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## Self-Regulation v. State Regulation?

### I. Introduction

We follow the rules not simply for the sake of doing so. Rather the fear of consequences for violations and the benefits of compliance constitute the main motives to behave within the scope of law. Likewise, the benefits of over-observance bring compliance even higher. To do so one has to regulate himself on his own (self-regulation) either independently or together with other members of the market or profession.

Self-regulation might be a cost-effective “addition” to the state regulation. But it inherently bears justifiable concerns. For example, the risk of collaboration (cheating) through secret arrangements among some but not all actors of private regulation.

That being said, another core principle of self-regulation might yet turn it into a working mechanism. Under self-regulation the regulators and regulatees are the same: those who observe the rules also establish them. Besides, they monitor each other’s observance. Therefore, observance is likely to be effective, because everyone is interested in assuring compliance by his competitors.

Mechanisms against cheating constitute one of the main issues to be resolved while constructing a successful self-regulatory regime. Inherently these potential mechanisms are a big dilemma, because the choice should be made between either organized monitoring structures, or relying on internal dynamics of self-regulation. Choosing the first option deprives the system of its self-regulatory nature transforming it into a state-style regulation. In turn it deprives actors, state, and society from the benefits of self-regulation. The second option is however very vague and unpredictable exactly because there is no direct regulation in its traditional meaning. The second option also constitutes the scope of this article.

An example of anti-cheating mechanisms failure is the arrangements of construction companies in Netherlands from the 1950s to the 1990s. After the Dutch government implemented self-regulation, nationwide private self-regulatory organizations (SROs) were founded for this purpose.<sup>1</sup> However, this turned into companies arranging the collusively cheapest bid before the tender. Afterwards the winner compensated the other companies, members of its SRO.

Some suggest this self-regulatory regime failed because it was implemented by government “from the top”. Since the industry itself was not yet ready for self-regulation, a cheating gap was formed between regulatory expectations and real practice. Another possible reason might be the lack of transparency, partly due to the informal rule “Don’t talk to strangers.”<sup>2</sup> All these internal dynamics problems are fair for any self-regulatory system.

Accordingly this article concentrates on internal dynamics of self-regulation while they shape the interplay between the state and self-regulation. The first part of the article focuses on understanding of self-regulation as a legal concept. Then the objective in focus is the scope of self-regulation: delimitation of self- and state regulation, range of legal relationships covered by self-regulation, application of the concept to practice and arising problems, legal forms of self-regulation, and, finally, the structure of self-regulatory regime’s bodies.

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<sup>1</sup> See MARC HERTOIGH, SELF-REGULATION AND THE FUTURE OF THE REGULATORY STATE: INTERNATIONAL AND INTERDISCIPLINARY PERSPECTIVES (Univ. of Groningen) (2009) 37, 39.

<sup>2</sup> for rule details see MARC HERTOIGH, SELF-REGULATION AND THE FUTURE OF THE REGULATORY STATE: INTERNATIONAL AND INTERDISCIPLINARY PERSPECTIVES (Univ. of Groningen) (2009) 47.

The second part discusses the internal dynamics of self-regulatory process. It first scrutinizes the factors and restraints of self-regulation. Then the attention is drawn to conflicts of interests among private actors within the same market/industry who attempt to regulate themselves mutually. Lastly the transparency of internal mechanisms of self-regulation is brought out.

The third part summarizes the research bringing both previous parts together in context of the broader picture of the state regulation. It first highlights the areas for successful self-regulation, and then talks about some other factors of success. A brief summary and a short description of further research questions follow.<sup>3</sup>

## II. The Phenomenon of self-regulation

Depending on philosophical standpoint, self-regulation might be seen as a “default setting” pre-existing the state. From this perspective the chaos in the universe gets organized through its own internal energy and dynamics.<sup>4</sup> A state (including its laws and regulations) is nothing more than a unit within this chain of self-regulation. Yet from the perspective of a narrow understanding self-regulation is fully encompassed by state regulation. In this case self-regulation is generously allowed by the state through private autonomy, freedom of contract, etc.

Self-regulation might also be seen as an interscientific issue. A market economy according to Adam Smith is based on self-regulation; psychologists study how an individual takes decisions self-regulating his private and professional life; physics explains how molecules that move chaotically can simultaneously self-regulate themselves. The list of scientific disciplines, not to mention game strategies that use self-regulation as their methodology are only limited by their understanding what self-regulation is.<sup>5</sup> One may even go further and transplant one science’s knowledge about self-regulation into another.<sup>6</sup>

A full understanding of the term “self-regulation,” therefore, requires an interdisciplinary approach. But let us focus on its legal definition.

### 1. Definition

In practical terms self-regulation refers to the establishment and enforcement of rules by private actors. Their associations might be (statutory) nominated “self-regulatory organizations”<sup>7</sup>

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<sup>3</sup> While analyzing self-regulation, it is reasonably suggested to focus on six questions: Who regulates? Who is regulated? What is being regulated? Why? What is the purpose? How? See DOREEN SCHOLZ, SELBST- UND FREMDREGULIERUNG VON WERTPAPIERBÖRSEN [Self- and foreign-regulation of stock exchanges] (2009), 9.

<sup>4</sup> See MIKTAD TIGREK, SELBSTORGANISATION ALS NATURWISSENSCHAFTLICHER BEGRIFF UND ALS BEGRIFF DER SOZIOLOGIE: DIE UNTERSUCHUNG EINES INTERDISZIPLINÄREN ANSATZES UND SEINER FOLGEN (Lit) (1998).

<sup>5</sup> Scholars see game theory as a tool to predict human behavior. For example, it shows why two individuals might not cooperate, even if it is in their best interests to do so (See the prisoner’s dilemma).

<sup>6</sup> However, transplantation of one science’s methods into another does not necessarily work well. For example, it is mathematically proven that “Achilles will never catch up with the tortoise, if it starts one second earlier”, because the quickest runner can never overtake the slowest: The pursuer must first reach the point where the pursued started, but while he does so the pursued keeps moving forward so that the slower always holds a lead. Yet according to common sense a quicker runner defeats the slower one. Therefore, using other sciences (psychology, synergy, mathematics, etc.) to resolve legal issues of self-regulation might be as misleading as helpful.

<sup>7</sup> Despite the similarity in names, SRO is not always a logical extension of self-regulation. Some statutory SROs have little to do with principles of successful self-regulation discussed in this article. There is also a difference in understanding of SROs in common law and civil code countries. Specifically, in the US SROs exist on the securities market to prevent fraud and to provide other investor protections. Self-regulation is however present in the US and in

(SRO). However, there are so many different forms of self-regulation that it is hardly possible to develop a universally applicable definition.

