced as the organization writes them and the hapless employee or consumer clicks, initials,

or otherwise accepts them. What that means is that we have a large swath of relationships in modern economies where the law of the relationship is chosen by a large organization and imposed on everyone who deals with the organization as an employee or consumer, with little oversight or interference from governments. Clearly this situation would only be made worse if the organization were free to select a private provider to supply the rules governing these contracts as well—as opposed to being required to at least subject them to the rules established by politically accountable legislatures, regulators, and courts. That market would not work well at all: the private provider would only be interested in selling a product that appealed to the only entity making the choice—the large organization. So the only legal rules we'd expect to emerge in this market would be those that favored the organization at the expense of consumers and employees.

This seems like a setting where we want *less* privately provided rules and not more. And yet: what we also see is that this is a setting that our state-based regulatory systems have not managed to address very effectively. Consumer protection law is often cumbersome and expensive. Lengthy warnings don't help consumers who are poorly equipped and situated to read and understand what they're getting and often don't have much of a choice in the first place. California can pass a law saying that online companies cannot offer a subscription service that automatically renews and charges a credit card on file unless this is prominently disclosed and the consumer has to affirmatively consent at renewal, but how many of us read and understand the disclosure? How many of us could litigate to get back the $40 or $140 dollars involved if the law were violated? And for companies trying to comply with consumer protection law, the sheer volume and fragmented nature of the rules and the frequency with which they are poorly designed to achieve their objectives at reasonable cost makes the prospect that the law will be effective slim indeed. Law on the books does not necessarily mean law on the ground.

Is it possible to take advantage of markets to find better ways to regulate? We turn to that question next.

Superregulation: Creating Accountable Competitive Markets for Regulation

The problem of overly complex, expensive, and poorly crafted state-based legal rules, of course, is precisely where we started. And while it would be a great move forward to introduce more markets into the production of commercial contracting and corporate organization rules, the real Holy Grail is

regulation. This is the law that is growing in leaps and bounds in terms of complexity. It's the law that is holding up things like self-driving cars and slowing down progress on goals like climate change and global financial stability.

We can have a larger role for competitively produced regulatory regimes. Not all regulation can be produced like this. And markets for private regulation would require substantial public oversight—superregulation—directed toward making sure that the markets for regulatory rules are both competitive in fact and overseen in such a way that they produce the results that the politically accountable state sets out for them. But there are settings in which developing the kind of superregulatory infrastructure needed to make reasonably competitive markets for regulatory regimes could reap the benefits of markets over planning: the capacity for greater innovation, lower costs, higher quality, and better responsiveness to multiple conflicting interests.

Here's how this might work. Think about the problem of workplace health and safety. This is something that, as we've seen, states have been regulating with detailed rules since at least the nineteenth century and the dawn of large-scale factories. We regulate workplaces because we expect that worker choice about whom to work for—competition between employers for workers—won't, by itself, be adequately protective of workers. Workers may lack reasonable alternatives if jobs are hard to come by, for example, and they have to take whatever they can. They may lack reasonable information about the risks of a particular workplace—the risks of exposure to chemicals or carcinogens, for example—because it's hard to assess the risks from the outside, or because the risks are many and complex, or because the risks are ones that don't make themselves known until long in the future. And some people may worry that even with information about risks, some workers will make poor choices, exposing themselves to risks that a reasonable person would avoid. People with these motives for regulation prefer not to live in a world where people are left to make bad choices and suffer the consequences. People of different political persuasions will come down differently in terms of when and how much regulation is called for to address these different concerns. Differences will also exist in terms of beliefs about how much we as a society should be willing to pay to protect workers from risks. Democratic politics sorts through these differences and produces a set of goals for workplace safety and its costs.

There are three basic ways that our current systems create laws to achieve those democratically set goals. The first, and oldest, is for governments to write explicit rules about how a workplace is to be organized and run. These

types of regulations delve into the minute details: what size mesh must be used to enclose the cage on a personnel hoist; what size and type of rock bolts must be used to secure a mining tunnel; what mathematical formula is to be used to calculate permissible noise exposure in construction jobs. This is the way the vast majority of regulation is still done.

