Innovation and Regulatory Vigilance

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Cristie Ford, **Innovation and the State: Finance, Regulation, and Justice** (2017).

Nearly everyone sings innovation's praises. Innovation brings progress and prosperity. It leads to a better tomorrow. Yet, is innovation really an unalloyed good? In a new book, legal scholar Cristie Ford argues that innovation actually "presents a clear and persistent risk—perhaps the single most significant and under-analyzed risk—to regulation itself." (P. 215.)

Innovation poses such an "existential challenge" to regulation, Ford argues in *Innovation and the State: Finance, Regulation, and Justice*, because the world subject to regulatory control is constantly changing. (P. 144.) Technological change, for example, has made hydraulic fracturing economical and led to a shale gas revolution in energy extraction. New, complex mortgage-backed derivatives in securities markets proliferated in the years leading up to the financial crisis. Changes such as these are continually occurring in every economy. Yet in a certain sense, regulation inherently stands still. Regulation operates by fixing words onto the pages of a rulebook. The world is dynamic, while regulation is static.

Ford is hardly the first to call attention to regulation's relatively static nature. Many policymakers, and even more business managers, believe that regulation impedes socially valuable progress. For example, a common argument is that the U.S. Food and Drug Administration's strict and slow pre-marketing review protocols keep life-saving drugs from helping patients sooner. More generally, the "clunkiness" and rigidity of regulation—such as its well-known problem of one-size-fits-all commands—creates a range of perversities, including increased costs and the locking in of suboptimal business practices.

This conventional view of the tension between regulation and innovation is most compatible with a critical posture toward regulation. Yet in her thoughtful book, Ford offers a valuable scholarly perspective that both skeptics and supporters of regulation should find instructive. She shows that regulation hardly impedes all innovation. Just as water in a river finds its way around or over boulders and other obstructions, innovation manages to occur even in a regulated economy. More importantly, the existence of ever-present innovation holds major implications for regulation, as changes in economic and social circumstances bring the constant potential to make rules antiquated and ineffectual. As Ford puts it, innovation has a "persistently corrosive effect on regulatory fit and effectiveness over time." (P. 164.)

This corrosiveness exists in part because of what legal scholar Gary Marchant has called law's "pacing problem." Economic and technological development simply moves much more quickly than legal institutions typically are able to act. We see constantly emerging new lines of businesses—Facebook, Uber, and more—as well as new technologies—genetic engineering, autonomous vehicles, and more. Each of these developments bring the possibility of risks to consumers and the public. But the legal system is slow to respond.

Another source of innovation's corrosiveness arises from firms' strategic behavior. When regulated firms maintain the same incentives and goals that created the initial need for regulation, those firms can be expected to search for—and eventually find—ways of satisfying their objectives within the parameters of the law. But sometimes these new ways still create problems for society. The starkest examples take the form of evasiveness or outright fraud—just think about Volkswagen's "innovative" approach to designing diesel engines so they could meet regulators' required laboratory emissions tests, even though the cars still polluted excessively when driven on the road. Adaptive behavior induced by regulation can also be more benign in intent but still allow problems to persist or even create new problems. Whatever the motivation, such strategic innovation undoubtedly underlies Ford's view that "the capacity to be innovative…is a form of power" and that this form power, like others, is not distributed equally in society. (P. 220.)

Ford's book helpfully reminds us that a major predicament facing society—and a major intellectual challenge confronting regulatory scholars—derives from the realization that regulation must "operate within a dynamic and uncertain environment." (P. 140.) What might be the solution to this predicament?

For much of the 1990s and early 2000s, regulatory scholars argued that the innovation predicament could be overcome through a form of regulation that Ford refers to as "flexible regulation." (Ford uses this common, if not oxymoronic, moniker from that earlier time period, but also explains that flexible regulation sometimes has also traveled under the banner of "responsive regulation, reflexive law, smart regulation, and new governance and experimentalism." (P. 21.)) Throughout much of *Innovation and the State*, Ford tells the intellectual history of flexible regulation. She shows how flexible regulation eschews top-down governmental control through bright-line rules, typically disparaged as "command-and-control" regulation. By contrast, flexible regulation prefers to work more from the bottom up, taking advantage of industry's superior knowledge of its operations and providing greater sensitivity to variation in business contexts. By relying on either broad principles or regulatory performance targets, as well as on softer tools or nudges (such as information disclosure), flexible regulation seeks to shape and guide private behavior rather than to control businesses' every action through the enforcement of strict, detailed legal commands.

