

# The Resilience of Private Authority in Times of Crisis

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## 1.1 INTRODUCTION

Private regulatory bodies, including trade associations of professionals and companies such as banks or big manufacturers, have been part and parcel of the neoliberal orthodoxy premised on the concepts of market competition and an increasingly limited role for the State.<sup>1</sup> Largely unleashed to determine their fate, such close-knit groups have shaped the trajectory of neoliberal globalization.<sup>2</sup> Yet all governance modes can be vulnerable to specific kinds of failures due to their innate weaknesses in different problem contexts.<sup>3</sup> Reliance on private expertise has not prevented regulatory disasters (that is, events of varying scale and scope resulting from the – often unintended and unforeseen – consequences of the design or operation of a regulatory system and its interactions with other systems) in finance and manufacturing from occurring.<sup>4</sup> Despite the ever-increasing powers that are transferred to such private actors, existing theories fail to explain satisfactorily

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<sup>1</sup> See C. Donnelly, *Delegation of Governmental Power to Private Parties: A Comparative Perspective* (2007).

<sup>2</sup> See P. Cerny, *Embedding Neoliberalism: The Evolution of a Hegemonic Paradigm* (2008) 2:1 *Journal of International Trade and Diplomacy* 1, at 32.

<sup>3</sup> See also M. Howlett and M. Ramesh, *The Two Orders of Governance Failure: Design Mismatches and Policy Capacity Issues in Modern Governance* (2014) 33:4 *Policy and Society* 317.

<sup>4</sup> See J. Black, *Learning from Regulatory Disasters* (2014) 10:3 *Policy Quarterly* 3.

why their dominance remains largely unaffected by regulatory disasters that they partly cause.<sup>5</sup>

Against this backdrop, this chapter argues that crisis events or other unfortunate regulatory disasters appear to empower such private-driven forces or generate new ones, whereas existing public checks and balances fail to pursue their initial objective. In this regard, we introduce the concept of “free riding of private ordering” to describe this phenomenon and expose this mismatch between costs and benefits of regulatory legitimacy transfer. We believe that this phenomenon is particularly visible in two critical areas of economic activity: manufacturing and finance.

Arguably, we currently witness early signs of a transition from a constellation whereby private bodies serve a role assigned to them by the State (reactive mode) toward a convention whereby private forces create rules that regulate economic activity more assertively, without being affected by regulatory disasters; rather, such crises constitute opportunities to accumulate knowledge and develop the capacity to expect the unexpected, absorb it, and grow (reactive mode). Our main claim is that the continued dominance of private authority through crisis events is premised on the core rule-making activities that such private bodies undertake. The most important of them is the continuous promulgation of voluntary standards that are rapidly prepared, adopted, and diffused to preempt rules by public rule-making competitors. Because of the voluntary nature of the standards but also the underlying potential and properties that allow for grabbing authority located elsewhere, we further introduce the concept of “voluntary economic activism” (VEA). Overall, our objective is to set the foundations for a theory that explains crisis-proof private authority.

The remainder of the chapter proceeds as follows. We draw from the resilience theory in Section 1.2 to unravel the phenomenon of the resilience of private collective action, using examples from the world of finance and manufacturing. We underscore the importance of malleability, flexibility, mutability, and heterogeneity as foundational traits of organizational continuity but also how the role of crises (and crisis management) has been largely neglected in the private governance scholarship. Section 1.3 complements the largely theoretical analysis of organizational resilience by discussing the essential features of the transition we arguably witness regarding the empowerment of private collective action, that is, from a reactive toward a proactive role of private regulatory bodies seeking more authority. Importantly, it describes the contours of a new theory of private collective action. Based on the analysis offered, Section 1.4 sets the foundations for studying the transition to a new era of private ordering and underscores the importance of further

<sup>5</sup> See also V. Schmidt and M. Thatcher, *Theorizing Ideational Continuity: The Resilience of Neo-liberal Ideas in Europe*, in *Resilient Liberalism in Europe's Political Economy* (V. Schmidt and M. Thatcher eds., 2013), 1, at 13.

research to test the new theory put forward and the hypotheses associated with it. Section 1.5 concludes.

## 1.2 THE RESILIENCE OF PRIVATE COLLECTIVE ACTION

### 1.2.1 *What Makes a System Resilient? Insights from Ecosystems Theory*

Resilience is the ability of recovery to the state of equilibrium that a subject would have depending on the risk management strategy it will employ. Resilience in ecosystems can relate to efficiency, control, constancy, or predictability (coined “engineering resilience”). In such, rather static, ecosystems, because uncertainty is low, the focus is on optimal performance. However, resilience can also relate to persistence, adaptiveness, fungibility, variability, and unpredictability (coined “ecosystem resilience”). In dynamic ecosystems, variability and novelty result in high uncertainty. As the latter form of resilience focuses on the interplay between stabilizing and destabilizing properties of a given system, it appears to be the most useful for developing sustainable social orders.<sup>6</sup>

Resilience would emphasize the capacity to absorb stress and reorganize after the occurrence of a disturbance that upsets the equilibrium; thus, it presupposes a phase of growth and accumulation, followed by a phase of reorganization and renewal; a resilient system would survive successfully through these four phases.<sup>7</sup> Perturbations can lead to a critical point (“a tipping point”) of such a disruptive nature that triggers a paradigm shift, thereby creating a new equilibrium, allowing for the continuation of the system. The occurrence of a tipping point is typically evidenced by the delay of recovery or by the fact that a system has become more vulnerable or fragile to small changes, resulting in critical transitions.<sup>8</sup> The transition is nonlinear and the new equilibrium reached is not necessarily better or worse.

Resilience would entail flexibility rather than rigidity and persistence rather than collapse.<sup>9</sup> Overall, it appears that systems are more resilient when they are moderately connected while maintaining high levels of heterogeneity.<sup>10</sup> More generally, a system, subject, institution, or idea is resilient when it can weather episodic or

<sup>6</sup> See C. S. Holling and L. H. Gunderson, Resilience and Adaptive Cycles, in *Panarchy: Understanding Transformations in Human and Natural Systems* (L. H. Gunderson and C. S. Holling eds., 2002), 25, at 27–28.

<sup>7</sup> See C. S. Holling, Understanding the Complexity of Economic, Ecological, and Social Systems (2001) 4 *Ecosystems* 390, at 393ff.

<sup>8</sup> See Y. Li et al, An Analysis of Power Law Distributions and Tipping Points during the Global Financial Crisis (2018) 13:1 *Annals of Actuarial Science* 80, at 85.

<sup>9</sup> See J. Ruhl, General Design Principles for Resilience and Adaptive Capacity in Legal Systems: With Applications to Climate Change Adaptation (2011) 89 *North Carolina Law Review* 1373, at 1389.

<sup>10</sup> See R. Biggs et al, Toward Principles for Enhancing the Resilience of Ecosystem Services (2012) 37 *Annual Review of Environment and Resources* 421, at 429.

gradual change and emerge closely resembling its former state and functionality after a disturbance.<sup>11</sup> Such a process of demonstrating adaptability may entail the change of resilience strategies without changing the fundamental attributes of a given system.<sup>12</sup> This reemergence of a given system into a feasible alternative status would also be efficient from an economic viewpoint.<sup>13</sup>

When applying these theoretical insights to private regulation regimes, we observe that a man-made system like a regulatory system can show its resilience by internalizing any succession of regulatory and governance paradigms (growth and accumulation). This can eventually lead to new constructs of alternative governance (reorganization and renewal), provided that the characteristics of the previous regime remain largely intact. Resilient private systems cannot survive without the idea that underlies them being resilient to shocks. Ideas can show resilience through adaptive processes of metamorphosis (old ideas returning in new guises), absorption (of seemingly contradictory ideas), and hybridization (adaptability in different contexts).<sup>14</sup> This approach would emphasize the heterogeneous and inclusive nature of ideas that aspire to be (or have been) resilient, as long as a connecting factor, even if only loose and remote, could bring them together. This coalescence can be the result of centripetal forces but many times will result from active inclusion management of a strategic nature.<sup>15</sup>

### 1.2.2 *The Rise of Private Collective Action to Authority as a Manifestation of Neoliberalism*

Much of the governance carried out in the last thirty years has been indirect, delivered via several private rule-making bodies acting as governance intermediaries, be it trade associations; professional bodies; private contractors delivering public services such as transport, health, security, or education; or associations of firms to which the State delegated a given task.<sup>16</sup> The retrenchment of the State that fitted

<sup>11</sup> See S. Kaufman, Complex Systems, Anticipation, and Collaborative Planning for Resilience, in *Collaborative Resilience: Moving through Crisis to Opportunity* (B. Goldstein ed., 2012), 61, at 65; also C. Folke, Resilience: The Emergence of a Perspective for Social-Ecological Systems Analyses (2006) 16:3 *Global Environmental Change* 253.