A second approach to regulation, called performance- or principles-based regulation, avoids setting detailed rules about how a workplace is to be built and operated. Instead, regulatory agencies write down performance criteria or principles that businesses are obligated by law to meet. Performance criteria in the workplace, for example, might establish acceptable levels for workplace injuries or factory air quality. More abstract principles might establish the objective of achieving reasonable risk reduction that balances the costs and benefits of preventive measures. Regulated businesses then have to figure out how to design and operate their workplace—what kind of safety equipment or ventilation to implement, for example—to make sure they meet these performance measures.

A third approach, called management-based regulation, creates legal rules requiring businesses to engage in a process for identifying the risks in their workplace—the risks of chemical exposure for workers, for example—and then to design and implement a plan for how to manage those risks.

In each of these approaches either civil servants or company managers are responsible for designing the details of how to achieve workplace health and safety. Their decisions determine the cost, complexity, and efficacy of regulation.

Here's how a market-based fourth alternative could be added to this mix. Instead of civil servants or the managers of a regulated company designing the details of how to achieve politically set goals for workplace health and safety, private for-profit and nonprofit companies could offer this as a service in the market, for a fee. In order to participate in this market, these companies would have to be approved as private regulators by the government. Approval would be based on meeting the policy objectives established by the government for regulation—developing a system that ensures that regulated businesses meet targets for maximum injury rates or exposure to harmful chemicals, for example. Regulated businesses would be required to choose a regulator from among the approved private regulators. The private regulators would regulate businesses, and the government would regulate the private regulators. Government would establish the regulatory objectives and targets for the scheme, set some rules for how private regulators operate, conduct reviews of the regulators' systems and audits of the the regulator's

performance: the extent to which the regulator's rules are followed by regulated companies and the regulator's system achieves government objectives and targets.

This is what some call metaregulation and what I'm calling *superregulation*.[6] It shifts the boundary between central planning and the market up a level.

The model of competing private regulators is not entirely unheard of in the modern world. As I noted in Chapter 9, since changes made in 2007 lawyers in England and Wales have been regulated in an explicitly superregulatory system. A Legal Services Board appointed by the government has authority to approve regulators of legal services. As of 2015, there were nine approved regulators, all of which were private nonprofit organizations. With the exception of notaries, none of the approved regulators oversees professionals with a monopoly. (This is a change from the historical practice under which only barristers, for example, could appear in higher courts and only solicitors could submit the paperwork required to conduct litigation.) In order to provide certain legal services, such as appearing in court or signing legal papers, a legal professional in England and Wales is required to choose from among the set of approved private regulators.

Approval as a private regulator is contingent on demonstrating to the Legal Services Board that the private regulator oversees a regulatory regime that meets the objectives of the governing law, the Legal Services Act. These objectives are set out in the form of principles, such as protecting the rule of law and the interests of consumers, promoting competition in the provision of legal services, and ensuring competence, duties toward courts, and confidentiality. The Board monitors the performance of the private regulators as well as the legal system as a whole, tracking the impact of regulation on prices and quality, for example. The Board also is authorized to create rules that the approved regulators must follow—such as rules setting the maximum penalties they can impose and requiring that they, like the Legal Services Board itself, must have a majority of members and a chairperson who are not members of the profession regulated by that regulator—solicitors must be in the minority and cannot chair the Solicitors Regulatory Authority, for example.

The English model of competitive private regulation for legal services, however, is a relative rarity. There are many examples of settings in which governments delegate regulatory authority to private organizations. As I noted earlier, reliance on voluntary compliance and self-regulation is widespread, often because the technological challenges make any other solution seem impossible. Governments also often incorporate standards set by

private standard-setting organizations into their regulations. For example, the US Occupational Safety and Health Administration (OSHA) has a regulation requiring that tractors used in agriculture have seatbelts that meet the standards set by the Society of Automotive Engineers, a private membership organization. Governments also routinely authorize some nonprofit organizations to regulate their members in a more arm's-length form of self-governance. The Financial Industry Regulatory Authority—FINRA—is a nonprofit corporation authorized by Congress to license and regulate broker-dealers who buy and sell securities on behalf of investors.

But all of these solutions have critical weaknesses. Self-regulation's primary weakness is that it is *self*-regulation, not third-party regulation. That puts a conflict of interest at the heart of the regulatory approach, even while it recruits the superior ability of the private entity to navigate complex technologies and systems. And third-party standard-setting or industry self-governance systems are not competitive systems. Governments generally select only one organization, often a nonprofit membership organization composed of those with industry expertise, to supply standards or industry rules and licensing. With a monopoly and as membership organizations, private standard-setting and self-enforcement organizations tend to operate on the central planning model, with studies and committees and votes on what standards to adopt.

