

## Consultation response

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### RE: Business Leadership in Consumer Protection

#### Introduction

Which? is an independent, not-for-profit consumer organisation with around 700,000 members and is the largest consumer organisation in Europe. Which? is independent of government and industry, and is funded through the sale of Which? consumer magazines, and books.

We welcome this opportunity to respond to the OFT discussion on the role of business and self regulation in consumer protection<sup>1</sup>. We would be very happy to discuss further any of the issues raised in this submission.

Prior to engaging with the questions in the document we would like to briefly clarify our understanding of regulation in general and self regulation in particular.

- > We believe that it is not possible to neatly compartmentalise self regulation, co-regulation and classic regulation as if they were entirely distinct entities in the real world. As is inherent with the use of typologies they often simplify away the subtleties and complexities of the real world.

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<sup>1</sup> OFT (2009). 'Business leadership in consumer protection', pub: Office of Fair Trading: London.



- > A more realistic understanding is to think of regulation as a concept existing along a continuum.
- > We understand the term self regulation as a situation where no agencies that are not already part of the industry concerned devise and enforce regulations governing the behaviour of the firms in the sector. This sits at one end the regulation continuum.
- > The term co-regulation - or enforced self regulation as it had been titled by some<sup>2</sup> - describes a situation where ‘...*the industry has some involvement in regulating itself but with a level of Government control*’<sup>3</sup>.
- > At the other end of the regulatory continuum is classic regulation - the strongest form of which is ‘command and control’ regulation<sup>4</sup>.
- > We believe most existing regulatory schemes and systems exist somewhere along the continuum and are unlikely to fit wholly into one category or another.
- > In the following response we argue to the first question of the discussion document that it is almost impossible to devise some *a priori* criteria in which self regulation would automatically be a suitable solution to a market problem.
- > With regard to the second question of the document, we believe that it is in fast evolving sectors with many firms that a self-regulatory scheme has the best chance of being effective. We further argue however that even when - *prima facie* - these conditions prevail in a sector it is still not enough for self regulation to be an effective regulatory option, as further industry-specific factors are in play as well as the concurrent requirement that the interest and behaviour of firms have to be aligned with the desired regulatory outcomes.
- > In response to the third question in the discussion document, we describe how given the very difficult circumstances in making self regulation work and the paucity of successful real world examples the OFT should look to promote the more successful co-regulatory approach.

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<sup>2</sup> Baldwin, R and Cave, M (1999). ‘*Understanding Regulation*’, pub: Oxford University Press: Oxford.

<sup>3</sup> Which? internal document.

<sup>4</sup> ‘*The essence of command and control...regulation is the exercise of influence by imposing standards backed by criminal sanctions*’. Source: Baldwin, R and Cave, M (1999). ‘*Understanding Regulation*’, pub: Oxford University Press: Oxford.



- > In answer to the final question in the discussion document, we briefly set out how the current economic situation has turned public opinion and the policy discourse towards increasing the quantity and quality of regulation, and if ever there was an appetite for self regulation - as a potentially effective solution to market problems - then it has mostly evaporated. This does create more opportunity for the OFT to increase the use co-regulation as a policy solution.

### The Four Discussion Questions

#### **Question 1: What types of market problem are most likely to be suitable for an industry-led solution?**

We believe that, fundamentally, there can be no definitive answer to this question. In essence, the use of industry to organise their own solution to a problem - in other words a self-regulatory solution - is going to be contingent on the particular circumstances in the sector and the robustness of the scheme on offer.

- > It is not possible to deduce *a priori* a set of potential problems with the market that systematically and regularly lend themselves to a self-regulatory solution over any other.
- > Any attempt at such an exercise risks becoming a potentially very damaging dogmatic response without allowing for the examination of the particular conditions pertaining in a specific instance.
- > Therefore, Which? believes that decisions on whether a self-regulatory solution is suitable to solve a particular market problem should be made on case by case bases.
- > The *quid pro quo* of the problem being amenable to a self-regulatory solution is that the suggested solution is rigorous and effective enough to ameliorate the market problem. In other words a self-regulatory option has to have an effectual system of governance. Which? has laid down a set of criteria that we believe any successful solution must fulfil<sup>5</sup>:

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<sup>5</sup> These are edited versions of the standards established in an internal Which? document '*Self-regulation: key features of a successful scheme*'.