<sup>12</sup> See B. Fath, C. Dean, and H. Katzmair, Navigating the Adaptive Cycle: An Approach to Managing the Resilience of Social Systems (2015) 20:2 *Ecology and Society* 24.

<sup>13</sup> See O. Williamson, Economic Organization: The Case for Candor (1996) 21:1 *The Academy of Management Review* 48, at 53.

<sup>14</sup> See V. Schmidt and M. Thatcher, Why Are Neoliberal Ideas So Resilient in Europe's Political Economy? (2014) 8:3 *Critical Policy Studies* 340, at 341.

<sup>15</sup> See C. Ansell et al., Understanding Inclusion in Collaborative Governance: A Mixed Methods Approach (2020) 39:4 *Policy and Society* 570.

<sup>16</sup> See K. Abbott, P. Genschel, D. Snidal, and B. Zangl, Two Logics of Indirect Governance: Delegation and Orchestration (2015) 46 *British Journal of Political Science* 719; also S. Shapiro, Outsourcing Government Regulation (2003) *Duke Law Journal* 389; and E. P. Stringham, *Private Governance: Creating Order in Economic and Social Life* (2015).

the neoliberal ideological framework proved fertile ground for this development, allowing for market-led governance and the gradual introduction of self-correcting processes, eventually leading to a reconfiguration of the role of the State.<sup>17</sup>

Privatization and deregulation of monopolies and later public authority was the inevitable consequence of the coalescence between the economic and the political. Economics (notably the Chicago School and the Law and Economics movement)<sup>18</sup> came to corroborate and justify such a constellation early on by finding that public goods such as regulations can be produced by non-state actors<sup>19</sup> or demonstrating how the use of nonlegal mechanisms such as informal rules and social norms can bring about efficient outcomes in the marketplace.<sup>20</sup>

These developments would pave the way for the ultimate decoupling of the regulatory function from the executive function. Regulation would merely shift “penholders” to become the very responsibility of the regulatees (often experts in a highly technical and complex field).<sup>21</sup> Proponents of market-led governance and self-regulation would advocate that a bottom-up approach to authority is more apposite due to expertise and insider knowledge that only the professionals possess.<sup>22</sup>

Various resilience-related attributes mentioned above can be identified in the modus operandi of private regulators: malleability, flexibility, and relatively low costs have defined the resilience of private regulators and the ideas they advocate.<sup>23</sup> Private bodies can draft and review rules more swiftly and flexibly than any public authority.<sup>24</sup> Norm-making groups can also adapt more quickly in the wake of exogenous shocks, thereby demonstrating their transformative capacity and mutability traits.<sup>25</sup> Furthermore, with the proliferation of technological advances that facilitated global exchange of ideas and commercial transactions, new layers of regulation at the national but also the international level would emerge, allowing

<sup>17</sup> See P. Kjaer, Law and Order within and Beyond National Configurations, in *The Financial Crisis in Constitutional Perspective: The Dark Side of Functional Differentiation* (P. F. Kjaer et al. eds., 2011), 395, at 418.

<sup>18</sup> See P. Mirowski and D. Plehwe (eds.), *The Road to Mont Pèlerin: The Making of the Neoliberal Thought Collective* (2009).

<sup>19</sup> See R. Coase, The Lighthouse in Economics (1974) 17:2 *Journal of Law and Economics* 357; and E. Ostrom, *Governing the Commons: The Evolution of Institutions for Collective Action* (1990).

<sup>20</sup> See R. Ellickson, *Order without Law: How Neighbours Settle Disputes* (1991).

<sup>21</sup> See also D. Levi-Faur, The Global Diffusion of Regulatory Capitalism (2005) 598:1 *Annals of the American Academy of Political and Social Science* 12.

<sup>22</sup> Cf. C. Cutler et al. (eds.), *Private Authority and International Affairs* (1999).

<sup>23</sup> See K. Abbott and B. Faude, Choosing Low-Cost Institutions in Global Governance (2021) 13 *International Theory* 397.

<sup>24</sup> See also J. Basedow, The State’s Private Law and the Economy: Commercial Law as an Amalgam of Public and Private Rule-Making (2008) 56:3 *American Journal of Comparative Law* 703.

<sup>25</sup> See also R. Ellickson, The Market for Social Norms (2001) 3:1 *American Law and Economics Review* 1, at 22.

for the creation of co-regulatory constellations and other types of partnership between the private and the public.<sup>26</sup>

The evolution of private regulation can be attributed to early successes of self-regulatory patterns. In other words, self-regulation is directly associated with the phenomenon of private regulation in that the former established solid foundations for the evolution of the latter. In turn, the very foundation of self-regulation (and, a fortiori, private regulatory power) is the legal principle of private autonomy, going back as early as the Roman times.<sup>27</sup> Self-regulation entails an explicit or tacit transfer of authority to private bodies, which allows them to delineate a sphere of expertise,<sup>28</sup> establish conditions for membership, limit competition for the excluded nonmembers (either because they objectively do not qualify or because the incumbents want to maximize their rents), and impose deontological rules of conduct on the regulatees.<sup>29</sup> Self-regulation further entails monitoring of compliance with such rules and instituting enforcement mechanisms based on the deterring impact of potential exclusion, transforming compliance into a “normative demand.”<sup>30</sup>

Private bodies have been key pillars of contemporary regulatory governance.<sup>31</sup> The emergence of private regulatory regimes has often been the result of a well-functioning, self-contained ecosystem, whereas in other cases it can be enlisted as part of experimental regulatory governance.<sup>32</sup> In this respect, professional associations are a good example. Certain associations gained immunity from public interference decades or even centuries ago and established normative principles of professional elitism.<sup>33</sup> These principles are meant to regulate access and pursuit of a given profession in the public interest: they are set out to ensure high levels of consumer protection and service quality. However, other than protecting public interest objectives, professional associations should also protect the interests of their members. This dual mission may lead to undesirable conflicts of interest.<sup>34</sup>

<sup>26</sup> See also I. Ayres and J. Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992); and N. Gunningham and P. Grabosky, *Smart Regulation* (1998).

<sup>27</sup> See L. Fuller, Consideration and Form (1941) 41:5 *Columbia Law Review* 799, at 806–807.

<sup>28</sup> See J. Black, Constitutionalising Self-Regulation (1996) 59:1 *Modern Law Review* 24, at 27.

<sup>29</sup> See also C. Coglianese and E. Mendelson, Meta-Regulation and Self-Regulation, in *The Oxford Handbook of Regulation* (R. Baldwin et al. eds., 2010), 146, at 146.

<sup>30</sup> See M. Auer, The Anti-network: A Comment on Annelise Riles (2008) 56 *American Journal of Comparative Law* 631, at 636–637.

<sup>31</sup> We adopt here a function-driven definition: Regulatory governance is the organized attempt to manage risks or behavior to achieve a publicly stated objective or set of objectives. See also Black, *supra* note 4.

<sup>32</sup> Cf. G. de Búrca, R. Keohane, and C. Sabel, Global Experimentalist Governance (2014) 44:3 *British Journal of Political Science* 477.

<sup>33</sup> See R. Suddaby et al., Transnational Regulation of Professional Services: Governance Dynamics of Field Level Organizational Change (2007) 32 *Accounting, Organizations and Society* 333.

<sup>34</sup> See H. McVea, Predators and the Public Interest: “The Big Four” and Multidisciplinary Practices (2002) 65:6 *Modern Law Review* 811.

Additionally, there is always the danger of regulatory capture from within,<sup>35</sup> as special interests are well-organized and homogeneous.

The concerns described above may become even more serious, as monitoring and harnessing the behavior of private bodies becomes more complex once private regulation of a given economic activity becomes borderless at the transnational level.<sup>36</sup> An interesting feature of these regimes is that procedural requirements become essential due to their reach and type of addressees, impact, and increased level of regulatory tasks that they have.<sup>37</sup> Issues of jurisdiction and conflict surface, and, quite interestingly, their complexity nourishes the evolution of transnational regulation, post-national legal authority and private ordering.

Similar concerns apply to co-regulatory constellations. Co-regulation or cooperative regulation in several sectors of the economy is a form of regulation that goes beyond the coercion that State authority can exert. In theory, co-regulatory approaches allow self-regulation, private regulation, and state regulation to come together with a view to optimizing regulatory performance and more efficiently addressing market failures and certain malfunctions.