The superregulatory alternative I'm suggesting differs from the existing use of private regulators because private regulators under superregulation would operate in a market in the sense that they would compete to provide regulated businesses with a system for achieving regulatory goals. To succeed in this competition, a private regulator would have to offer a system that *simultaneously* meets government criteria for approval *and* is attractive, relative to the market alternatives, to regulated businesses. Private standard-setting organizations and self-governing bodies with a monopoly role in regulation aren't subject to that market discipline. They can bring more expertise to bear on a problem than government can—because they are comprised of professionals such as engineers or members of the securities industry. But expertise alone is not enough to get us to lower-cost, less complex, and more effective systems in a complex world.

We can also find current examples of competition between approved regulators but the competition is thus far limited to government regulators. These are cases of Government A selectively approving the regulatory regimes of Governments B, C, and D and allowing those subject to regulation by Government A to choose the regulatory regime of one of those other

governments. We see this within federalist systems such as the United States, where, as I mentioned earlier in this chapter, each state allows companies in its borders to choose to be governed by the corporate law of any other state. We also see some examples of this in the international setting. Many countries recognize the system for issuing drivers' licenses in other countries: you don't need to pass a French driving test to drive a rental car on vacation in the south of France. More elaborate systems for what is sometimes called mutual recognition are beginning to emerge. Just before the global financial crisis upset the apple cart in 2008, the securities regulators in the United States and Australia had agreed to recognize each other's regulatory regimes for stock exchanges, brokers, and dealers, meaning that these financial services providers only had to worry about complying with one set of rules even if they operated in both countries. The plan was put on hold in the aftermath of the crisis, but the idea is back on the table—laying the groundwork for potential competition between states for more effective ways of delivering regulations that states recognize as achieving comparable results to their own.[7] Still these countries are not yet talking about allowing nonstate providers to enter the competition.

The key to a market-based approach to regulation is to create the potential for innovation and incentives to invest in smarter, more effective, and less expensive systems for meeting regulatory objectives. Private regulators that secure a larger market share and higher profits (or better returns on nonprofit goals—the motive animating many nonprofit organizations such as private universities and hospitals) by offering a better regulatory service have powerful incentives to figure out how to achieve regulatory objectives more effectively at lower costs.

Some private regulators might design systems that follow one of the three existing approaches we see in government regulation—explicit technology and process rules, performance criteria, and management-based oversight. But in the competition for market share, we can also expect private regulators to invest in developing alternative methods as well. Some regulators might specialize in particular industries or even particular regulatory objectives (such as limiting chemical exposure, ensuring data security, or achieving greater safety in self-driving cars). Others might implement experimental protocols to identify risks and lower-cost means of managing them. Systems could emerge that integrate employee selection, compensation, and promotion with health and safety performance. Almost certainly we could expect to see regulatory approaches that are rooted in data systems and blockchain technology, and integrated across multiple locations, participants, and facets

of the business—there are likely to be economies of scope in achieving compliance not only with regulatory requirements but also with corporate strategy and contracts. Private regulators would not focus exclusively, or even, perhaps, very much at all, on writing complex rules and then hunting down and adjudicating violations—which is the only technology available to government (whether it writes the rules or requires the regulated business to write its own). Private regulators can employ the full range of alternatives for coaxing outcomes closer to the targets set by policy.

The greatest promise of market-induced innovation in regulatory design is much-improved understanding of the relationship between the complexity of a regulatory setting and the complexity of regulation. Our current regulatory technology, largely limited to writing rules and enforcing compliance with them, increasingly operates on the basis of the idea that the more complex the regulatory problem, the more complex regulation has to be. This is the justification we hear for thousand-page statutes and volumes upon volumes of regulations. But there is good reason to think that this reasoning is faulty in important ways. For one thing, as the complexity of regulation increases, there comes a point at which compliance must begin to fall off, simply because of the high cost of figuring out what you're supposed to do. There's also the increased likelihood that specific instructions in one place conflict with those in another.