In an **Australian** study self-regulation has been identified as part of a broader concept of responsive regulation.<sup>8</sup> Specifically it is “a form of legal control [which assumes] that regulatory goals might be most efficiently achieved by [allowing] local leeway to decide on how in detail to arrange their practices to meet those broad goals [...In this way] the autonomy and special knowledge of the targets will be engaged in creating the most practicable and efficient methods for meeting the regulatory goals.”<sup>9</sup>

The cited approach of statutory setting a goal and giving local leeway as to details of its achieving is widely supported. Yet there are other definitions of self-regulation in that are worth mentioning for comparative reasons:

- **(Russia)** “Independent activity on own initiative which is exerted by [actors] with the same business or professional interests and the content of which is the development and establishment of standards and rules for such activity, and the monitoring of compliance with these standards and rules.”<sup>10</sup>
- **(UK)** Individuals or organizations act collectively to regulate their conduct.<sup>11</sup>
- **(US)** Regime of collective rulemaking; a regulatory process whereby an industry-level (as opposed to a governmental or firm-level) organization sets rules and standards governing the behavior of the members of that industry and monitors and enforces compliance with the rules. As a matter of principle, this concept of industry self-regulation is not inherently incompatible with some form of direct government regulation.<sup>12</sup>

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the UK in many related fields (banking, insurance, take-overs, etc.) and professions (legal, medical, etc.). In Western Europe there are no statutory SROs. In CIS countries the scope of SRO activities is much broader than in the US. Here an SRO is a non-profit organization created for the purpose of self-regulation; it is based on membership, bringing together entrepreneurs united by production of goods, works, services, or market; it can also combine entities of the type of professional activity. (*See the Model Law of CIS on SRO*). The securities SROs here exist in Russia, Ukraine, Kazakhstan, and Moldova. In Moldova SROs represent joint stock companies, securities market participants, brokers, dealers and trust companies. In Ukraine and Russia SROs exist in audit, insurance, mediation, tourism, credit cooperation, evaluators, and private pension funds. In addition to these fields, Russia hosts SRO in advertisement, construction, town planning, and other fields. Membership in some of them (securities SROs and – in Russia only – construction SROs) is a prerequisite to conduct business activities. SROs in CIS countries mostly deliver technical, ethical, and other standards mandatory for their members. According to the Russian Law “On self-regulatory organizations” a SRO may prosecute its members for violation of both rules/technical standards of this SRO and for violating the state law. This duplicates the powers of law enforcement agencies and courts, and given mandatory membership in some SROs it opens the door to frank abuse.

In brief, statutory SROs in all mentioned countries basically function between the government and private sector to execute duties that have been delegated to them.

<sup>8</sup> Responsive regulation basically means that governments should be responsive to the conduct of those they seek to regulate in deciding if a more or less interventionist response is needed. *See MAKING GLOBAL SELF-REGULATION EFFECTIVE IN DEVELOPING COUNTRIES* (Oxford University Press) (2007), 153.

<sup>9</sup> ARIE FREIBERG, *THE TOOLS OF REGULATION* (Federation Press) (2010), 28-29.

<sup>10</sup> Federal’nyi Zakon RF o Samoreguliruemykh Organizacijach [Federal Law of the Russian Federation on Self-regulatory organizations] *See* <http://base.garant.ru/12157433/#2>. According to Art. 2 self-regulation is exercised only by SRO.

<sup>11</sup> *See* COLLIN SCOTT ET ALL, *REFRAMING SELF-REGULATION IN EUROPEAN PRIVATE LAW* (Kluwer Law International) ((Fabrizio Cafaggi et al. eds., 2006), 132 (citing Julia Black).

<sup>12</sup> Saule Omarova *Wall Street As Community Of Fate: Toward Financial Industry Self-Regulation*, 159 *U. Pa. L. Rev.* 411, 426.

- **(Italy)** A form of regulation by a profession, trade or industry which purports to set rules for the behavior of its members. A self-regulatory scheme may be set up by the organization(s) in one particular trade or profession.<sup>13</sup>
- **(Canada)** The role of SROs is to balance the interest of the public in diligently administered regulation with the interest of the public in affordable services from professionals who can apply their individual knowledge, skill and judgment to best serve their clients.<sup>14</sup>

All these definitions do not contradict each other. Rather they focus on different features of self-regulation.

## 2. Some features of self-regulation

Notably, all the definitions above highlight that the source of self-regulation is private actors.

The private actors are supposed to strive voluntarily to cooperate. One can have a long debate about to what extent the voluntary incentive to cooperate and thus self-restrict is truly voluntary. For our purposes cooperation is voluntary if there is no direct command from the government. Willingness of the industry to self-regulate is also one of the key predispositions for successful self-regulation, as we shall see later.

Another distinct feature of self-regulation is that it is different from regulation where a single member of a group makes or enforces rules applicable to the rest of that group.<sup>15</sup> Instead, under self-regulatory regimes all regulatees take part in implementing rules. This raises questions as to the structure of the self-regulatory model, discussed in more detail in chapter III.

An important distinction of self-regulation is also its purpose: it is deemed to serve the “public interest”. For this reason scholars sometimes tie the definition of self-regulation to ideas of moral obligations. Yet moral obligations and voluntarism are justifiably the most critical points of self-regulation. It would be wrong to limit self-regulation to these categories.<sup>16</sup>

Self-regulation offers a number of valuable benefits to private actors, such as competitive advantages, reduction of commercial and other risks, devaluation of government interference, and more predictability compared to government regulation. Industry participants balance all these benefits against the cost of the duty to self-regulate and self-restrict in the public interest. Whatever the public interest is, it means more than simply allowing leeway to discriminate among competitors solely for one’s own commercial benefit, like to create a cartel or criminal organization. Albeit the later examples are to some extent also “self-regulation” since they connote private rule-based regulation of one’s self, this is not self-regulation in the meaning of

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<sup>13</sup> See EWOUT HONDIUS ET ALL, REFRAMING SELF-REGULATION IN EUROPEAN PRIVATE LAW (Kluwer Law International) (Fabrizio Cafaggi et al. eds., 2006), 243.

<sup>14</sup> William Lahey *Self-Regulation and Unification Discussions in Canada’s Accounting Profession*, May 2012, [http://unification.cpacanada.ca/wp-content/uploads/2012/05/Self-Regulation-and-Unification-Discussions-Final\\_title.pdf](http://unification.cpacanada.ca/wp-content/uploads/2012/05/Self-Regulation-and-Unification-Discussions-Final_title.pdf)

<sup>15</sup> See Saule Omarova *Rethinking The Future Of Self-Regulation In The Financial Industry*, 35 Brooklyn J. Int’l L. 665, 698.

<sup>16</sup> GABRIELE ROBKOPF, SELBSTREGULIERUNG VON UBERNAHMEANGEBOTEN IN GROBBRITANNIEN: DER CITY CODE ON TAKEOVERS AND MERGERS UND DIE DREIZEHENTE GESELLSCHAFTSRECHTLICHE EG-RICHTLINIE (Duncker & Humblot) (2000), 37.

this article, or in general parlance. It is the purpose of serving a socially valuable goal that makes “true” self-regulation legally protected and endorsed.<sup>17</sup>

Now the critical point here is goal setting. Assuming a self-regulatory system proves able to enforce its goal (due to its internal dynamics and societal and governmental pressure from the outside, both described in the next chapter), there is always a question of selecting those goals. Only public interest oriented goals turn private rule making into legally protected self-regulation. However, in many instances it is hard to lay out clearly what the best public interest is.