As a rule, rule-making within such bodies is highly political. Internal politicization can often turn into a battle for internal dominance, which requires an investment of sometimes substantial financial resources and effective representation.<sup>38</sup> However, toward the external addressees, a persistent problem has been the high level of immunity from liability that private bodies largely enjoy. Immunity for some is the result of theories of corporation and liberalism that have dominated economic activity over the years. In such a framework, liability becomes an abstraction, scattered in the private regulatory sphere.

### 1.2.3 *The European Example of Private Governance*

In the history of European economic integration, the involvement of the private sector is well documented.<sup>39</sup> The contribution of private authority proved a key ingredient of European integration, in line with the neofunctionalist approach that essentially characterized much of the evolution of European rapprochement, as exemplified by the New Approach in mid-1980s, the controversial Lisbon strategy

<sup>35</sup> See G. Stigler, *The Theory of Economic Regulation* (1971) 2 *Bell Journal of Economics* 3; also R. Posner, *Theories of Economic Regulation* (1974) 5 *Bell Journal of Economics* 335.

<sup>36</sup> See also G. Teubner, *Global Bukowina: Legal Pluralism in the World Society*, in *Global Law without a State* (G. Teubner ed., 1996), 1, at 3.

<sup>37</sup> See F. Cafaggi, *New Foundations of Transnational Private Regulation* (2011) 38:1 *Journal of Law and Society* 20.

<sup>38</sup> See W. Mattli and T. Büthe, *The New Global Rulers: The Privatization of Regulation in the World Economy* (2011), at 12.

<sup>39</sup> For a critique, see G. Majone, *Rethinking the Union of Europe Post-crisis: Has Integration Gone Too Far?* (2014), at 149ff; also *Private Regulation and Enforcement in the EU* (M. de Cock Buning and L. Senden, eds., 2020).

and the better regulation initiative at the beginning of the twenty-first century, but also the more recent Europe 2020 flagship initiative. The accumulated technical expertise in private bodies and the adoption of a less top-down regulatory approach rendered their involvement inevitable. The contribution of the “depoliticization” desire and the spread of non-majoritarian regulatory agencies that characterized European integration was equally important.<sup>40</sup> In this landscape, private regulators have been to date among the most transformative and motivating forces of economic activity in Europe and an essential component of the EU legal order.<sup>41</sup>

The Court of Justice of the European Union (CJEU) also played an important role in the creation of a neoliberal normative model for the regulation of markets within the EU. Such a model was based on promoting competition and cross-border market liberalization, thereby giving greater leverage to markets to the detriment of States. The Court adopted a rather agnostic approach as to legal forms and regulatory institutions thereby eroding the role of the State as a monopoly supplier of regulation.<sup>42</sup> The next step taken by the Court would be to consider private conduct as a potential trigger of violation of the fundamental freedoms, allowing other private parties to challenge such conduct, coined as the infamous “horizontal direct effect” of the fundamental freedoms. This adoption of a functional approach to authority was decisive: while the Court’s stance strengthened the European rule of law, it also legitimized authority that was previously elusive and internal to the private parties at issue.

Enrolling private actors in the regulatory process has then been a manifestation of so-called Europeanization, a term aiming to capture the influence of EU law on national practice but also a method that aims to cater for the lack of accountability and legitimacy of European institutions, as it brings to the fore more participatory forms of governance and rule-making.<sup>43</sup> However, this process carries with it several risks as noted earlier; identifying and addressing such risks may become less straightforward once the activities by private actors transcend national borders.<sup>44</sup>

From European integration to domestic politics to the development of the global economy, technocracy has flourished within the ebb and flow of European politics, thereby shaping, harnessing, and monitoring economic behavior. In recent times, the intermingling of technocracy and politics<sup>45</sup> may have contributed to the rise of

<sup>40</sup> See M. Moran, The Rise of the Regulatory State, in *The Oxford Handbook of Business and Government* (D. Coen and W. Grant eds., 2010), 383, at 393.

<sup>41</sup> See H. Schepel, *The Constitution of Private Governance: Product Standards in the Regulation of Integrating Markets* (2005).

<sup>42</sup> Cf. G. Davies, Tough Love in the Internal Market, in *The Internal Market and the Future of European Integration: Essays in Honour of Laurence W. Gormley* (F. Amtenbrink et al. eds., 2019), at 15.

<sup>43</sup> Cf. S. Weatherill, *Law and Values in the European Union* (2016), at 105.

<sup>44</sup> See C. Joerges, Integration through De-legalisation (2008) 33 *European Law Review* 291.

<sup>45</sup> Cf. N. Fligstein and A. Stone Sweet, Constructing Politics and Markets: An Institutional Account of European Integration (2002) 107 *American Journal of Sociology* 1206.

populism and the antiestablishment movement.<sup>46</sup> In Europe and beyond, transnational (that is, increasingly international, but non-State-centered) private standard-setting became the norm in central areas of economic activity, including financial services and manufacturing. It is in these two areas of economic activity in particular that global interdependence increasingly manifests itself.

#### 1.2.4 Resilience and Crises

Exogenous shocks such as financial crises, technological disasters, or a pandemic increase the likelihood of non-incremental institutional change at the global level.<sup>47</sup> Every crisis brings with it urgent calls for a new regulatory paradigm in dealing with a certain area, be it food safety, technology and its use, finance, or accountancy services. Although the global financial crisis of 2008 has thrust policy-making failures into the limelight, such regulatory disasters have been diachronic, albeit with a varying degree of specific configuration, probability (ex ante) and casualties (ex post).<sup>48</sup>

The current scholarship appears to suggest that the State (previously a monopoly regulator) has been transformed into the orchestrator of private regulatory activity. In this setting, the State, via soft influence and other voluntary means, enlists the third party (here, a non-State body) through material or ideational support and nudges it toward governance goals that align to the State's.<sup>49</sup> Such enrollment may be beneficial for both sides: whereas the State economizes on resources, the private body at issue increases its legitimacy as the prime collaborator of the State in a given issue area.<sup>50</sup> Other theories focus on the delegation relationship, suggesting that agency-related challenges shall be resolved by the State as the last resort and ultimate commander; for instance, information asymmetries shall be addressed via transparency-related legislation or disclosure requirements for financial institutions.

If one attempts to apply these theories into practice, it would expect a new era of significant State intervention in case of misuse of delegation or deviation from the pursuit of public policy objectives, thereby upending conventional wisdom about self-regulation and private authority.<sup>51</sup> Arguably, the great return of the State has not really happened as of yet.<sup>52</sup>

<sup>46</sup> See I. Colantone and P. Stanig, The Surge of Economic Nationalism in Western Europe (2019) 33:4 *Journal of Economic Perspectives* 128.

<sup>47</sup> R. B. Collier and D. Collier, *Shaping the Political Arena: Critical Junctures, the Labor Movement and Regime Dynamics in Latin America* (1991).

<sup>48</sup> See C. Reinhart and K. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (2011).

<sup>49</sup> See K. Abbott, P. Genschel, D. Snidal, and B. Zangl (eds.), *International Organizations as Orchestrators* (2015).

<sup>50</sup> See J. Braithwaite and P. Drahos, *Global Business Regulation* (2000).

<sup>51</sup> The Growth of the State – Leviathan Stirs Again, *The Economist*, January 21, 2010.

<sup>52</sup> See C. Crouch, *The Strange Non-death of Neo-liberalism* (2011).

This reveals the need for more theoretical and empirical work on the mechanics of the transformative, motivating, adaptive, and reinvigorating forces of private economic regulation. We suggest that particular focus shall be given to finance and manufacturing, where striking levels of resilience with obvious consumer welfare implications are particularly discernible. Several scholars have previously pinpointed the various conflicts of interest that permeate private regulation, from credit rating agencies<sup>53</sup> to professional associations,<sup>54</sup> label accreditation bodies,<sup>55</sup> and ICT private standard-setters.<sup>56</sup> However, in these two areas, private collective action has dominated the field, taking a largely unchallenged pole position despite crisis events.

In addition, in both issue areas, private regulatory activity was translated into an important degree of constitutionalization (which suggests an effort to increase legitimacy but is also indicative of a higher degree of institutional complexity), although this characteristic did not render it crisis-proof. For these reasons, the two fields identified are significant test-beds for the theoretical background of institutional resilience and the role of crises described above.

In what follows, we briefly identify certain illustrative examples. Our modest intention is to instigate further research in the two important issue areas of private standard-setting through the conceptual lens proposed in this chapter, rather than exhaustively present them and confirm our hypotheses.

#### 1.2.4.1 Finance

Private rule-making in finance has flourished in the last three decades, notably after the creation of significant transnational organizations that were established to ensure that capital account liberalization and financial openness would not disturb global financial stability.<sup>57</sup> Finance is an important area for our purposes, as it not only exemplifies the problem of domestic enforcement in a global economic

<sup>53</sup> See A. Johnston, Corporate Governance Is the Problem, Not the Solution: A Critical Appraisal of the European Regulation on Credit Rating Agencies (2011) 11:2 *Journal of Corporate Law Studies* 395.