The designers of checklists understand this. If the checklists that airline pilots or surgeons are supposed to work through before they respond to an emergency or start surgery are too long and complicated or if they are filled with ambiguous terms, they become less effective because they are less likely to be implemented correctly or at all. Moreover, sometimes the best way to intervene in a complex setting is with simplicity. Some management strategies recognize this: a simple but powerful principle—support the decisions of your flight attendants (Southwest) or eschew periodic sales in favor of everyday low pricing (Walmart)—can outperform efforts to control and fine-tune responses to a complex environment. As management experts Donald Sull of the London Business School and Kathleen Eisenhardt of Stanford's School of Engineering show in their work on simple rules for a complex world, picking a small (but very carefully chosen) set of objectives can lead to better overall results than trying to manage every detail.[8]

The hope that regulated businesses can figure out better ways to achieve regulatory objectives is of course the idea behind two of the three standard regulatory approaches we already see in governments now: performance- or principles-based regulation and management-based regulation. And clearly

regulated businesses have an incentive to find better, less-costly ways to implement regulation. There are two additional benefits, however, that come from getting this incentive through the use of private regulators rather than relying on the regulated business itself, both of which come from the fact that private regulators operate within a market. First, private regulators who can sell their system to multiple companies in a market have an incentive to invest in innovation at a higher rate than an individual company does. They can spread the cost of innovation across larger scale. Second, private regulators operating in a market may have better incentives to ensure that the system they design achieves compliance with regulatory objectives than the regulated business itself. The reason is that the private regulator, if properly regulated itself by government, will have an interest in maintaining its reputation for compliance. Failures of compliance won't just bring the risk of fines; they will bring the risk of losing status as an approved regulator. We could expect that regulated businesses would have an interest in choosing only those private regulators that are expected to reliably achieve compliance and maintain their status as an approved regulator: regulated businesses will incur costs if they have to switch regulators, costs they would like to avoid. For the private regulator, that means the risk of going out of business.

Of course we're assuming here that the superregulator—the government—puts its teeth into actually regulating private regulators and does so without bias or corruption. Private regulators have to fear losing their approval status if this market is to work. An assumption like this may seem ambitious, which it is. (The failure to effectively regulate private contractors such as those operating prisons in the United States is a case in point.) But this is the same expectation we have now of how government regulates under any model—an expectation that is, and would continue to be, only as good as our systems of political accountability. Superregulation doesn't solve that problem—although it may shrink it by making it easier to understand and see what the government is failing to do. It is pretty demanding to expect voters to be well informed and active in evaluating how well the government's occupational safety and health agency is choosing thousands if not millions of specific workplace standards, like what kinds of seatbelts need to be used in the luggage trucks airport workers use to load and unload airplanes. It may be less demanding to expect voters to be well informed and active in evaluating how well the agency is policing the obligation on a private regulator to meet targets for workplace injury.

There's another important benefit that comes from creating a market for private regulators. It's the core benefit of specialization and the division of

labor. Regulated businesses are not primarily in the business of regulation. They are in the business of manufacturing cars and chemicals, operating restaurants and mines, transporting packages and people, selling securities and soap. Under performance- or management-based regulation, these businesses also have to figure out how to design systems to achieve regulatory objectives. This requires these businesses to be somewhat vertically integrated when it comes to regulation services. But as we've seen, the increased complexity of the modern economy has made vertical integration more and more costly. Creating a market for private regulators would allow businesses to do with regulation services what they are doing throughout their value chain—coordinating across a global network rather than producing everything in-house.

We can already see evidence of the incentive for businesses to find ways to get out of the business of designing their own compliance systems. Over the past decade or so, the market for compliance services has grown substantially. These services consist of various combinations of systems design consulting and data- and transaction- tracking software. Banks that are obligated by law to avoid participation in money-laundering schemes, for example, have a demand for software and services that help them to identify and report suspicious transactions. US companies doing business in foreign countries have a demand for software and services that help them to detect whether their employees are violating the Foreign Corrupt Practices Act, which makes it a violation of US law to bribe a foreign official. These compliance services operate within the framework established by government regulations. And one of the key services they offer is expertise in the regulations, both where they are and where they may be going.

A competitive market for private regulators would take compliance services to the next level: drawing on a combination of technological and regulatory expertise not only to design systems and software, including blockchain technology, to manage compliance but also to develop the criteria for judging compliance. These criteria might take the same form as government regulations—detailed written rules. But, perhaps more likely, they could also be embedded directly in the software and systems these private regulators develop to achieve their own regulatory goal of maintaining their status as an approved regulator.