This being the case, it is probably true that self-regulation often empowers considerably more knowledge and flexibility than governmental regulation. Yet being more knowledgeable and skilled in implementing rules (goals) does not necessarily mean more knowledgeable and skilled in selecting those rules (goals). In practical terms this means that even when industry is willing to self-regulate voluntarily for the public benefit, it might be unable to do so.

Can stronger governmental control over rule making overcome this obstacle? Probably not. First of all, a “perfect” standard is unattainable, *inter alia* for the rapid changeability of the industry and its demands. Besides, government’s controlling authority might be less knowledgeable about the industry’s needs and less familiar with the daily challenges facing the industry simply because these issues are complicated. Finally, governmental control would erase the distinction between self- and state regulation and thus reduce the benefit gained by self-regulation as an alternative.

To meet these challenges, government must remain in the background. In the meanwhile, some leeway must be left for the industry to act in its own interest. This is the incentive and *benefit* that induces private actors to restrain some of their other interests in order to serve the public goal (*cost*). Since laws are being violated, governmental regulation is insufficient. Therefore, if government gives the industry some leeway to act in its own interest (which would have been a minor violation had the law to this point existed) to a limited extent in exchange for a promise not to violate more severe rules otherwise in existence or even to contribute above their requirements. Once industry breaches this promise, the government introduces its sanctions.

This focus on regulatory control “on the exit” rather than on the process is supposed to solve the goal-setting problem.

The intensity of governmental involvement into self-regulation signifies the wide range of regulatory systems. That is why self-regulation sometimes is defined through comparing it to and related or overlapping concepts, such as “command-control system”, “deregulation”, “co-regulation” (represents a greater level of governmental intervention in comparison to self-regulation<sup>18</sup>), “foreign regulation”, “governance”, “private autonomy”, “soft law”, “private regulation”, different public-private arrangements, and others.<sup>19</sup> However, as in all other legal questions it is hardly possible to draw a firm line between legal categories, because they usually are strongly connected, interchanging, and yet ambiguous. These attempts to compare self-regulation to neighboring terms are not very helpful in understanding the nature of self-regulation. Instead of depicting what is not self-regulation, it makes more sense to understand

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<sup>17</sup> There is also a considerable scientific debate about the ethical incentives that are supposed to induce the industry members to self-regulate in public interest manner. The ethical and moral drivers of self-regulation are not presented in this article, because of their little persuasive and influential value.

<sup>18</sup> See ARIE FREIBERG, *THE TOOLS OF REGULATION* (Federation Press) (2010), 48.

<sup>19</sup> See Saule Omarova *Wall Street As Community Of Fate: Toward Financial Industry Self-Regulation*, 159 *U. Pa. L. Rev.* 411, 425; PETRA BUCK-HEEB & ANDREAS DIECKMANN, *SELBSTREGULIERUNG IM PRIVATRECHT* (Mohr Siebeck) (2010).

self-regulation by concentrating on its internal features, structure, principles and other internal characteristics.

### 3. Scope of self-regulation

#### a) Self-regulation v. state powers

Self-regulation comes into play mostly when deregulation occurs. However, in our opinion it does not amount to deregulation. Instead, it includes much more than simply reducing governmental intervention: activation of private activity and engagement, private rule making, or even a whole separate regulatory regime, to name a few. Sometimes, though, self-regulation is seen as “the absence of direct governmental intervention”, “the “default” setting [...] within a broader legal, political and economic framework provided by the state.”<sup>20</sup>

It is hard to say whether self-regulation is in fact the default setting that encompasses governmental regulation as one of its forms or rather is an extension of governmental regulation. The answer to this question partly depends on one’s school of legal philosophy.

One of the possible approaches here is the **New Governance** paradigm. It studies “how regulatory decisions are made [...] and how both power and responsibility are allocated among different public and private actors [... One of the key insights of this school is that] regulation is a multi-layered process that takes place on many different levels and in many different fora.”<sup>21</sup>

Approaching this question from the perspective of the continental law system, a German study concludes that public and private regulatory systems are “**neither opposites, nor alternatives** to each other.” Instead, while interplaying, they compensate each other. Their differences stand mainly in terms of the degree of personal responsibility and private freedom given to private actors.<sup>22</sup>

The third way of looking at these instances is distinguishing self- and state regulation as **two different regulatory regimes**. Taking bar associations as an example, we see how American lawyers developed their own system of rules (Model Rules of Professional Conduct and internal rules of every bar association). Lawyers voluntarily subject themselves to these rules made by them and which they supervise and amend. Any MPRE violation is investigated, “judged” and sanctioned by authorized members of this private actors association. Yet this system of self-regulation is only possible and enforceable within the environment of state regulation and enforcement.

This and numerous other examples of interaction of state and self-regulation lead to the question of the legitimacy of self-regulation and the source of its power. Regardless of one’s philosophical view on the default setting of self-regulation, in legal terms all extensions of self-regulation legitimately exist as the state law allows them. Self-regulation stems from the delegation of state powers (concession of public service, regulation by the private sector) or recognition of private autonomy.<sup>23</sup> Other ways for private rules to acquire legally binding power might be incorporation of a private rule into a legal norm (for example, when a legislator enforces by provision of a law a privately developed rule), enforcement of contract, or referral to a private rule (like to Model Rules of Professional Conduct).

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<sup>20</sup> ARIE FREIBERG, *THE TOOLS OF REGULATION* (Federation Press) (2010), 48.

<sup>21</sup> Saule Omarova *Rethinking The Future Of Self-Regulation In The Financial Industry*, 35 Brooklyn J. Int'l L. 665, 673.

<sup>22</sup> WAHLERS CHRISTINE, *SELBSTREGULIERUNG AM BEISPIEL DES KAPITALMARKTRECHTS: VORTEILE, NACHTEILE, OPTIMIERUNG* (V & R unipress) (2011), 40-41.

<sup>23</sup> See ALBRECHT LANGHART, *Id.*, 97.

This also illustrates the need of the state in self-regulation. It is impossible for the state to regulate every single relationship of every single private actor. States “employ” self-regulation as their **agents** to be where states have no time or capacity to reach.

But even granting legal authority to privately made rules does not make those rules enforceable on their own. Private actors always face the problem of not being powerful enough to enforce legally binding rules fully. Even if a self-regulatory structure employs an executive and dispute negotiation bodies, it still must rely on the enforcement power of the state.

For example, entering any SRO or other self-regulatory association (corporate law) connotes signing several arrangements, like membership, confidentiality, and other agreements (contract and corporate law) and assuming the burden to be subjected to internal rules (legal duty, enforced through the judicial and executive branches).<sup>24</sup>

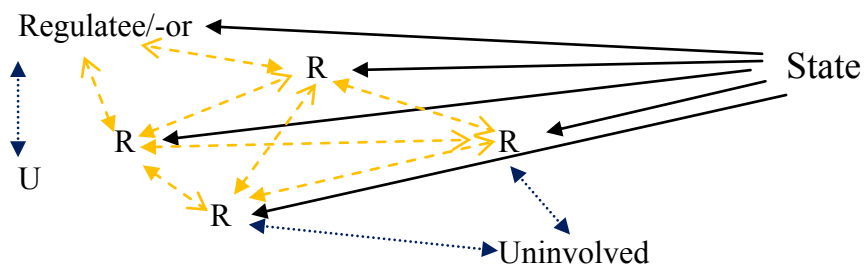
As we see, state and self-regulation benefit from and use each other. At the same time, neither of them can accomplish its goals relying fully and only on itself.