- *Strong Independent Governance* - Any self-regulating body should have a strong independent governance structure, separate from the industry it is regulating.
- *Clear objectives including a consumer focus* - The primary purpose of a self-regulatory scheme should be to ensure consumer protection and, as such, should have a goal of consumer protection explicitly written into the objectives.
- *Robust Standards* - A self-regulatory system should address consumer problems and ensure consumer protection. Therefore robust standards should be put in place reflecting the goal of consumer protection. They should be set at a level that prevents consumer detriment from occurring, but flexible enough to respond to market dynamics.
- *Transparency* - Whilst self regulation means self policing by industry, schemes should be subject to a high level of transparency throughout their operations, applying in particular to complaints, adjudications and sanctions.
- *External Consultation* - In addition to gathering external input into any formal review process, it is vital the consumer voice is heard. This necessitates some form of external consultation and the creation of checks and balances, e.g. a consumer panel or a specific duty to conduct consumer research among others.
- *Adequate funding* - This is crucial to ensure the long-term viability of a scheme.
- *Promotion of the scheme* - There should be active promotion of self-regulatory schemes to ensure awareness.
- *High take up in the sector* - Low levels of involvement by firms will make it a meaningless scheme.
- *Effective monitoring, inspection and reporting* - To be successful a scheme needs to keep on top of its members' activities. This will help ensure confidence and identify problems before they lead to detriment.
- *Robust Sanctions* - Complementing the inspection and reporting regime, a good scheme will effectively deal with members that transgress the agreed rules or code.
- *Adequate redress* - One of the most important aspects of a successful self-regulating industry will be a well developed complaints mechanism, enabling consumers to have their problem dealt with quickly and fairly.



In summary:

- It is impossible for it to be decided outside a rigorous analysis of the particular sector and market problem whether self regulation is a suitable policy response.
- As part of that thorough analysis - to establish whether a self-regulatory solution is suitable - a vital part of that must be an examination of how robust any specific regulatory scheme is to be. The robustness of it being a crucial component in the calculus of the effectiveness of self regulation to solve a problem.

**Question 2: In which market conditions is self regulation more likely to be an effective solution than legislation and enforcement?**

Which? believes that the market conditions under which a self-regulatory scheme is likely to be successful - in terms of delivering for consumers - are going to be:

- > Where the market structure and other sectoral characteristics are such that self regulation cannot act as a potential barrier to the effective operation of the market process and will help maintain or enhance the satiation of consumer demand; and
- > Where the interests and behaviour of economic actors can be aligned with the desired regulatory outcomes.

These two conditions are described in greater detail below.

The first market condition necessary for an effective self-regulatory solution describes how certain market structures and other sector characteristics perhaps align themselves more naturally with a potentially self-regulatory option for solving a market problem. The highly contingent nature of these needs be emphasised:

- > In terms of market structure, less concentrated sectors are likely to be a more successful crucible for a system of self regulation. This is because they are more likely to be markets with greater entry and exit with a large number of firms reducing the opportunities for any self regulation to operate as a competition dampening mechanism - which is a chief danger when concentrated industries look to establish self-regulatory schemes.
- > The above position should not be understood as meaning self regulation works in all, many or even some sectors that have a large number of firms. It merely



suggests that it is more likely to succeed as a problem solving solution than in more concentrated sectors. In sectors with many firms the same problems can be evident as in the more concentrated industries. There are additional problems arise too. These potential issues must be considered carefully before trying self regulation.