Regulating private regulators would almost certainly be a new and substantial challenge for governments. Private regulators will, if the market works well, gain substantial expertise in their fields, potentially outstripping the expertise available in government bureaucracies, making oversight difficult. But there are two reasons to think that this challenge is nonetheless one worth taking on.

First, our current regulatory approaches already face this challenge. Banking and financial services regulators, for example, are already faced with trying to understand the complex systems developed by thousands of individual banks and financial services firms. The difficulties they face in doing so, because of the gap in expertise, were undoubtedly a factor in the failures of regulation to ward off the global financial crisis of 2008. At a minimum, a shift to overseeing private regulators reduces the number of entities that need to be overseen.

Second, a focus on regulating private regulators shifts the regulatory expertise burden from unpacking the complex details of how a business operates—the ins and outs of financial transactions, for example—to evaluating outcome criteria. Regulation of private regulators can, for example, rely on audits and indicators to evaluate systemic achievements and failures within a private regulator's client base. That allows government regulators to take a broader view that requires less knowledge of the details. It also exploits the benefits of a larger database: private regulators can be evaluated on the basis of the results achieved across a set of regulated businesses, rather than the results achieved in a single business. Regulating private regulators is a different task for government than direct regulation of business but it is not necessarily a more complex or expensive one. Indeed, there are good reasons to think that in several settings it will place lower demands—in terms of expertise and money—on governments.

The deeper challenge may lie in identifying those cases in which a market for private regulation can be structured so as to be reasonably competitive. Although this is a hard problem, it is a completely familiar one. For any good or service that we want, we need to determine whether markets can operate reasonably competitively or whether we need the state to step in. Economists are weaned on this problem, one of analyzing the risk of market failures and the relative performance of markets and governments in light of those failures.

A first question is whether the market can support enough private regulators to ensure there is competition between them. This is largely a matter of the scale of the market—how many users of the service there will be—relative to the fixed costs of providing services—that is, costs that are the same regardless of how many users there are. The fixed costs of providing regulation services will likely be substantial. The design of systems to achieve the outcomes that our political process seeks—lower workplace injury rates, greater financial stability, fewer data breaches—will require significant upfront and ongoing investment in understanding the complex relationships

between those outcomes, the way businesses operate, and the opportunities for effective regulation and change. Indeed, inducing those system-design investments in a complex setting is precisely why we are interested in finding ways to get private market-based providers into the act. These relatively high fixed costs will need to be spread across enough users, relative to how much each is willing and able to pay, to make the business of a private regulator sufficiently profitable that people want to get into the business. (This is true even for private regulators that organize as nonprofit companies: short of substantial and ongoing philanthropic contributions, they still need to be able to cover the costs of providing their services.) Unlike standard markets, where buying a good or service is completely voluntary, approved private regulators would be able to count on the fact that regulated businesses are required by the government to buy regulation services from one of them. But still the total number of users would have to be high enough that these users can be shared across multiple private regulators, with enough for a given regulator to cover its fixed costs. That doesn't mean a guarantee of enough users to cover fixed costs: the point of competition is that a private regulator that fails to produce an attractive cost-effective service while still meeting the standards necessary to maintain status as an approved regulator will not stay in business for long. It's the risk of not generating a return on that investment that secures the incentive for developing better, lower-cost, more effective regulatory systems. That's the incentive we want to harness to address the problems of overly costly, overly complex regulatory regimes. But if private regulators succeed in that, there have to be enough users to go around. That means we can't look to this regulatory approach for overly narrow or specialized areas that are relevant to only a few regulated businesses.

In some markets, the relationship between fixed costs, scale, and competition can, perversely, undermine competition. This happens when there are great returns to getting bigger and bigger. The modern information economy sees a lot of this, in the form of network externalities and increasing returns to scale. These are the effects that make everyone want to use a widely installed operating system, a widely subscribed social network, and a widely used website for restaurant reviews. They are what gave us free broadcast TV and now Facebook. They are why Jeff Bezos started Amazon selling books online—and why he named his business after the biggest river in the world. In all of these cases, the more people who are using the system, the more valuable it is to be a member of (or an advertiser on or an app developer for or a retailer distributing through) the system. Bigger is better. But if bigger is better, then there will be powerful forces driving the

number of providers in a market down to just a few, or maybe even one. That undermines competition.