### b) What is being self-regulated

Generally speaking any legal relationship arising from the private legal activity within the legal framework constitutes self-regulation. In this broad vision writing a will or any purchase-sale agreement might be regarded as self-regulation.

However, for this research the meaning of self-regulation as a complete system described below is the issue.

Self-regulation encompasses far more than (a) the direct regulator-regulatee relationships (yellow arrows on picture 1). It also involves (b) relationships between regulatees/-ors and the state (black), and (c) between regulatees/-ors and those who are (initially unintended, by chance) involved for non-complying behavior (blue).



Pic. 1. Relationships covered by self-regulation

Another perspective to look at the relationships covered by the scope of self-regulation is the number of persons involved at the same time into a separate self-regulatory activity. From this point of view there are three levels of self-regulation:

- On the individual level every person freely regulates her behavior on her own to the extent possible given legally and socially established frames and other pressures. Yet the focus of this research is on dynamics of self-regulation by several individuals.
- The group level of self-regulation encompasses diverse individuals. It might be a firm or an organization, an industry, or a profession. Basically, every kind of union with a shared

<sup>24</sup>for more details about enforcement of private rules see Ada Kachan *Selbstregulierungsorganisationen in Russland und in der Ukraine* [Self-Regulatory Organizations in Russia and in Ukraine], 2013 *Wirtschaft und Recht in Osteuropa* [WiRO] 295, 297-298.



interest or cause exercises self-regulation to some degree to achieve their common interest. The law of Russia on “Self-regulatory Organizations” allows members of different professions, industries or markets to cooperate in the same self-regulatory system if they have the same interest. For the purposes of this research mostly the profession-wide and industry-wide self-regulation is regarded.

- It might make sense to talk about the global level of self-regulation, such as self-regulation within a whole state or supranational self-regulation involving several smaller (regional) systems of self-regulation. Albeit this is very similar to group self-regulation in terms of internal dynamics, there might be, however, differences in structure, external, and additional factors of influence.

#### 4. Application of self-regulation

Self-regulation solicited by the state (self-regulation “from the top”) is considered to be less effective than self-regulation initiated by private actors (“from the bottom”) who are willing to self-regulate themselves. Like the Dutch construction industry example shows, industry that is granted the privilege of self-regulation uses it fully for its own benefit.

Given all the risks of abuse and noncompliance that self-regulation bears, it is crucially important to give a thoughtful deliberation to areas and conditions when and under which circumstances it should apply.

Self-regulation under an Australian study is recommended where:

- “there is no strong public interest concern, in particular, no major public health and safety concern;
- the problem is a low-risk event, of low impact or significance; and
- the problem can be fixed by the market itself. For example, there may be an incentive for individuals and groups to develop and comply with self-regulatory arrangements (industry survival, market advantage).”<sup>25</sup>

This approach provides conclusions contradictory towards practice of self-regulation in the US, Russia, and Ukraine. In these countries self-regulation takes place on the financial markets in the first place (high risk and significance). There also are SROs of dentists and other medical professions (public health concern). The construction and building SROs in Russia even license private firms to allow them to deal with high-risk activities with public safety concern.<sup>26</sup>

As to question under which circumstances self-regulation should apply we need to find out the patterns and tendencies of conduct of participants of self-regulation.

There are four generic strategic positions that private actors might take within self-regulatory system (or within attempts to create such a system):<sup>27</sup>

	Do not participate	Participate in self-regulation
Self-regulate	Loners	Leaders
Do not self-regulate	Free riders	Laggards

Table 1. Positions within self-regulatory system

<sup>25</sup> ARIE FREIBERG, THE TOOLS OF REGULATION (Federation Press) (2010), 28-29.

<sup>26</sup> Gradostroitelniy Kodeks Rossiiskoi Federatsii [GRAK RF] [Code of Urban Architecture] art. 55.8. (Russ.). Available in Russian at: <http://base.consultant.ru/cons/cgi/online.cgi?req=doc;base=LAW;n=148422>.

<sup>27</sup> See MAKING GLOBAL SELF-REGULATION EFFECTIVE IN DEVELOPING COUNTRIES (Oxford University Press) (2007), 70-73.

According to this study improvements due to self-regulation by “leading” actors in the industry is less, given “laggards” and “free riders.” They might enjoy benefits of self-regulation in the industry while not committing to it. An interesting solution might be to “differentiate [participants from nonparticipants] in such a way that the value created by the self-regulatory effort is appropriated solely by participants.”<sup>28</sup>

The free rider risk raises the strategic question whether self-regulation should be mandatory or voluntary. On the one hand, mandatory membership in a self-regulatory system does not induce voluntary compliance. Besides, the number of “leaders” will be substantially fewer than of any other category. For these reasons mandatory self-regulation neither substantially differs from state regulation, nor is likely to be effective. On the other hand, voluntary self-regulation connotes that unless there is a substantial interest a small number of market actors will participate. The last one, however, also depends on many other reasons, such as level of development of civil society, rule of law in the society, etc. These factors are discussed in Chapter “Other factors of success.”

The supporters of self-regulation claim that as a regulatory system it has substantial advantages over state regulation. According to them, self-regulation is often considerably more flexible, instantly informed about market and other changeable conditions, diminished in cost, and high in voluntary compliance with the resulting rules.<sup>29</sup> Self-regulation is also not limited to national borders or other jurisdictional limitations and might govern instead throughout industry or profession.<sup>30</sup>

These advantages are not absolute and should be evaluated in conjunction with surrounding factors of influence. Thus the opponents of the idea of self-regulation justifiably challenge them. Specifically, opponents might claim that even when the advantages of self-regulation are all put in practice, they do not, however, dismiss all regulatory hurdles. One of the hurdles is that the most correct and proper decision is not always given effect even if it has been determined. There are always several factors that influence decision-making (economic, practical, political, personal, etc.). The final decision strongly depends on which of those factors prevails in particular situation. Thus, the objectively best solution under some circumstances may not be adopted. The mere substitution of the decision-taking person (private actors or SROs instead of a state) does not solve this problem of applying the best solution available.

Therefore, in order to be more effective than state regulation and apply the best solution available, a self-regulatory regime must prove its ability to be independent not only from external factors of influence but also from internal conflicts of interest. This need is heightened by the inherent nature of state oversight of self-regulatory regimes. In successful self-regulatory regimes, the private actor or SRO bears the burden of future, current, and retrospective regulation through decision-making and enforcement; the state is merely concerned with the outcome of the self-regulation. In other words, while self-regulation is in place the state is in charge of not the decision-making to improve a social issue, but rather it is in charge of the outcome – whether the desired result of self-regulation has been achieved. This interface of dual oversight makes application of the best solution available more likely.

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<sup>28</sup> *Id.* at 72-73.