- The dangers of self regulation in more concentrated industry sectors - that they can and do dampen competitive intensity - can hold equally for sectors that are less concentrated in their structure.
  - Additionally, it is potentially much more difficult in such a sector to bring all companies within a self-regulatory regime. All firms may not be willing to submit to it<sup>6</sup>. In such circumstances the efficacy of any self-regulatory regime is immediately reduced with some firms bound by it and others - competitor firms - not.
  - A further danger is that to try and capture the wide range of companies in a sector, the regulations devised may have to be so compromised to be almost meaningless in terms of changing/ directing behaviour.
- > Other structural characteristics that make an industry more suitable for a self-regulatory solution include a high level of dynamism. Rapid industrial change is often due to factors such as technology. Sectors based around new technologies generally experience greater levels of innovation and therefore a faster evolution in market conditions. Classic regulation is unlikely to be able to keep up with such developments sufficiently and therefore a more responsive regulatory approach - the type self regulation can potentially offer - may be more appropriate.
- This is highly contingent on a range of factors. Along with dynamism comes uncertainty and for example, in the area of nanotechnologies there is much uncertainty over definitions and the implications of technologies. This is making moves towards self regulation more difficult. This is just one example of how just because *prima facie* these other sector characteristics are evident, it does not mean that an observer can assume that self regulation will be an effective regulatory solution.
- > This rapidity of regulatory reaction to market dynamics by self-regulatory schemes may partly be explained by the greater willingness - by those

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<sup>6</sup> One example: is that the firms who will exclude themselves are the less reputable ones, thus undermining the point of the self regulation as it will only capture those who are already providing satisfactory products and/ or services. A second example is perhaps some firms, for commercial sensitivity reasons may be reluctant to share information with potential competitor firms. This may be necessary if one of the aims of a self regulation scheme is the creation of product standards.



covered by the scheme - to abide by it and co-operate in its evolution. This in turn stems from the feeling of ownership firms have over a self-regulatory scheme, as by definition they have been involved in establishing it<sup>7</sup>.

- Again though this is highly contingent on several factors including the rapidity of the mechanisms of the self-regulatory scheme for changes in standards, how many firms are part of the scheme and how companies judge how they should balance the range of possible strategic interests e.g. short term competitive advantage over the self-regulatory obligations they have entered into.

The second market condition - under which a self-regulatory scheme will be effective - is where the strategic interests of firms in an industry are aligned, or can be, with the desired regulatory (socially desirable) outcomes.

- > This approach is discussed in a recent Ofcom publication looking at self and co-regulatory solutions<sup>8</sup>. They describe how self regulation is only likely to work where there is this alignment of interests and desired outcomes. They identify the market conditions where self regulation is most likely to succeed. These are where:
  - Industry collectively has an interest in solving the issue;
  - Industry is able to establish clear objectives for a potential scheme; and
  - Likely industry solutions match the legitimate needs of citizens and consumers.
- > This type of alignment of interests and desired regulatory outcomes is rare and is not a state of affairs that occurs often in reality. It may only be in the presence of a range of incentives<sup>9</sup> or high levels of trust that such an alignment can be brought about. With regards to the former two factors this would almost certainly require some kind of state involvement on some level to help design and enforce the incentive architecture - immediately turning it into a co- or classic regulatory solution and not a self-regulatory one.

<sup>7</sup> Behavioural psychology has identified how a participatory approach to problem solving can ‘...be highly motivational and effective in encouraging behaviour change...’. Source: Dawney, E and Shah, H (2005). ‘Behavioural economics: seven principles for policy makers’, pub: New Economics Foundation: London.

<sup>8</sup> Ofcom (2008). ‘Identifying appropriate regulatory solutions: principles for analysing self and co-regulation’, pub: Ofcom: London.

<sup>9</sup> The term ‘incentive’ encompasses both inducements for companies and sanctions/ punishments that could befall a firm not complying.



- > The arguments presented above suggest that examples of self regulation are rare given the confluence of factors that needs to occur. The example often held up as proof that it can work does not help make the larger point that self regulation can be more widely used as a solution to problems. The example often quoted is that of the Advertising Standards Agency (ASA) - and indeed it has been a successful organisation<sup>10</sup>. However, firstly the fact that it is always quoted as the exemplar suggest that there is a paucity of other successful schemes. Secondly the ASA is not an example of pure self regulation. For extreme and persistent transgressors the ASA has the ability to refer advertisers to OFT for sanction.
- > In summary, it is clear that a range of factors (outlined above) needs to be in place before self regulation can be considered an effective regulatory response. The chances of this range of factors occurring simultaneously to make self regulation a widely viable solution to problems for industries are low. As is described, even the ASA - the supposed exemplar for self-regulatory achievement - has co-regulatory elements. This suggests - and as will be described more in the answer to the next question - it may be more useful to concentrate on co-regulation as an effective and more widely applicable solution to market problems than self regulation.