<sup>54</sup> See P. Delimatsis, The Future of Transnational Self-Regulation: Enforcement and Compliance in Professional Services (2017) 40:1 *Hastings International and Comparative Law Review* 1.

<sup>55</sup> See A. Marx et al. (eds.), *Private Standards and Global Governance: Economic, Legal and Political Perspectives* (2012).

<sup>56</sup> See P. Delimatsis, O. Kanevskaia, and Z. Verghese, Strategic Behavior in Standards Development Organizations in Times of Crisis: The Case of IEEE (2021) 29:1 *Texas Intellectual Property Law Journal* 127.

<sup>57</sup> See P-H. Verdier, The Political Economy of International Financial Regulation (2013) 88 *Indiana Law Journal* 1405.

environment but also the fluidity of authority, whereby public and private regulators and enforcers interact.<sup>58</sup>

In the aftermath of important privatization efforts in the 1980s, financialization became the hallmark of the neoliberal new world order.<sup>59</sup> Financial services regulation was routinely discussed in international fora where State regulators were absent or simple observers. New rules would be the outcome of joint legal engineering between bankers and independent national central banks in London, New York, or Basel. Many of these rules were initially established as voluntary benchmarks, indeed, as suggestions that a group of like-minded financiers brought forward.<sup>60</sup> However, they soon became either important benchmarks that companies or financial institutions could not ignore or even mandatory technical requirements referenced in State laws, thereby determining market access to global markets.<sup>61</sup>

Two examples from the world of finance are telling for the resilience of financial private rule-making despite crisis events; both relate to the mortgage markets: in the immediate aftermath of the subprime crisis and amidst protests against banking practices, only one small community bank, Abacus, with assets of \$282 million – that is a hundredth of 1 percent of the assets of Bank of America – was brought to trial for mortgage fraud in the United States. Securitization, created by lawyers<sup>62</sup> and once lauded as a source of resilience and stability for financial institutions, continues to be a problem that governments appear to be scratching nothing more than the surface by instituting simple, transparent, and standardized (STS) frameworks.<sup>63</sup>

The second example relates to the scandalous manipulation of the infamous London Interbank Offered Rate or “LIBOR,” the most important inter-bank interest rate globally that determines the price of multiple financial instruments and contracts, worth hundreds of trillions of dollars. LIBOR used to be administered by the British Bankers Association (BBA), calculated by Thomson Reuters based on data submitted by major London banks.<sup>64</sup> The BBA is a private organization. It is the leading trade association for the UK banking sector but has a global reach with 200 member banks established in over 50 countries. BBA represents over 80 percent of global systemically important banks. The use of LIBOR has been pervasive:

<sup>58</sup> See Pierre-Hugues Verdier’s contribution in this volume, “Resilience and Change in Private Standard-Setting: The Case of LIBOR” (Chapter 5).

<sup>59</sup> See G. Krippner, *Capitalizing on Crisis: The Political Origins of the Rise of Finance* (2011).

<sup>60</sup> See P. Tucker, *Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State* (2018).

<sup>61</sup> See P. Delimatsis, Financial Innovation and Prudential Regulation: The New Basel III Rules (2012) 46:6 *Journal of World Trade* 1309.

<sup>62</sup> See T. Frankel, The Law of Cross-Border Securitization: *Lex Juris* (2002) 12 *Duke Journal of Comparative and International Law* 475.

<sup>63</sup> See also S. Schwarcz, Securitization Ten Years after the Financial Crisis: An Overview (2018) 37 *Review of Banking and Financial Law* 757.

<sup>64</sup> See also Bangsters – How Britain’s Rate-Fixing Scandal Might Spread – and What to Do about It, *The Economist*, July 7, 2012. See also Pierre-Hugues Verdier’s contribution in this volume, “Resilience and Change in Private Standard-Setting: The Case of LIBOR” (Chapter 5).

mortgages, student loans, financial derivatives, and other financial products use LIBOR as a reference rate, suggesting that any interference with this benchmark can have negative financial consequences for millions of people.

Revelations about extensive rigging unleashed when evidence was adduced about banks falsely inflating or deflating their rates to profit from trades.<sup>65</sup> In the aftermath of the scandal, the Financial Services Authority recommended the transfer of LIBOR oversight and governance away from the BBA.<sup>66</sup> The Financial Conduct Authority (FCA), the offspring of the recent financial reform in the United Kingdom, guaranteed the overall success of the process of transferring the LIBOR administrator. The call for tender resulted in the transfer in 2013 of the LIBOR administration from BBA to the NYSE Euronext Rate Administration Ltd., a UK-based company licensed by the FCA.<sup>67</sup>

Thus, despite the admitted failure of LIBOR oversight by the BBA, which is a private body, LIBOR oversight was entrusted, against all odds, to another private body, NYSE Euronext. NYSE Euronext is a Delaware corporation, although the actual headquarters are in New York. NYSE Euronext was acquired by the Intercontinental Exchange (ICE), an energy-related commodities trading company, in 2012. The ICE Benchmark Administration (IBA) is currently the de facto administrator of LIBOR.<sup>68</sup> An oversight committee composed of nineteen members oversees IBA. Crucially, only three members of this committee are representatives of regulators: the Bank of England, the National Bank of Switzerland, and the US Federal Reserve. These three representatives merely have an observer status.

An inherent finance-related peculiarity for any regulator is that most financial information is produced privately. Consider, for instance, the mechanics of credit ratings. Credit rating agencies were heavily criticized in the aftermath of the financial crisis and regulations on both sides of the Atlantic attempted to tame conflicts of interest and other governance issues. That aside, however, any public intervention may be unable to introduce mechanisms to substitute for such information produced privately. Likewise, in the case of benchmarks, the participating financial institutions in the calculation of LIBOR possessed private (sometimes constructed) information, which served to standardize and synchronize the

<sup>65</sup> See *The Rotten Heart of Finance*, *The Economist*, July 7, 2012.

<sup>66</sup> Financial Services Authority (FSA), *The Wheatley Review of LIBOR: final report* (hereinafter the “Wheatley Review”), September 2012.

<sup>67</sup> See *The Hogg Tendering Advisory Committee Announces that NYSE Euronext Is to Be the New LIBOR administrator*, Press Release of July 9, 2013, [www.gov.uk/government/groups/hogg-tendering-committee-for-libor](http://www.gov.uk/government/groups/hogg-tendering-committee-for-libor).

<sup>68</sup> Recently, the UK Financial Conduct Authority announced that LIBOR will be replaced by the end of 2021 with a system of Overnight Financing, Risk-Free Rates which will be administered by the Bank of England. See also A. Schrimpf and V. Sushko, *Beyond LIBOR: A Primer on the New Reference Rates* (2019) *BIS Quarterly Review* 29; and *LIBOR Is Due to Die in 2021. Hurry up and Drop It, Say Regulators*, *The Economist*, June 8, 2019. However, new financial contracts maturing after the end of 2021 continue to reference LIBOR.

otherwise uncoordinated actions of public and private actors by offering a common code.<sup>69</sup> Despite their integrity and credibility being shaken during the crisis, the channels of financial information largely remain private.

Often, efforts for dominance and intensive lobbying by private bodies lead to strengthening of their regulatory power. For instance, the International Swaps and Derivatives Association (ISDA), a transnational coalition of banks with a crucial role in the over-the-counter (OTC) derivatives market, has managed to maintain and even strengthen the role that its successive Master Agreements have played in OTC transactions. One successful action was to codify the contractual language used by market actors into a Master Agreement (MA), thereby minimizing transaction costs.<sup>70</sup>

Another, more important, victory for ISDA was to successfully lobby for ISDA's netting rules so that ISDA members are able to net out their positions before the imposition of the judicial stay that would occur in ordinary bankruptcy proceedings. The justification given was that any other solution may increase systemic risk.<sup>71</sup> However, the financial crisis showed that such favouritism – unavailable to other creditors – weakens the incentives of derivatives counterparties for market discipline, as they do not need to cater to counterparty solvency, as the cases of AIG, Bear Sterns, and Lehman suggested.<sup>72</sup> Despite its role in the financial crisis, ISDA remained the private regulator par excellence in global derivatives contracts: it collaborated with the eighteen largest banks and the FSB for the adoption of the Resolution Stay Protocol, which is yet another indication of the regulatory role that ISDA plays in the derivatives market via its MA.