<sup>29</sup> Saule Omarova *Wall Street As Community Of Fate: Toward Financial Industry Self-Regulation*, 159 *U. Pa. L. Rev.* 411, 422-423.

<sup>30</sup> Saule Omarova *Rethinking The Future Of Self-Regulation In The Financial Industry*, 35 *Brooklyn J. Int'l L.* 665, 670.

That being said, the inherent conflicts of interest and inefficiency still remain the major points of criticism.<sup>31</sup> It is argued that self-regulation has lack of incentives, enforcement capabilities, and sanctions. Instead, it is deemed to have free riders. Thus self-regulation bears risk of turning into simply a symbolic gesture.

It is true that the idea behind self-regulation is that private profit-seeking enterprises regulate their own business activities, which causes an inherent conflict of interest. However, self-regulation does not amount to a form of deregulation and absence of governmental involvement. What distinguishes self-regulation from it are (a) the internal structure of self-regulatory regime and (b) the legal framework provided by the state. These last ones are expected to be sufficient to prevent severe misconduct.

In the legal discussion the advantages and disadvantages of self-regulation are often opposed and compared to those of state regulation. However, recognizing that self-regulation and state regulation are neither alternatives, nor substitutes to each other,<sup>32</sup> **these two systems co-exist and complement each other**. This leads in turn to elimination or shift of each system's boundaries of advantages and disadvantages. Rather, there arises a totally new, combined regulatory regime with its own boundaries, lacks, and benefits. **Therefore, the focus of legal research should be given not to study of these two regulatory systems separately, but to their possible combinations.**<sup>33</sup>

The key issues while implementing and/or running self-regulation therefore are the following: monitoring, transparency, system of enforcement and sanctions, including expelling from the self-regulatory system.

## 5. Forms

It is hardly possible to get all forms of self-regulation in focus. Even a state can act as a private market entity while, for example, purchasing pencils for its officers. Given the variety of private actors as well as the variety of entities that might act as private actors while not being such by their nature, it is impossible to identify all potential actors of self-regulation. Accordingly, it seems difficult to systematize and categorize forms of self-regulation in a way that would be exhaustive. However, in legal literature is widespread belief that usually what is being self-regulated is a profession, an industry, or a market.

An additional hardship when classifying forms of self-regulation is that the variety of its forms also depends in part on the understanding of term "self-regulation" in the first place. What matters is not only the scope of interacting actors, but also the way they interact. The question here would be what exactly we label as self-regulation and what not; what features of a private cooperation lead to calling it "self-regulation." Given the diversity of manifestations of self-regulation in different countries, it makes sense to look at forms of self-regulation on the global scale.

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<sup>31</sup> See Saule Omarova *Wall Street As Community Of Fate: Toward Financial Industry Self-Regulation*, 159 U. Pa. L. Rev. 411, 423.

<sup>32</sup> PETRA BUCK-HEEB & ANDREAS DIECKMANN, SELBSTREGULIERUNG IM PRIVATRECHT (Mohr Siebeck) (2010), 40-41.

<sup>33</sup> In this context the main focus should be drawn to motivating, monitoring and controlling the industries conduct. A year after the financial crisis of 2008 the CEO of Morgan Stanley, John Mack, stated that regulators "have to be much more involved [...]. We cannot control ourselves." Morgan Stanley's Mack: "*We Cannot Control Ourselves*", N.Y. Times DealBook (Nov. 19, 2009, 8:47 AM), <http://dealbook.blogs.nytimes.com/2009/11/19/morgan-stanleys-mack-we-cannot-control-ourselves>. Whether regulators have to be more involved or another mean is appropriate, the statement of an in-sider about industry's inability to control own conduct is alarming.

S. Omarova (USA) classifies the settings of contemporary self-regulation into at least three forms: “professional self-regulatory arrangements in law and medicine, private accreditation and product-certification schemes, and formal self-regulatory organizations.”<sup>34</sup>

Under the study of A. Freiberg (Australia) “organizational self-regulation is manifested in formal arrangements within a professional or occupational group or firm by certificates, registration, standards or voluntary codes of practice or conduct.”<sup>35</sup>

G. Bachmann (Germany) distinguishes between self-management of professional and commercial bodies, commitments (like voluntary reduction of emissions), collective agreements (Kollektivverträge), private codes and rules, voluntary self-control, and Lex Mercatoria.<sup>36</sup>

On the other hand C. Wahlers (Germany) sees only four forms of self-regulation: purely private non-binding rulemaking (Lex Mercatoria, stock emissions to privates); private rulemaking within a legal framework; legislative activity under private standards (incorporation, reference, etc.); and statism rulemaking (verstaatliche Normsetzung) like stock exchanges or municipal authority.<sup>37</sup>

Many scholars distinguish among “voluntary” self-regulation (without direct government intervention), “sanctioned” (government’s approval), and “mandated” (government requires private actors to establish a self-regulatory regime).<sup>38</sup>

Self-regulation might also be seen as interplay of three components: creation of a body of self-regulation (institutionalizing), developing a rule of conduct (professionalizing), and proceedings.<sup>39</sup>

Different approaches identify differences in understanding of the scope of self-regulation, its levels, and patterns. The form of self-regulation that is identified in all these approaches is the adoption of codes of practice or other legal form of mutually binding rules by competitors. These codes of conduct usually determine the minimum requirements, such as quality standards, ethical and moral demands, etc.

The forms of self-regulation that are present in almost all mentioned jurisdictions are ethical rules or codes of conduct for a profession or industry members. Those codes and rules come from the industry and profession members themselves.

## 6. Institutional design of self-regulation

One may argue about the proper relationship balance between self- and state regulation. Nevertheless, both self-regulation and state regulation are subsets of regulation in general. Yet any regulatory system requires rulemaking; communication of rules so that regulatees are aware of the behavior expected or required; monitoring to ensure compliance; official decision making about the consequences of noncompliance or settlement of disputes; sanctions for noncompliance; enforcement; and evaluation.<sup>40</sup>

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<sup>34</sup> Saule Omarova *Wall Street As Community Of Fate: Toward Financial Industry Self-Regulation*, 159 U. Pa. L. Rev. 411, 422.

<sup>35</sup> ARIE FREIBERG, *THE TOOLS OF REGULATION* (Federation Press) (2010), 28.

<sup>36</sup> See GREGOR BACHMANN, *PRIVATE ORDNUNG* (Mohr Siebeck) (2006), 27-37.

<sup>37</sup> See CHRISTIANE WAHLERS, *PRIVATE SELBSTREGULIERUNG AM BEISPIEL DES KAPITALMARKTRECHTS: VORTEILE, NACHTEILE, OPTIMIERUNG* (V&R Unipress) (2011), 93-99.

<sup>38</sup> See Saule Omarova *Rethinking The Future Of Self-Regulation In The Financial Industry*, 35 Brooklyn J. Int'l L. 665, 677.

<sup>39</sup> EBERHARD SCHMIDT-ABMANN ET ALL, *REGULIERTE SELBSTREGULIERUNG ALS STEUERUNGSKONZEPT DES GEWÄHRLEISTUNGSSTAATES* (W. Hoffmann-Riem ed., Duncker & Humblot) (2001), 257.