**Question 3: What type of support from the OFT would be appropriate to encourage more self-regulatory solutions to market problems?**

- > Given that successful self regulation schemes are largely unknown in the real economy, Which? believes the OFT could more successfully look to use co-regulatory schemes as a more effective way of harnessing business leadership in consumer protection.
- > Co-regulation has a much stronger track record in delivering regulatory aims. This is because co-regulatory solutions are able to combine some of the best elements of self regulation, e.g. the flexibility and inclusivity elements, while avoiding some the negatives through the involvement of state authorities to ensure there is no reduction in competitive intensity and that firms operate with strong incentives to deliver socially desirable outcomes.

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<sup>10</sup> Speech to the Advertising Standards Agency by Peter Vicary-Smith: CEO Which?, November 2008.



Examples of successful co-regulatory schemes include:

- Government approving self-regulatory codes of practice (e.g. - OFT Consumer Codes Approval Scheme). Which? believes these have much potential but currently they are limited in the number of sectors they cover, awareness is low and it takes to long to establish schemes.
  - Government appointing the reviewer of a self-regulatory code of practice.
  - Government requiring membership of a self-regulatory body to be mandatory, e.g. as with Estate Agents, post the implementation of CERA<sup>11</sup>.
  - Government acting as a ‘backstop’ enforcer (e.g. - the OFT role in advertising whereby the self-regulatory body, the ASA, can, as an ultimate sanction, refer a member to the OFT to consider taking action under the *Control of Misleading Advertisements Regulations 1988*).
- > We believe a recent exemplar of a co-regulatory system is the recent changes to the regulation of legal services with the establishment of the Legal Services Board<sup>12</sup> that approves and supervises the regulation of the different branches of the legal profession.
- The Legal Services Board has the consumer interest at the heart of its remit; as the overarching body for the legal profession it can ensure that the self-regulatory bodies, i.e. the Bar Council, Law society etc. do not ignore or treat as less important the interests of those consuming legal services, while at the same time allowing them to regulate the fast changing legal profession in a flexible and proportionate way.
- > In summary, the OFT should look to promote co-regulation as a far more successful model of effectively dealing with market problems than self regulation is. Co-regulation incorporates many of the strengths of self regulation and eliminates some of the weaknesses through having a formal role for state authorities albeit that role is a background one.

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<sup>11</sup> CERA - *Consumers, Estate Agents and Redress Act 2007*. This Act obliged all Estate Agents to become members of a redress scheme. This was an idea fully supported by Which? but the reality has fallen short of what we hoped, with two schemes being established - leading to consumer confusion - rather than one.

<sup>12</sup> Established by the *Legal Services Act 2007*. This act not only changed the regulatory structure from a self-regulatory one to a co regulatory one but established an independent ombudsman to deal with complaints about legal services and liberalised the rules around the types of business models that legal professionals can employ.



### How will the current economic climate impact on the role of self regulation as a solution to market problems?

- > There is no doubt that the current economic climate has changed the mood in public and policy circles. Where previously solutions closer to the self-/co-regulatory end of the regulation continuum would have been considered the way forward, in the current climate more formal regulatory solutions are higher up the priority list for policy makers.
- > This may be a permanent shift in opinion. It will almost certainly make regulatory solutions that are biased towards the self regulation end - and possibly even those around the co-regulatory portion - of the continuum harder to propose, when there are problems with the market.
- > Consequently it might be reasonable to expect the incidence of schemes closer to the self-regulatory end of things to reduce.
- > The current economic climate may also bring about a change in existing schemes or if any new ones are established then it may be the case that these are more robust in their structures than they would have been prior to the recent economic problems. In other words they might be much more rigorous self-regulatory systems than would have been the case had it been set up two years previously.
- > Which? would expect however, that this change in the mood allows more scope for the establishment of regulatory schemes that are more co-regulatory in their make up. This opens up more possibilities for the OFT to spread schemes like Consumer Codes Approval Scheme (CCAS).
- > In summary, self regulation is going to be less and less acceptable as a solution to market problems, giving rise to an opportunity to promote the use of more successful co-regulatory solutions.