There might be powerful drivers toward a small number of megaproviders in private regulation. Almost without a doubt, a system that gets more users will become smarter faster and hence have an accumulating edge over competitors that lag behind. Regulated businesses may also discover that they prefer to be on the same system as their own competitors, partners, and collaborators to reduce the costs of compliance. To the extent that private regulation systems require complementary services—such as software or consulting—that are supplied by third parties, those services may be more widely available and lower cost for a widely adopted regulatory system than they are for a new entrant that is still working to gain market share. All of these effects can make markets for private regulation less competitive.

But these are not new problems. Indeed, they are pervasive, as we've noted, in the modern economy. Network externalities and powerfully increasing returns to scale abound. Clearly, however, we don't want every good and service that is subject to these pressures produced with central planning by governments. The fact that Microsoft operating systems are installed on three-quarters of all desktop computers doesn't mean we want a government-produced—or government-designated—operating system for our computers. What we do want is regulation—antitrust law, for example—that tries to make sure Microsoft cannot exploit that market dominance and that new competitors can find every chance to get a foothold. We would need the same, where possible, for private regulators. It may not be possible in all cases—and in those cases we do need to turn to government. But that is the same question we face (and may not yet be answering very well) in many other markets. There's nothing special, in this sense, about regulatory services as compared to other economic goods and services.

Regulatory services will also be much like many other economic goods and services in that they may need some level of intellectual property protection. Indeed, the hope is that a market for regulatory services will induce innovation and substantial investments in knowledge about how regulation can be designed to work better. In some cases those types of investment require some form of protection in order to give innovators a chance to recoup their investment. As in other markets, protection might be secured formally by embedding the innovation in a patentable piece of software or business process or through copyright of written materials or by keeping new ideas secret, protected by confidentiality agreements and trade secret law. As in other markets, protection might be secured through business models that

embed the benefits of innovation in services—smart consultants and arbitrators, for example—that are difficult to appropriate without purchasing the service. Again, these are challenges faced in many markets, and regulatory services are not all that different.

It will also be important to design the superregulation of private regulators to protect the capacity of regulated businesses to switch providers. Competition requires this kind of user mobility. This may require ensuring that private regulatory systems do not require users to bear all the costs of switching to a new provider. User data stored with one system, for example, may need to be easily transferable to another. Pricing models may have to be regulated so that systems do not rely too heavily on nonrefundable upfront fees and low maintenance fees. Other features of regulation might similarly make it difficult to switch. One challenge encountered by the regulatory system in the UK's new regime for legal services is that although lawyers can ostensibly choose their regulator from an approved list, they must make highly specialized investments in becoming a member of a particular regulatory regime. Switching professional membership—which means switching between approved regulators—is a very costly proposition. Avoiding lock-in to a particular regulatory regime will be important to support competition in fact between multiple private regulators.

Ultimately, relying on market-based private regulators will be only as effective and attractive as the quality of the government oversight of the system. If corporations are making the choice, for example, between alternative providers of regulatory systems for protecting the consumer's interest in safe products or the security of private financial information, they will be looking for a regulator that helps them maximize profits, not protect consumers. Consumers will be depending on the government to ensure that private regulators are only offering systems that serve the regulatory goal of protecting consumers—and so limiting the capacity of regulators to cater to business and not consumer interests. This is a very real threat. In the areas of consumer and employment arbitration, for example, companies offering arbitration services have an incentive to design systems that serve the interests of the corporation over consumers and employees. This is because the corporation chooses which company's system to put into the arbitration clauses of the standard-form contracts that consumers and employees sign—without much awareness of what they're signing and often without much alternative. Consumer and employee interests aren't well protected in this regime because the arbitration systems on offer are not regulated to ensure that they protect those interests. That's a flaw, and it's a flaw that any regime of market-based

private regulation would have to be able to correct for this to be a reasonable alternative to our other methods of government-based regulation. Weak government oversight of private regulators—like weak government oversight of the operators of private prisons or highways—could quickly gobble up the potential benefits of harnessing market incentives to develop better, simpler, less costly, and more effective regulatory systems. But that is a challenge we should be taking up.

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CHAPTER 10

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CHAPTER 11

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