<sup>40</sup> See Margot Priest *The Privatization of Regulation: Five Models of Self-Regulation*, 29 Ottawa L. Rev. 233, 238.

Generally accepting these requirements, self-regulation sets its own accents on them. Thus, under self-regulation some of these requirements receive more attention than they usually get under other forms of regulation and vice versa.

### III. Internal dynamics

Whatever the elements of a particular self-regulatory system are, they all interplay with each other. The dynamics of their interaction is also influenced from the outside – by the environment within which self-regulation takes place.

A country’s national regulatory system provides the environment for self-regulation. Although no regulatory system is an island isolated from foreign and international regulation,<sup>41</sup> there is also another side of the “non-island”: its sub-levels. Here both instances are encompassed: private law relationships (contracts between private persons or businesses, standards of conduct or quality of private persons, etc.) and non-legal ones (market rules, privately run policies, informal norms, etc.). They all influence the decision-making within a self-regulatory system and its enforcement.

The key feature of self-regulation’s dynamics is the interplay of its two major factors: private rulemaking and governmental regulation in the background.

#### 1. Pressure and restraints

One of the modern studies concludes that self-regulation is highly influenced by external, internal, and additional factors<sup>42</sup> presented in table 2 that shape the self-regulatory process simultaneously. The presence of these factors does not assure it will be effective, since this study was made on a relatively limited set of empiric examples.<sup>43</sup> None of these catalysts is effective enough to lead self-regulation on its own. Moreover, the list of these factors is not exhaustive.

EXTERNAL	INTERNAL	ADDITIONAL
Acute crisis of public confidence	Regulatory structure, homogeneity of interests and interconnectedness	Nature of public interest involved
Political and social pressure	Leadership	Degree of actual/potential public involvement in debate about need to regulate
Regulatory context, threat of governmental interference	Conflicts of interest	
	“We are in this together” understanding	

Table 2. Factors steering self-regulation

<sup>41</sup> ARIE FREIBERG, THE TOOLS OF REGULATION (Federation Press) (2010), 42.

<sup>42</sup> Saule Omarova *Wall Street As Community Of Fate: Toward Financial Industry Self-Regulation*, 159 U. Pa. L. Rev. 411, 451.

<sup>43</sup> *Id.* at 454.

Each external factor is circumstantial. They exist in society always, but they might be “activated” to serve self-regulation by influencing its members as background norms.

## 2. Internal conflicts of interest

While self-regulation strongly relies on motivation of the industry members to comply with its rules voluntarily, it can be sufficiently diminished by the constant threat of internal conflicts of interest.

Generally conflicts arise when there are contradictory or overlapping interests. Since participants of self-regulation are all highly interested in (a) regulating themselves (b) in a way which is adverse to many other participants and (c) bear a lot of decision making power, self-regulation is inherently ripe for internal conflicts of interest.

One of them is created by diversity of interests private actors have. Primarily private actors base their business judgments on personal interests. When this decision-making basis conflicts with rules of an SRO/other self-regulatory system, the private actor has more leeway than when it conflicts with a state law.

In this case voluntary compliance might be close to minimal. In theory the next step here would be the governmental interference to ensure compliance. However, this might not always be as effective as traditional governmental regulation on its own: the self-regulatory system must first find out about the non-compliance, make a decision whether to report about it to the state authority, report, and then will the state authority begin the inquiry whether it has jurisdiction, whether any norm was violated, and whether it can/should impose sanctions. This whole process – even if non-compliance is self-evidentiary and does not need a long formal investigation – is time consuming. Besides, for many directly unrelated reasons this process may stop on every step.

For example, if the private actor in question has power and influence within the SRO (or economic supremacy on the market), he can block the reporting of his non-compliance to the authorities. Knowing this in advance, by taking the decision about (non)compliance every private actor goes through the cost-benefit analysis: what is the benefit and cost of complying versus what is the benefit of noncomplying plus cost of suppression? Once the second option looks more profitable, voluntary compliance automatically sinks without any remedial measure from either the self-regulatory system or the state.

This is probably the main reason why self-regulation should be applied in areas deprived of significant public concern. As for areas where such concern is present, self-regulation apparently should be narrowly contemplated by state regulation and transferred into some kind of co-regulation regime.

One more concern in terms of conflicting interests is about monitoring and enforcement of self-regulation. While every participant is interested in detection of non-compliance of all others, he might be interested in non-reporting of a particular misconduct. For example, non-reporting about a specific violation can bring an imminent financial or other gain for the loyal “company man” or open the door for blackmail. Besides, becoming a whistle-blower has a reputational sequel. For all these reasons the system of monitoring might fail.

Another concern about internal conflicts of interest is related to the question of participation of all or only some actors of an industry or profession in self-regulatory system. On the one hand, it is questionable whether it is possible at all to get all of the market actors into a self-regulatory system. Even if it were possible, there is a practical problem here: should the actors be united industry/profession-wide or by the city/state/federal level? And how can a fair representation and decision-making be provided: one member – one vote or by cumulative

system? For the purpose of manipulating the decision-making, private actors – depending on the voting system – can, for example, create and get involved into self-regulatory system their branches that will vote in a way favorable for their parental organization. On the other hand, if branches are deprived of voting rights while rules-making (that is, if only *some* actors of an industry/profession participate), does such self-regulation make a difference?

### 3. Transparency

Transparency is a crucially important internal issue within a self-regulatory system that keeps it from turning into a cartel or any other illegal scheme. The example with Dutch construction companies is one of the empirical proofs of it.

In the first place transparency connotes systematic free access to information. This access may be granted voluntarily, but is very unlikely, because success on the market requires acting with unique and publicly unknown information. Private actors might however be willing to disclose voluntarily some limited information to a limited number of other actors on the market when it is in their interest. This kind of disclosure is of a permanent nature and, thus, is not in favor of permanent self-regulation.

Mandatory disclosure required either by the state or by any SRO to which the private actor belongs might be an effective tool in providing systematic free access to information. In fact, law often requires registering, licensing and other special permits, and/or reporting to agencies about the course of work of private actors as well as about outcomes of their work. However, the effectiveness of mandatory disclosure is highly dependent on the rule of law in the society, political and economic stability, level of social consciousness, civil society, etc. If there is no social demand on enforcing of mandatory disclosure, the full amount of truthful information might never reach the public.

Mandatory disclosure is also adverse to the idea of self-regulation. This requirement is rather a tool of state regulation. The idea of self-regulation though deems an additional – internal – mechanism of transparency.

The development of its own internal mechanism of transparency is the task of any successful self-regulation. Part of it inherently is the mechanism of watching out each other by the members of the self-regulatory system. But a system of monitoring and revealing within an SRO as an institution does contribute to internal transparency as well.

## IV. Lessons and ways of improvement

### 1. Areas for successful self-regulation?

Self-regulation is not a panacea for ideal regulation. Its effectiveness depends on its internal dynamics at a certain time in a certain situation.

It is believed there are areas inherently inclined for self-regulation. The tricky thing though is identifying these areas.