However, and crucially for our purposes, ISDA managed to remain relevant in the post-crisis landscape by adopting an adaptation strategy that focused on more intensive and swift standardization of key contractual terms for credit default swaps (CDS) and other trading terms for other types of products and processes such as interest rate swaps. Furthermore, through the creation of the CDS determination committees (DC), ISDA has also become the de facto arbiter of credit event questions globally. After the controversy this governance issue sparked, in 2018, ISDA transferred the role of credit derivatives DC secretary to DC administration services, Inc. (DCAS). However, although ISDA no longer participates in the DC

<sup>69</sup> See B. Carruthers, *Financialization and the Institutional Foundations of the New Capitalism* (2015) 13:2 *Socio-Economic Review* 379, at 386.

<sup>70</sup> See J. Braithwaite, *Standard Form Contracts as Transnational Law: Evidence from the Derivatives Markets* (2012) 75 *Modern Law Review* 779.

<sup>71</sup> See K. Borowicz, *Contracts as Regulation: The ISDA Master Agreement* (2021) 16:1 *Capital Markets Law Journal* 72, at 85.

<sup>72</sup> See M. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator* (2011) 63 *Stanford Law Review* 539.

process, DCAS is a Delaware-incorporated subsidiary of ISDA.<sup>73</sup> In addition, it appears that DCs continue favoring the seller side in the composition of committees, even if a supermajority is required.

If anything, the examples mentioned above exemplify the resilience of private regulatory bodies overtime and the existing difficulties for financial regulators, be it public- or private-driven, to move toward a paradigm shift despite the significant losses from the most recent financial crisis. The inherent complexity of a given industry certainly plays a crucial role in the type, timing, and determination of public intervention. Financial regulators must make regulatory and supervisory choices, as the “human factor” and personal judgment can have far-reaching repercussions on financial institutions. As regulators are risk-averse, complexity of a given industry can lead to limited intervention.

#### 1.2.4.2 Manufacturing

Similar instances can be traced in manufacturing, whereby the proliferation of private standard-setters has grown at a rapid pace in the last three decades. Product safety became the prerogative of private bodies (companies and associations thereof) that have proactively sought participation and influence in setting standards and confirming compliance therewith.<sup>74</sup> Some of these private bodies, such as the ISEAL Alliance, have built coalitions to also assume a meta-governance role in that they develop codes that govern the conduct of private standard-setters such as the Forest Stewardship Council (FSC) or the Marine Stewardship Council (MSC).<sup>75</sup>

Private meta-governance initiatives in areas such as fair labor (the Joint Initiative on Corporate Accountability and Workers’ Rights or JO-IN), sustainable tourism (the Global Sustainable Tourism Council or GSTC), or organic agriculture (the International Task Force on Harmonization and Equivalence in Organic Agriculture or ITF) and environmental labelling (ISEAL) have gained significant traction in the last two decades.<sup>76</sup> In practice, however, it is not always easy to distinguish the benign intentions from a strategy of growing dominance that allows occupying the relevant field of meta-governance.<sup>77</sup>

<sup>73</sup> See ISDA, ISDA Transfers Determinations Committees Secretary Role to New Independently Managed Company, October 12, 2018, [www.isda.org/a/P6dEE/DCAS-Appointed-DC-Secretary-final.pdf](http://www.isda.org/a/P6dEE/DCAS-Appointed-DC-Secretary-final.pdf).

<sup>74</sup> See J. Doh and T. Guay, Corporate Social Responsibility, Public Policy, and NGO Activism in Europe and the United States: An Institutional Stakeholder Perspective 43:1 (2006) *Journal of Management Studies* 47.

<sup>75</sup> See also S. Bernstein and H. van der Ven, Best Practices in Global Governance (2017) 43:3 *Review of International Studies* 534.

<sup>76</sup> See B. Derx and P. Glasbergen, Elaborating Global Private Meta-governance: An Inventory in the Realm of Voluntary Sustainability Standards (2014) 27 *Global Environmental Change* 41.

<sup>77</sup> See A. Loconto and E. Fouilleu, Politics of Private Regulation: ISEAL and the Shaping of Transnational Sustainability Governance (2014) 8 *Regulation and Governance* 166.

The proliferation of private schemes setting voluntary food safety standards is a recent phenomenon that can be traced back to previous food crises that grew out of consumer wariness of food quality and safety.<sup>78</sup> As quality and safety became more important and NGOs calling for increased responsibility and accountability by retailers became stronger and more vocal,<sup>79</sup> the emergence of such schemes that expand the scope of self-regulation was inevitable.<sup>80</sup> Additional reasons for such emergence were the increased awareness of the importance of brand protection, the need to minimize reputational costs,<sup>81</sup> the possibility for the creation of new markets for certified products,<sup>82</sup> the growing outsourcing and the global diffusion of the production by supply chains that call for better monitoring, and, a fortiori, standardization as a logical step once best practices at the upstream level that streamline processes have identified.

Voluntary sustainability standards (VSS) specify requirements that producers, traders, manufacturers, retailers, and, increasingly, service suppliers (such as the standards created by the Global Sustainable Tourism Council) may be asked to meet. Such standards may relate to a particular aspect of the production process or be otherwise concerned with various stages until the product reaches the consumer.<sup>83</sup>

VSS schemes differ on three dimensions: on governance (including the governance arrangements and actors involved, the regulatory mechanisms, and the strategies in place), on the content of standards (social and/or environmental), and the market coverage and potential for growth.<sup>84</sup> Such schemes have come to the forefront not only because of the breadth of areas that they cover (such as forest management, agriculture, or mining) and the novelty of the criteria they highlight (ranging from social issues to greenhouse gas emissions to the protection of biodiversity) but also because of their organizational resourcefulness and the institutional breakthroughs that they allegedly advance: bottom-up and inclusive, participatory platforms that sometimes bring together State actors, NGOs, trade

<sup>78</sup> See Havinga and Verbruggen's contribution in this volume, "The Evolution of the Global Food Safety Initiative: The Dynamics of the Legitimacy of a Transnational Private Rule-Maker" (Chapter 9).

<sup>79</sup> Cf. C. Rhodes, *Democratic Business Ethics: Volkswagen's Emissions Scandal and the Disruption of Corporate Sovereignty* (2016) 37:10 *Organization Studies* 1501, at 1513.

<sup>80</sup> See D. P. Baron, *Morally Motivated Self-Regulation* (2010) 100 *American Economic Review* 1299.

<sup>81</sup> See Y. Chen and X. Hua, *Competition, Product Safety, and Product Liability* (2017) 33:2 *Journal of Law, Economics and Organization* 237.

<sup>82</sup> See T. Bartley, *Certification as a Mode of Social Regulation*, in *Handbook on the Politics of Regulation* (D. Levi-Faur, ed., 2011), at 441.

<sup>83</sup> See P. Delimatsis, *Sustainable Standard-Setting, Climate Change and the TBT Agreement*, in *Research Handbook on Climate Change and Trade Law* (P. Delimatsis ed., 2016), 148, at 152.

<sup>84</sup> See E. Lambin and T. Thorlakson, *Sustainability Standards: Interactions between Private Actors, Civil Society, and Governments* (2018) 43 *Annual Review of Environment and Resources* 369.

unions, corporations, and private parties; experimental governance methods; benchmarking and continuous impact assessment reviews.

However, food-related crises were not prevented from occurring. From the mad-cow/BSE disease to the food and mouth disease to the horsemeat scandal, crises have shaped the VSS landscape and called for regular changes in the rules of the game. When reviewing more recent crises, the State may maintain oversight, but it remains unclear as to how much control and effective supervision the public authorities actually exercise, as the private regulatory landscape becomes increasingly convoluted and multifaceted (often with retailers playing a dubious role in production, standard-setting, and certification)<sup>85</sup> and by implication contests the State legitimacy and ability to regulate food safety.<sup>86</sup>

### 1.2.5 *The Role of Crises, Regulatory Disasters, and Tipping Points in Challenging Resilience*

Exogenous crises (but also internal heated situations such as intra-institutional conflicts or inter-institutional pluralism and ensuing competition)<sup>87</sup> that amount to tipping points are opportunities for organisms and systems to test and demonstrate their resilience. A crisis brings disorder with it: it is a moment of – often severe – mutation that leads to a rapid and intense oscillation of a given process or system. It typically is a moment at the interstices of regularity in that it follows the business-as-usual process and time period. Such a critical moment is expected, depending on its severity, to allow for recovery or the establishment of a new status quo. However, it may lead to disruption and the collapse of the system as well, depending on the system's resilience and internal dynamics.<sup>88</sup> For the final repercussions of such a critical moment, whether the crisis is endogenous or exogenous is critical. An endogenous critical juncture may follow from an exogenous episode that shakes and raises doubts about the fundamentals, object, and purpose of a given system due to new ideas, revelations about the functioning of the system in a previous period or other new information that calls for a reorientation of the system as a whole.<sup>89</sup>

A crisis is not necessarily a moment of decline for a particular system. Crises can be of a varying magnitude, thereby affecting the choice of the moment of

<sup>85</sup> See S. Henson and J. Humphrey, Private Standards in Global Agri-food Chains, in Marx et al., *supra* note 55, at 98.