In theory, flexible regulation overcomes both the rigidity and corrosiveness associated with traditional regulation. Instead of locking in specific, prescribed behaviors and technologies, a principles- or performance-based regulatory regime gives responsible firms leeway to adapt and find the most cost-effective means of achieving regulatory goals. In this way, flexible regulation is more receptive to "good" innovation. And by its reliance on broad principles or outcomes instead of bright-line rules, flexible regulation can allow government regulators to respond more nimbly to evasiveness and to adapt in the face of new business practices that might not be addressed by highly detailed, prescriptive rules. Flexible regulation in this way is thought to be more protective against "bad" innovation.

But the regulatory theory that developed in the 1990s looks different from this side of the financial crisis of 2007-2008. Ford cautions regulators and regulatory scholars against putting too much faith in the precise form of regulation, flexible or otherwise. A specialist in securities regulation herself, Ford devotes much attention in *Innovation and the State* to financial regulatory issues. Comparing how different countries fared in response to various innovations in finance in the years prior to the crisis, she concludes that "it would be difficult to establish that more 'flexible' systems like the United Kingdom's more principles-based system were any more (or less!) susceptible to gaming or weaker in regulatory terms than more rigid, bright-line systems like the United States'." (P. 133.)

Ford's design-agnostic conclusion merits wide consideration. Both bright-line rules and principles-based regulatory designs have their strengths and weaknesses. And neither are immune to challenges posed by innovation. It oversimplifies, but perhaps only somewhat, to say that just as bright-line rules can block both bad and good innovation, flexible regulation can be accommodating to both good and bad innovation. Both the financial crisis and the Volkswagen scandal, each of which extended across national borders, remind us that bad innovation, flouting legitimate regulatory goals, can arise in vastly different regulatory systems.

Ford is correct to identify innovation as a daunting challenge confronting any regulatory system. She makes a persuasive claim that, at least as a technical or legal matter, "we simply cannot seem to 'solve' the problem of innovation, no matter what flexible, bright-line, or innovation-framing strategy we take." (P. 47.) But then, if she is right, is there ever any hope for sensible, effective regulation?

Ford offers no simple, easy answers—and surely we should be most skeptical if she did. Still, I read her to be both realistic and hopeful. In her telling, "the way forward is…through a new kind of state action." (P. 128.) That new action, she says, should entail thoughtful, fair, public deliberation and efforts by regulators to seek to identify changes in social and economic circumstances and learn how to respond to them.

She offers near the end of the book a helpful “[f]ramework for innovation-ready regulation” (P. 226) which includes a list of questions intended to help focus regulators’ attention on possible innovation threats on the horizon. That framework encourages the leaders of any regulatory organization to assess three key features of their operating environment: (1) “the basis of the regulator’s knowledge and the nature of its assumptions;” (2) how the regulatory regime is structured, and what implications flow from that structure;” and (3) “what mechanisms exist to allow the regulatory regime to learn and adapt, and whether they are adequate.” (P. 224.)

The operative word in Ford’s ultimate solution comes down to “action.” In looking at the regulatory failings in the lead up to the financial crisis, Ford points not to any particular failure in regulatory instrument design but to the lack of appropriate and adequate action by regulatory officials: “Across jurisdictions, underfunding, under-resourcing, lack and misdirection of information, lack of focus, and lack of regulatory independent-mindedness were the common thread.” (P. 133.) The solution, then, is not so much smart regulation, but smarter regulators.

In the end, whatever form regulation itself may take, regulators must also acquire the vision to notice change as it is evolving, possess the early-warning data to anticipate seismic shifts in the larger landscape, and inculcate the independent-mindedness to take appropriate action when needed. If innovation creates regulation’s existential problem, the solution lies in constant regulatory vigilance.

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