For example, financial markets are traditionally considered as a field of self-regulation<sup>44</sup> because they are so dynamic and specific that they need a quick regulatory reaction that a relatively slow legislator cannot provide. On the other hand, a modern study argues that today's

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<sup>44</sup> In the UK and U.S. SRO and gentlemen's agreements as a form of self-regulation exist since 19th century.

financial institutions are not a proper area for self-regulation, because of “fragmentation and [diversity of their interests, little direct public involvement, insufficient political pressure, and lack of understanding that their future prosperity depends on collective self-restraint of industry members].”<sup>45</sup> One can argue until he is blue in the face that financial markets a century ago were more controlled than today. However, it is true that financial markets significantly increased in complexity. As such, modern financial markets might be a tough target for effective self-regulation, because most of the key factors of internal dynamics of self-regulation do not apply here.

This concern about aptitude of self-regulation to the financial market industry is justified especially in light of the 2008 crisis. That market crash took place while relatively weak governmental regulation.<sup>46</sup> Undoubtedly regulatory promptness in the financial market is indeed of essence and self-regulation is a quicker regulator than a state. But at the same time the harm of a failure of self-regulation on the financial market outweighs the benefits of its speediness.

A possible resolution could be the advanced oversight of self-regulation in public concern areas, such as the financial market. For example, in Ukraine SROs in financial industry have a special regulatory regime in comparison to other SROs: they are limited in number (only three SRO might be created, one for each field of professional activity on the financial market); they are subjected to stricter governmental monitoring requirements; changes of their internal rules need state ratification.<sup>47</sup> Other kinds of professional SROs in Ukraine enjoy much more freedom in terms of regulation of their members.

It is also hard to distinguish between areas where self-regulation is inherently more likely to succeed and the areas where it is more in demand. On the one hand, self-regulation intrinsically fits into rapidly changeable areas, such as financial markets. On the other hand, the state does need self-regulation in this area as a tool at hand. However, the financial market is not the area where pure self-regulation without any governmental support is likely to survive.

## 2. Some other factors of success

Some other factors shaping self-regulatory process can be classified as internal and external. The first ones might include the nature of relationships under self-regulation, the interest (incentive) and motive of the actors involved, their number, leaders, the actors’ acceptance of their homogeneous interest and mutual dependence, the system of monitoring and assessment, as well as system of punishments and advances, transactional costs (cost-benefit analysis), and some others. The external factors contribute to self-regulation by creating its environment. They might include governmental regulation in the background, the surrounding political, social, and other circumstances, culture, etc., and any random factors of influence that usually are not involved in self-regulation in the first place.

Self-regulation turns out to be not always equally effective under different combinations of these factors. Based on this research, the answer to the question why and when self-regulation is most effective is overall narrowly tailored to its internal dynamics.

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<sup>45</sup> Saule Omarova *Wall Street As Community Of Fate: Toward Financial Industry Self-Regulation*, 159 *U. Pa. L. Rev.* 411, 420.

<sup>46</sup> However, weak governmental regulation does not yet mean the presence of a good self-regulatory system.

<sup>47</sup> See Polozhennia pro samoregylivni organizazii profesijnuch ychasnukiv fondovogo runky, apporoved by Rishennia DKZPFR of Ukraine of 02.17.2009 № 125 [Decree on Self-regulatory Organizations of Professional Members of the Stock Market, approved by the Decision of the State Commission of Ukraine on Securities and Stock Market] (Ukr.). Available in Ukrainian at: <http://zakon2.rada.gov.ua/laws/show/z0458-09>.



One of the most powerful factors is the incentive (motivation) to self-regulate. It is crucial that the incentive to self-regulate in public interest – or at least not only in one’s own interest – vests within the industry itself and comes from it. When the industry itself is willing to self-regulate, there is less need of enforcement.

The motivation to self-regulate is often induced by the state by its legal framework. But examples in this article clearly demonstrate that self-regulation is more effective when its incentive originates from the industry. Mostly these two factors contribute simultaneously.

The interest in self-regulation that comes from industry mostly constitutes some kind of financial benefit, usually combined with one of the incentives described below. Not all of them are present in every single example of self-regulation. The degree of influence they exercise on the dynamics of self-regulation also varies.

One of these factors is a formal framework of governmental regulation and enforcement.<sup>48</sup> The state law provides background for self-regulation and steps into play once the self-regulatory system fails to enforce itself.<sup>49</sup> The industry’s incentive is therefore the valuable privilege to make rules by itself in a way – and only to the extent – most favorable for the industry. While making and enforcing those rules, the industry is stimulated to act in public interest to avoid direct state interference and loss of privilege to self-regulate.

Another factor is seeking of long-term benefits combined with understanding of necessity to self-restrict: “Industry’s perception of [dependence of its] future prosperity upon its ability to impose collective self-restraint on its members’ profit-seeking activities.”<sup>50</sup> It is arguable however to what extent a private business is willing to seek long-term (as opposed to quick) benefits on a competitive and rapidly changeable market. Besides, like in the prisoner’s dilemma, competitors tend to decline cooperation. The same concerns apply to self-limiting incentives.

Also, it is hard to describe empirically the origination and persistence of industry member’s understanding of homogeneity of their interests. Most commonly the competitive market works as an exchange of a favor for a favor. Such a favor operates as the imminent instant benefit and is more lucrative than a potential benefit of self-restriction for the sake of common interest.

Therefore the common understanding, even if it exists, that the industry members’ future prosperity depends on their voluntary self-restriction is arguably an effective catalyst of self-regulation. It does definitely contribute, especially if the market share where those actors operate is small and strong business connections between them are developed. Otherwise market actors are less inclined to manage their conduct based solely on homogeneity understanding.

Another factor deals with the monitoring and feedback system. Regulators, either private or public, should be able to get feedback to identify, assess, and promptly react to the hazards. Therefore, monitoring systems within self-regulation should be established.

But once monitoring systems are established, there is not much value of merely reporting noncompliance. Thus an effective system of punishments is vital to solve the free rider problem, collaboration, and other obstacles of non-compliance. The scope of punishments within self-regulation is, however, limited to an apology, injunctive relief either from a court based on

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<sup>48</sup> Saule Omarova *Wall Street As Community Of Fate: Toward Financial Industry Self-Regulation*, 159 U. Pa. L. Rev. 411, 445.

<sup>49</sup> Ada Kachan, *Selbstregulierungsorganisationen in Russland und in der Ukraine [Self-Regulatory Organizations in Russia and in Ukraine]*, 2013 *Wirtschaft und Recht in Osteuropa [WiRO]* 295, 297.

<sup>50</sup> Saule Omarova *Wall Street As Community Of Fate: Toward Financial Industry Self-Regulation*, 159 U. Pa. L. Rev. 411, 443, 448.

internal standards of self-regulatory system or directly from a self-regulatory body, monetary punishment, or exclusion.

All these punishments are rather of reputational nature, unless exclusion amounts to a loss of the license or other permit essential to the normal course of business. Yet this fairly limited spectrum of sanctions does not deprive self-regulation of effectiveness.

For example, Model Rules of Professional Conduct while being a product of self-regulation might be a basis for sanctioning a lawyer under the administration of a disciplinary authority or it can be evidence of professional misconduct even for a court.<sup>51</sup> Once again, self-regulation is most effective when it is desired by the industry itself without looking for a leeway and when the state is in the background. Thus the question of sanctioning noncompliance, though being acute, is not the priority concern of self-regulation.