<sup>86</sup> See T. Havinga et al. (eds.), *The Changing Landscape of Food Governance: Public and Private Encounters* (2015).

<sup>87</sup> See A. Marx and J. Wouters, Competition and Cooperation in the Market of Voluntary Sustainability Standards, in *The Law, Economics and Politics of International Standardization* (P. Delimatsis ed., 2015).

<sup>88</sup> See A. Rinscheid et al., Why Do Junctures Become Critical? Political Discourse, Agency, and Joint Belief Shifts in Comparative Perspective, in *Regulation and Governance* (2019).

<sup>89</sup> See B. Cashore et al., *Governing Through Markets: Forest Certification and the Emergence of Non-State Authority* (2004), 219ff.

intervention against the disturbance. In that case, internal dynamics and past behavior is a significant variable. Organization studies have identified several characteristics and safeguards that institutions may have to ensure the continuation and recovery of a given system in times of uncertainty. For instance, an important feature of such a system would be its intrinsic value for those attached to it. The more established a system is the lower transaction costs will be (e.g., those relating to enforcement of private norms).<sup>90</sup> The possibilities that members have to raise their voice and be part of a potential way out of the crisis is another significant variable.<sup>91</sup> Another feature relates to the cultural construction of the institutional preferences in a given system, which may allow taking advantage of an uncertain situation to promote reform and even normative change strategically.<sup>92</sup> Docility of the actors involved and the system as a whole is also an important trait allowing for the continuous fitness of a given system.<sup>93</sup>

Whereas actions, decisions, or omissions of individuals may play a decisive role for a crisis to occur, the organizational context where individuals and systems interact and affect each other is important.<sup>94</sup> Individual responsibility and behavioral bias may be significant in all parts of a failing regulatory chain.<sup>95</sup> However, focusing on individuals alone may lead to drawing only incomplete lessons from a crisis. Often, inadequate training and skills of senior staff; incentive-related challenges that do not align with the goals of the regulatory system at issue; poor leadership and oversight management; and lack of or inefficient internal communication and coordination channels within and among the relevant stakeholders in the system, including in the vertical axis regulator-regulatee, are common causes that lead to regulatory disasters.<sup>96</sup>

Regulatory disasters and crises are quite significant in understanding institutional dynamics and resilience-related strategies. Yet events of lower scale can also bring about disruptive changes within institutions in the medium run and therefore are worth examining if we are to describe a more comprehensive picture of the complex private standard-setting ecology in manufacturing and finance. Thus, depending on the institutional and organizational context, certain turning points within

<sup>90</sup> See A. Aviram, Forces Shaping the Evolution of Private Legal Systems, in *Law, Economics and Evolutionary Theory* (P. Zumbansen and G.-P. Calliess, eds., 2011), at 187.

<sup>91</sup> Cf. A. Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations and States* (1970).

<sup>92</sup> See G. Capoccia, Critical Junctures and Institutional Change, in *Advances in Comparative-Historical Analysis* (J. Mahoney and K. Thelen eds., 2015), at 147.

<sup>93</sup> See H. Simon, Organizations and Markets (1991) 5:2 *Journal of Economic Perspectives* 25, at 35.

<sup>94</sup> Also J. Reinecke et al., The Emergence of a Standards Market: Multiplicity of Sustainability in the Global Coffee Industry (1991) 33 *Organization Studies* 613 .

<sup>95</sup> Cf. R. Deeg and M. O'Sullivan, The Political Economy of Global Finance Capital (2009) 61:4 *World Politics* 731.

<sup>96</sup> See B. Hutter and S. Lloyd-Bostock, *Regulatory Crisis: Negotiating the Consequences of Risk, Disasters and Crises* (2017).

organizations are decisive moments to test adaptability and change, including regime interaction and disruptions due to State-driven actions.

### 1.3 FREE RIDING OF PRIVATE ORDERING

#### 1.3.1 *The Initial Rise to Authority*

The retrenchment of public authority in recent times is inextricably associated with the ideational continuity and appeal of neoliberalism. Free trade, competition, liberalization, and laissez-faire are essential features of a neoliberal dogma, mediated through law,<sup>97</sup> which increasingly limits the powers of the State. The latter may focus on greater social obligations, in line with the ordo-liberal ideas that strive for a strong role of the State in certain areas and otherwise a facilitative function when it comes to market governance. As described earlier, this results in the failure of the State to get a handle on private rule-making bodies, also due to intermittent crises and unpredictable episodes, which keep the public-driven entities busy with remedying the consequences of such events. Arguably, this creates ideal conditions for opportunism by private rule-making bodies. In practice, a crisis event allows private bodies to consolidate their autonomy and move forward with proactive usurpation of regulatory power.

Crises, unfortunate regulatory disasters, and broader institutional changes in a given organizational ecology are the triggering points that empower such private-driven forces or generate new ones, whereas existing checks and balances and a rigid approach toward the enforcement of rule of law fail their initial purpose. Such private-driven forces are virtually uncontrollable vis-à-vis their alleged principals, the States. The initial delegation mandate of powers or the enhanced oversight-related responsibilities that the State may have in theory are not sufficient to reverse such a situation. Potential cooperation with the State is not the outcome of orchestration by the State whereby governmental actors steer interactions to improve regulatory performance. After all, orchestration at the transnational level is difficult and costly;<sup>98</sup> rather, it arguably is yet another expression of a strategy to increase the *terrain occupé* of private authority. That moment of increasing authority would occur in the wake of intermittent crises when the possibility for opportunism is at its highest, as the State and public-driven entities are in their most vulnerable phase, busy with alleviating the negative impact of such crises.

<sup>97</sup> Cf. D. Singh Grewal and J. Purdy, Introduction: Law and Neoliberalism (2014) 77:4 *Law and Contemporary Problems* 1, at 9.

<sup>98</sup> B. Eberlein et al., Transnational Business Governance Interactions: Conceptualisation and Framework for Analysis (2014) 8:1 *Regulation and Governance* 1; also K. Abbott and D. Snidal, Strengthening International Regulation through Transnational New Governance: Overcoming the Orchestration Deficit (2009) 42:2 *Vanderbilt Journal of Transnational Law* 501.

When delegation of regulatory power backfires, the State takes most of the blame in the public opinion<sup>99</sup> and acts through extreme instruments such as bailouts or the enforcement of import bans. However, in the meantime, a peculiar organizational progeny evolves apace “in the shadow of the State,”<sup>100</sup> detached from political constraints, which is difficult for the State (in its capacity as principal) to reverse due to substantial network effects that accompany the creation of new governance structures, coordination challenges among their overseers (principals),<sup>101</sup> political interferences that call for a light-touch regulatory and supervisory approach,<sup>102</sup> or cognitive constraints that the regulators face and that lead them to inferences that are often skewed by systematic information processing biases.<sup>103</sup> The fact that such public regulatory and supervisory authorities enjoy policy and bureaucratic autonomy exacerbates such phenomena,<sup>104</sup> as such independence is contained by ideological, operational, and communicative factors.<sup>105</sup>

We term the underlying phenomenon “free riding of private ordering” and are interested in the evolutionary process that nourishes private authority in finance and manufacturing activities. Arguably, the use of this theoretical construct has sufficient analytical power to cast new light upon the social processes of authority transformation described in this chapter rather than being a mere example of a trend that it seeks to explain.

Free riding refers to an individual or group that benefits from group actions without bearing the corresponding share of the costs incurred by the group or without contributing any efforts or resources to the beneficial group actions. Typically, free riding is discussed in the political theory but also the trade policy literature to explain intrinsic motivations of political or social groups in influencing (trade) policy formulation.<sup>106</sup> The pioneering work in this field is by Mancur Olson, who revised the prevailing theory at the time, which would preach the virtues of very large groups, to instead suggest that small group size allows for better coordination and more optimal outcomes.<sup>107</sup>

<sup>99</sup> See J. Black, Guest Editorial: Rebuilding the Credibility of Markets and Regulators (2009) 3:1 *Law and Financial Markets Review* 1.

<sup>100</sup> Cf. T. Johnson, *Organizational Progeny: Why Governments Are Losing Control over the Proliferating Structures of Global Governance* (2014).

<sup>101</sup> See W. Mattli and J. Seddon, The Power of the Penholder: The Missing Politics in Global Regulatory Governance Analysis, in Delimatisis, *supra* note 87.

