Recommendation 94-1

The Use of Audited Self-Regulation as a Regulatory Technique

(Adopted June 16, 1994)

Audited self-regulation is defined as congressional or agency delegation of power to a private self-regulatory organization to implement and enforce laws or agency regulations with respect to the regulated entities, with powers of independent action and review retained by the agency. This self-regulatory organization is often an association of regulated entities formed for the explicit purpose of self-regulation. Audited self-regulation is an alternative for Congress to consider in legislating any regulatory program. Properly implemented and monitored, a program of audited self-regulation may effectively advance the statutory objectives consistent with the public interest and the interests of the regulated entities.

In certain circumstances, this approach may result in better regulation because the agency's statute and rules are supplemented and enforced by those entities directly involved in the regulated activity, which may have more detailed knowledge of the operational or technical aspects of that activity. The regulatory program also may be more effective because it can be tailored to the individual industry or group. In addition, the agency's regulatory enforcement costs may be reduced by this approach, although such cost reductions should be considered only if they can be achieved without eroding the effectiveness of enforcement.

On the other hand, audited self-regulation may present the significant risks of uneven enforcement, capture of the regulators by the regulated industry, and creating barriers to entry or competition. Where the potential for institutional self-interest is too great, self-regulation is undesirable. Other risks can be lessened by requiring the self-regulatory organization to establish and follow procedures similar to those that would be applicable if the self-regulatory organization were an agency.[1] For these procedures to work, effective interest groups must exist, and must have access to the agency, to raise concerns about the conduct of the self-regulatory organization. And of course, the agency itself must vigilantly oversee the activities of the self-regulatory organization and of the regulated entities themselves.

[1] Such procedures generally provide for public participation and require all points of view to be taken into account and addressed. For example, rulemaking ordinarily should provide notice and opportunity for comment to all affected parties, and adjudications should be open to the public and include notice and hearing safeguards.

A survey of agency experience with audited self-regulation[2] reveals several common elements typically present in effective programs: (1) Industry members are organized, expert, and motivated to comply; (2) the regulatory program requires individualized application of clear rules which can be objectively applied; and (3) the agency itself has sufficient expertise to audit the self-regulatory activity effectively. The survey also revealed that audited self-regulation programs that were terminated or not implemented lacked at least one of these elements.

In those cases where the prerequisites and safeguards discussed above are present, Congress and the agencies should consider audited self-regulation as a regulatory technique.[3]

Recommendation

1. Congress and agencies should consider audited self-regulation as a regulatory technique when designing, revising, or reevaluating regulatory programs, but only where it can be effective, as specified in Paragraph 2 below, and only where it can operate fairly, as specified in Paragraph 3 below. Audited self-regulation is defined as congressional or agency delegation of power to a private self-regulatory organization to implement and enforce laws or agency regulations with respect to the regulated entities, with powers of independent action and review retained by the agency.

2. *Effectiveness.* Audited self-regulation can be effective if it meets the following requirements.

a. The substantive standards, whether imposed by statute, regulation, or otherwise, are clearly stated and are capable of objective application, even if judgments must be made in applying them.

b. A self-regulatory organization with the ability and incentive to implement these substantive standards in cooperation with the agency exists or can be created.

[2] Audited self-regulation has been used in diverse programs, including quality of medical care under government insurance programs, stock exchange and commodities regulation and trading, agricultural marketing agreements, and certification of medical testing laboratories.

[3] Note, for example, that Executive Order 12,866, Regulatory Planning and Review, 58 Fed. Reg. 51,735, 51,736 (October 4, 1993), states that, to the extent permitted by law, agencies should identify and assess alternative forms of regulation.

i. *Ability.* The organization must have the expertise, experience, authority, and commitment to design, implement, and evaluate effective compliance measures. It must also, by itself or in combination with other self-regulatory organizations, have jurisdiction over all regulated entities.

ii. *Incentive.* The organization must be motivated to undertake effective and fair self-regulation consistent with the public interest, as that interest has been articulated by Congress and the agency. This motivation can be provided by, among other things: (A) the members' common incentives; (B) effective monitoring by groups that may be harmed by noncompliance; (C) potential legal liability of the self-regulated entities or the self-regulatory organization; or (D) the potential for direct government regulation.

c. The agency responsible for implementation and oversight must have the ability and incentive to implement the substantive standards through a self-regulatory program.

i. *Ability.* The agency must have (A) statutory authority, including at least the powers specified in Paragraph 2(d) below; (B) sufficient substantive expertise; (C) knowledge of organizational behavior and internal control procedures of the self-regulatory organization and its members; and (D) sufficient resources, including effective auditing capability to monitor compliance.

ii. *Incentive.* The agency must have the incentive to implement the self-regulatory program effectively. Effective implementation requires the commitment of the agency to achieving the objectives of the statutory scheme through the self-regulatory program. It also requires the agency to consider the rights and needs of the intended beneficiaries of the regulatory program, who may be harmed by noncompliance, as well as the rights and needs of the regulated entities.

d. The self-regulatory program is expressly authorized by legislation that includes:

i. An explicit statement of the scope of permitted delegation to the self-regulatory organization;

ii. Authority for the agency (A) independently to enforce the law, agency regulations, and rules of the self-regulatory organization relevant to the program; (B) to enforce the organic requirements of the self-regulatory organization against the organization, and require that the organization in turn enforce its own rules against its members; (C) to review all rules and enforcement actions of the self-regulatory organization relevant to the program; and (D) to

amend, repeal or supplement the rules of the self-regulatory organization or require the self-regulatory organization to do so; and

iii. A requirement that the agency, in promulgating its own rules or reviewing the rules of the self-regulatory organization, examine the effects of those rules on competition.

3. *Fairness.* Audited self-regulation can operate fairly only if the procedures of the self-regulatory organization ensure that the decision maker is properly informed and unbiased. Procedures for adjudication and for establishing rules of general applicability should conform generally to those that would be followed if the proceeding were conducted by the agency. In addition to the agency's plenary review authority referred to in Paragraph 2(d)(ii)(C), the agency should provide parties with a right of appeal.

4. *Access to records and proceedings of the self-regulatory organization.* Congress and the agency should provide public access to records of the self-regulatory organization relating to the organization's regulatory activities, to the extent such records would be available under the Freedom of Information Act if the self- regulatory organization were an agency. Congress and the agency also should consider whether to require any non-adjudicatory proceeding of the organization to be open to the public.

5. *Alternative dispute resolution.* The rules of the self-regulatory organization should provide for use of informal and consensual procedures to resolve disputes where appropriate.[4]

Citations:

59 FR 44701 (August 30, 1994)

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[4] The Administrative Conference has repeatedly encouraged agencies to use alternative dispute resolution and negotiated rulemaking techniques in appropriate circumstances. The same factors supporting those recommendations suggest the value of informal and consensual processes in the context of self-regulatory organizations. See, e.g., Recommendations 82-4 and 86-3.