Another forceful factor for the dynamics of self-regulation is the surrounding circumstances, such as political and macro economic situation, or level of development of civil society, to name a few. Developed countries have more mechanisms both to enforce self-regulation and to improve lacks in the industry through self-regulation than developing countries.<sup>52</sup> For example, in the US these mechanisms would include class actions, boycotts, protests, loss of reputation, etc.<sup>53</sup> In developing countries loss of reputation does not have a big impact on the business, because there are no other actors on the market who would have had a significantly better standing.

So the influence of the surrounding circumstances on internal dynamics of self-regulation depends in turn on other factors and their interplay. Therefore the role of surrounding circumstance for the internal dynamics of self-regulation is very unpredictable.

For instance, to build on the developed/developing countries example: the recent political shift in Ukraine also caused a boycott of goods of certain origin on the Ukrainian market.<sup>54</sup> According to the study above, a boycott in a developing country like Ukraine is of a little effectiveness due to less social awareness and lack of civil society. Yet Ukrainian consumers abstained from spending \$15 million on pro-presidential businesses in just a few months. So even in a developing country its traditionally ineffective catalyst of self-regulation might push the industry towards re-shaping and re-orientation. Therefore, the output of the surrounding circumstances as a factor influencing internal dynamics of self-regulation is highly unclear and unpredictable.

Self-regulation is also more likely to succeed if the intent of its participants is a long-term benefit and presence on the market. Usually it happens under stable political and economic climate. Once the political and economic environment is unpredictable, the intent of an industry switches to a short-term gain and improving rules or codes of practice does not matter that much.

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<sup>51</sup> Model Rules of Professional Conduct: Preamble & Scope, [20] [http://www.americanbar.org/groups/professional\\_responsibility/publications/model\\_rules\\_of\\_professional\\_conduct/model\\_rules\\_of\\_professional\\_conduct\\_preamble\\_scope.html](http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_preamble_scope.html)

<sup>52</sup> MAKING GLOBAL SELF-REGULATION EFFECTIVE IN DEVELOPING COUNTRIES (Oxford University Press) (2007), main thesis.

<sup>53</sup> For example, class actions against tobacco industry resulted into huge settlements and self-restrictions of the industry. See Jonathan Goldman, *Take That Tobacco Settlement and Super-Size it!: The Deep-Frying of the Fast Food Industry?*, 13 TEMP. POL. & CIV. RTS. L. REV. 113. (2003)

<sup>54</sup> Since November 2013 Ukrainians protested demanding the President Yanukovich to resign. Activists called to boycott businesses linked to his regime. It resulted into those businesses turning their backs to Yanukovich and depriving him of their support.

Original in Ukrainian on the *Ukrainska Pravda* website, Saturday, December 28 2013: <http://www.pravda.com.ua/news/2013/12/27/7008636/>.

If under these circumstances other subfactors of social milieu do not work either, self-regulation fails fully.

This explains the special status of financial types of self-regulation. The financial markets tend to change especially rapidly, and thus the short-term gain is almost always the case. Other factors, like reputation or homogeneity of interest, usually are of little significance for the same reason. So self-regulation possesses few means to keep this field beneficial for the society. On the other extreme, the state cannot limit quick and very specific financial markets in its usual way of regulation. As a result there is a combined double regulation: financial market actors are granted the privilege of self-regulation, though out of necessity, and also are subjected to strict and direct governmental regulation. This combined double regulation method is used in all described jurisdictions: in the US, in Ukraine, Russia, Australia, and in the UK until 2000 when financial market self-regulation was abolished there.

It is hard to say whether some factors always play a predominant role. While it is true that absence of some key factors makes self-regulation very likely to fail, at the same time many factors can be substituted by others. In addition, depending on the specific situation a particular (generally minor) factor might have far more value than a (generally) key factor. That is why it is hard to predict or model the internal dynamics of self-regulation.

Likewise it is hard to build up rules to shape this dynamics. Apparently, a successful self-regulatory system should possess its own internal incentives and powers to fix any destructive trends.

In any event, the internal dynamics is the instance that makes or makes not self-regulation successful, beneficial to the actors, state, and society. That is why a close attention should be paid to the internal dynamics of self-regulatory process.

One can study factors of successful self-regulation, or even try to build a model of a perfectly working mechanism of self-regulation or its legal framework. But at the end of the day the final appearance of self-regulation is shaped by the unpredictable interplay of an unpredictable chain of influences that can be referred to as organizational dynamics. Maybe, such sophisticated instance as self-regulation requires a specific, more sophisticated, way of governmental supervision than traditional regulation. Maybe this undercovers a new revolutionary method of co-regulation of state and democratic society that before long will become a default way of “regulation.”

### **3. Brief summary and further research questions**

Self-regulatory structures are internally complex systems interacting with and reacting to their environment - the state and society.

Institutional change is only possible from the top. But one gets to the top through being changed by the system first. On the opposite, self-regulation enables changes before being changed by the system. It enables changes from the bottom. This is the main feature of self-regulation that makes it so helpful. The inherent ambivalence here is that generally being a helpful tool, self-regulation vitally needs government (the system) in the background.

State laws limit one's liberty and that is why they tend to be violated or evaded. Within the self-regulatory system, however, the regulatee himself is responsible for both rule making and enforcement. In other words, the regulatee becomes responsible for achieving the rule's specific goal. This deprives him of the main incentive to violate or evade and makes self-regulatory rules self-enforcing.

What makes self-regulation an imperfect regulatory system is mostly also true for the state regulation: enforcement, fairness of decisions and rules, equality of impact of single

members on decision making, etc. These are still not fully clarified questions for the state regulation as well.

The most influential external factors that shape self-regulation are: state regulatory context political and social pressure, crisis of public confidence, threat of governmental interference, nature of public interest involved, and positive incentives. The most influential internal factors are: regulatory structure, homogeneity of interests, leadership, feedback systems, and transparency standards. The external and internal factors are also contemplated by a number of unpredictable additional factors.

The output of self-regulation in different areas is not the same. It depends on the social and economic context where self-regulation takes part, and on the structure and institutional design of self-regulation.

If a self-regulatory rule gets violated or evaded, sanctions will be imposed just as if the rule was of a state law nature. But if violation is repetitious or severe, or the rule is ineffective inherently, it results in failure to achieve the rule's goal. This is the stage that shows the major difference between self- and state regulation. While outcomes of failure of state law are mostly reorganization of an authority/board or change of that law, failure of "self" rules results into deprivation of the privilege to self-regulate (set up own rules) and brings the strong government's hand into action. Therefore paradoxically by establishing or legalizing existing self-regulation the government gets an additional tool of influence.

For further research in this field it probably makes sense to distinguish industry and professional self-regulation. These might have features that distinguish them much enough to generate different demands, expectations, and factors of major influence. For example, entities involved in industry self-regulation usually follow different incentives than natural persons carriers of certain profession. As such these different types of regulatees probably need differentiated regulatory approaches.