<sup>102</sup> See Hutter and Lloyd-Bostock, *supra* note 96, at 48ff.

<sup>103</sup> Cf. H. Simon, Rational Decision Making in Business Organizations (1979) 69:4 *American Economic Review* 493, at 503.

<sup>104</sup> See T. Bach et al., The Role of Agencies in Policy-Making (2012) 31:3 *Policy and Society* 183, at 185.

<sup>105</sup> See R. Baldwin and J. Black, Driving Priorities in Risk-Based Regulation: What’s the Problem? (2016) 43:4 *Journal of Law and Society* 565; also R. Baldwin and J. Black, Really Responsive Regulation (2008) 71:1 *Modern Law Review* 59.

<sup>106</sup> See P. Fontaine, Free Riding (2014) 36:3 *Journal of the History of Economic Thought* 359.

<sup>107</sup> See M. Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (1965).

The concept of free riding and its features relating to the enjoyment of the benefits of collective action without incurring the costs is particularly appealing for our purposes. We argue that, in the two areas of manufacturing and finance that we study, such free riding has been reactive for the most part. More specifically, it is the result of a process whereby, at the initial stage, private bodies respond favorably to calls for assistance conveyed by the State; these could entail, among others, the creation of hybrid partnerships or engaging in co-regulation.<sup>108</sup> One example among many is the private and hybrid European governance fervor that followed the European Commission's White Paper on Governance in 2001 – itself a reaction to a regulatory disaster at the time.

For our purposes and according to the vernacular we use here, free-riding has occurred in that private bodies benefited from increased legitimacy without however internalizing the costs of, first, acquiring this legitimacy and, second, regulatory disasters with substantial financial consequences for taxpayers. Typically, in such situations, the State will bear virtually all costs associated with this occurrence (a result of moral hazard that agency creates). This free-riding is even more astonishing if one considers that private bodies are also responsible – at least in part – for such catastrophic events.

### 1.3.2 *The Transition to Proactive Free-Riding*

As exogenous crises disturb the balance of distribution of authority to public and private actors, it appears that significant power shifts with potentially long-standing effects take place. We submit that, in recent times, we witness a transition from a phase of reactive free-riding, that is, a process where private bodies were offered authority by the State, toward a phase where private bodies actively seek and claim authority by a worn-out State that is occupied with addressing the effects of a crisis within the society. We argue that proactive free-riding has become a growing empirical phenomenon, which emerges out of several decades of bounded rationality, untested theories of uncontested technical superiority, the ideational flexibility of neoliberal rhetoric, and an increasingly globalized – and stateless – economic activity that domestic laws fail to regulate due to their non-extraterritorial application.

Proactive free riding is VEA's very manifestation at the transnational level. The success of proactive free riding derives from the core rule-making activities that such private bodies undertake, notably the continuous promulgation of voluntary standards that are promptly prepared, adopted, and diffused to preempt rules by public rule-making competitors and thus ensure increased authority and continuous

<sup>108</sup> See C. Chinkin, *Monism and Dualism: The Impact of Private Authority on the Dichotomy between National and International Law*, in *New Perspectives on the Divide between National and International Law* (J. Nijman and A. Nollkaemper eds., 2007), 134, at 135.

dominance.<sup>109</sup> Paradoxically enough, this phenomenon is particularly manifested and appears to grow stronger in the wake of regulatory failures and even disasters that raise doubts against the adequacy of the regulatory philosophy in a given field and the aptitude and fitness for purpose of private authority.<sup>110</sup> Against all odds, reclaiming authority in that material time comes at a relatively low cost.

More and more, private bodies take advantage of the procrastination of the State, grow stronger, and create norms more assertively in a strategic manner, overriding and even substituting for State powers. Regulatory disasters leave them intact. Rather, such crises constitute opportunities to accumulate wisdom and develop the capacity to expect the unexpected, absorb it, and grow.<sup>111</sup> Absent organizational hierarchies, formal accountability structures, scrutiny, pressure, and obligation, private bodies enhance their collective memory and identity and eventually use a critical shock to become grow stronger.<sup>112</sup>

Proactive free riding results from a lengthy process of volatility and shifting authority in complex regulatory areas where complex adaptive organizations are present. Private power accumulation is a continuous process that starts with the delegation (explicit or tacit) of power and thus the transfer of legitimacy to a private body. Thereon, through rule-making and intensive drafting of standards, the private body accumulates knowledge and builds trust toward its addressees as a reliable interlocutor.

Crucially, whereas the values and objectives of a complex adaptive system of this type are aligned, the characteristics and motivations of the group as a whole are not necessarily homogenous. Rather than this being an inhibitory factor, heterogeneity allows a particular group to overcome distress and adversity, thereby enhancing its resilience. In line with the discussion above relating to and the lessons drawn by the study of resilience of ecosystems,<sup>113</sup> diversity and heterogeneity are important traits for any group that aspires to harness its complexity for its benefit and establish solid foundations for exercising such authority over the long run.<sup>114</sup> Such traits appear to equip a given group with sufficient flexibility to be shielded from internal challenges

<sup>109</sup> Cf. A. H  ritier and S. Eckert, *New Modes of Governance in the Shadow of Hierarchy: Self-Regulation by Industry in Europe* (2008) 28 *Journal of Public Policy* 113.

<sup>110</sup> See also N. Arnold, *Accountability in Transnational Governance: The Partial Organization of Voluntary Sustainability Standards in Long-Term Account-Giving* (2022) 16 *Regulation and Governance* 375 .

<sup>111</sup> See C. Folke et al., *Adaptive Governance of Social-Ecological Systems* (2005) 30 *Annual Review of Environment and Resources* 441.

<sup>112</sup> See B. Goldstein (2009), *Resilience to Surprises through Communicative Planning* (2009) 14:2 *Ecology and Society* 33.

<sup>113</sup> See *supra* Section 1.2.1.

<sup>114</sup> See R. Axelrod and M. Cohen, *Harnessing Complexity: Organizational Implications of a Scientific Frontier* (2000), at 32ff.

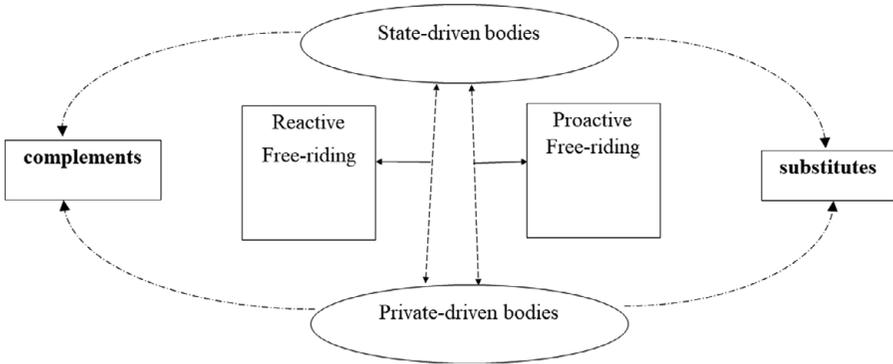


FIGURE 1.1. The evolution of free riding on authority

of due process and balance of interests and external attacks of arbitrariness and lack of legitimacy.<sup>115</sup>

In a given turning moment, the critical transition occurs: the private rule-making body overrides State power and reigns over a regulatory field, thereby slowly creating a new hierarchy; in other words, a different equilibrium and stable state of authority in a system.<sup>116</sup>

Much of proactive free riding is detached from any particular territory. Such free riding is led by powerful transnational elites that reinforce their independent norm-creating authority and expand the group of these norms' addressees,<sup>117</sup> gradually moving into the creation of legal authority and the production of authoritative collective action. In this emerging constellation, the State and the private bodies are no longer complements but rather substitutes (Figure 1.1).

How can one explain the mismatch between the expectations vis-à-vis public supervisory authorities and their lack of action? First, as we argued earlier, it appears that path dependencies and the irreversibility of delegation weakens their leverage. Supervisory authorities often make irrational decisions and adopt similarly irrational processes in their supervisory tasks. Additionally, cognitive biases developed during the interaction with the regulatee negatively affect the enforcement of existing laws and the appetite for decisive and timely action.<sup>118</sup> It has been argued that such inaction may be the result of cultural capture, that is, the interaction of supervisors with interest groups that increases industry influence through certain

<sup>115</sup> See C. Fiedler, M. Larrain, and J. Prüfer, Membership, Governance and Lobbying in Standard-Setting Organizations, TILEC Discussion Paper No. 2018-42.

<sup>116</sup> For a stylized illustration of institutional dynamics, see M. Janssen, The Future of Surprises, in Gunderson and Holling, *supra* note 7, 241, at 250.

<sup>117</sup> See C. Brölmann, Deterritorialization in International Law: Moving Away from the Divide Between National and International Law, in Nijman and Nollkaemper, *supra* note 108.

<sup>118</sup> C. Needham, Listening to Cassandra: The Difficulty of Recognizing Risks and Taking Action (2010) 78 *Fordham Law Review* 2347.

mechanisms.<sup>119</sup> Second, on the brink of a crisis, regulators and supervisors are occupied with reflecting on how to address and lessen the effects of the crisis. Eventually, stricter regulations that follow are frivolously enforced or the regulators have recourse to cosmetic changes, a type of indulgent regulation that allows for the maintenance of a system that turns random disruptive advantage to lasting advantage for private bodies.<sup>120</sup>

#### 1.4 AN EMERGING AGENDA TOWARD A NEW THEORY OF PRIVATE COLLECTIVE ACTION

Driven by globalization, the ambitious progeny of transnational VEA seems to be in need of harnessing in the sectors discussed above and under certain circumstances. To do so, revisiting existing theories of private collective action, including the concepts, actors, and processes of private governance in finance and manufacturing in the light of what preceded, offers an exciting vista of the contemporary regulatory landscape in finance and manufacturing. To do so, however, meticulous empirical, longitudinal studies are an important prerequisite for any intervention with an ecosystem that has shown its resilience in multiple occasions.<sup>121</sup> Such studies need to be balanced and contextualized; VEA encompasses not only the type of free riding described earlier but also some of the most creative forces of private nature and rule ingenuity (think of codes of conduct, bylaws, guidelines and recommendations, performance and design standards, and other persuasion-based instruments) for centuries now.

Based on insights by complexity and resilience theories as well as law and economics and behavioral sciences, our analysis above suggests that certain properties need to be present for a system to reach the tempting stage of proactive free riding: such private rule-making bodies must have at least four types of different capacities: to grow, develop, survive, and renew. Thus, the system at stake should display a certain level of internal energy for activation, that is, available resources, information (for instance, feedback loops), and entrepreneurial and innovative leadership to start growing and invest in structure-building, notably a constellation that is relatively straightforward (for the capacities of the system) to scale. The latter will be the result of experimentation, stable network connections, internal trust-building, and dependencies: all of them important ingredients for the system's stable foundations.

<sup>119</sup> See J. Kwak, Cultural Capture and the Financial Crisis, in *Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (D. Carpenter and D. Moss, eds., 2014), 71.

<sup>120</sup> See also J. Black, Paradoxes and Failures: The "New Governance" Techniques and the Financial Crisis (2012) 75:6 *Modern Law Review* 1037, at 1048.

<sup>121</sup> Cf. M. Jacobides, C. Cennamo, and A. Gawer, Towards a Theory of Ecosystems (2018) 39 *Strategic Management Journal* 2255.

Furthermore, in order to develop further, the system should be sufficiently self-organized to store information and capital that was acquired in the phase of growth with a view to strengthening its qualitative indicators. The system would also be keen to continued development, which may be crucial for persisting through a crisis event. In the wake of a crisis event (which is inevitable although its scale is unknown *ex ante*), a system would need to improvise to maintain vital functions. The previous accumulation of resources and innate characteristics of the system structure will allow for leadership (both existing and emergent) to invest effort for the survival of the system, leading to new knowledge, new forms of adaptive capacity, and, ultimately, resilience.

At this stage, modularity (the low levels of interdependence among components, which can still maintain a system's collective memory); diversity and heterogeneity (in function, in order to allow for leadership to emerge if needed, and in responses, to allow for short-notice varying action); as well as the ability for effective communication, information intermediation, and swift but robust decisions (such as new creation of standards and organizational rules) increases the likelihood of survival through crises. The subsequent renewal phase may lead to a reorientation of the system, drawing on lessons taken.<sup>122</sup>

It is exactly the moment that proactive free-riding may take place, which, however, depends on several variables, including the strength and determination of the private body when adopting new or modifying existing standards in an expedited manner as well as the strength and determination of the overseer to act upon a crisis event. In practice, one often gets the impression that rational public regulators, overseers, and even judges, constrained by political conditions and boundaries (including demands for swift action by an aroused public), massive uncertainty, bounded rationality and path dependencies, but also awareness of their own ignorance, hand the reins to private parties and hope for the best too often too easily.

Admittedly, the complexity of the two issue areas of finance and product safety we identified earlier does not help paint a candid image of the internal dynamics and the relational fabric of social interactions among the different actors and stakeholders. Both modern finance and food or technological product safety entail some of the most complex dynamics, structures and patterns, and interactive processes. However, whereas private regulatory entities, many times acting in uncharted waters full of uncertainty and risks, fail in their mission, the State and its public agents will rarely exercise coercion *vis-à-vis* private regulatory bodies and even less reclaim authority to protect the public interest.<sup>123</sup> Sometimes, these bodies will struggle to survive and eventually may disappear. However, if such bodies dissolve or lose part of their authority, it is not because of State intervention but rather

<sup>122</sup> See Fath et al., *supra* note 12.

<sup>123</sup> See M. Feintuck, *Regulatory Rationales beyond the Economic: In Search of the Public Interest*, in Baldwin et al. *supra* note 29.

because they lose in relevance, as new, typically private-driven, contesters emerge, many times internally, with a view to regaining strength.<sup>124</sup>

The new type of VEA that we witness is quite anarchic as much as it is conservative. Just like every evolving entity, its current preferences, structures, mechanics, and methods bear similarities with previous iterations of rule-making activity. However, it also displays innovative characteristics that nourish its resilience and dominance. Low connectivity, high diversity, and possibilities for collaborative learning, as well as strategies of system innovation, smoothed transition, and identity building are important attributes that render private regulatory bodies stable.<sup>125</sup>

The standard-setting activities of these bodies active in the areas of manufacturing and finance are directly related to crises of varying scales that may even lead to regulatory disasters. Safety and innovation in technology-laden products or financial instruments heavily rely on the smooth functioning and stability of such bodies. Arguably, whereas delegation of power contributes to their empowerment, crises allow them to capitalize on certain tipping points that strengthen their status and influence. While existing literature describes the dynamics among standard-setters, it fails to shed light on the possibility for a commonality of mind among actors in a given private regulatory body (or a group thereof) to exploit the weaknesses of the State at times of crisis. Yet it is quite striking that, in these complex ecosystems, periods of crisis were almost immediately followed by intensive, fast periods of expedited standard-setting by private bodies, thereby enlarging the breadth and reach of their output, which would typically come in the form of standards. This new form of antagonistic private ordering deserves closer attention and research, as it may allow for opening the black box of economic governance and the evolution of contemporary private collective action.

## 1.5 CONCLUSION

In what preceded, this contribution offered the contours of a new conceptualization of the resilience of private authority, particularly in the aftermath of crises. It argued that existing theories of delegation, orchestration, and private collective action fail to explain satisfactorily the survival of certain private regulatory bodies, notably in the fields of finance and product safety. Rather, the resilience of such bodies needs an alternative explanation that portrays more accurately the innate characteristics, mechanics, and dynamics of certain private bodies active in the regulation and governance of economic activity. In stressing the centrality of the role, the effects of,

<sup>124</sup> Cf. J. Morse and R. Keohane, Contested multilateralism (2014) 9 *Review of International Organizations* 385.

<sup>125</sup> Cf. A. Haldane and R. May, Systemic Risk in Banking Ecosystems (2011) 469 *Nature* 351; and C. Freeman and C. Perez, Structural Crisis of Adjustment, Business Cycles and Investment Behaviour, in *Technical Change and Economic Theory* (G. Dosi et al. eds., 1988).

and the reactions to crisis events, that is, tipping points that call for a paradigm shift in regulatory patterns and *modi operandi*, the above analysis aspires to recalibrate the study of private governance. The empirical study of crisis events, we argue, is key in understanding the resilience of private governance and may allow unraveling the reasons for an ever-increasing transfer of power to private regulatory bodies. Crucially, the chapter described the contours of a new theory of proactive free riding of private regulatory forces that use regulatory episodes as catalysts for gaining more regulatory power to the detriment of the State.

We hypothesized that the secret for the success of such free riding activity lies at two core features of resilient systems: the first relates to heterogeneity in membership, sources, and crisis responses – conflicting interests that manage to identify common denominators that allow things to keep going for the common (private) good; and the second relates to the core standard-setting activities of such private bodies and the rapidity with which such activities occur in the wake of a regulatory catastrophe in the field of finance or manufacturing and product safety. In that respect, we introduced VEA, yet another strategic effort by private bodies to maintain and increase the *terrain occupé* of their regulatory power by means of promulgation of voluntary but forceful standards.