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# Regulation by Third-Party Verification

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# REGULATION BY THIRD-PARTY VERIFICATION

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**Abstract:** This Article proposes greater governmental reliance on private auditors to enhance the achievement of regulatory objectives. Regulatory failure is a growing problem as governmental agencies lack resources to adequately monitor and detect noncompliance. Third-party verification partially privatizes the regulatory function by requiring regulated entities to hire independent third parties to verify compliance data and make compliance determinations. As a type of privatization, third-party verification presents both opportunities and potential problems. The key issue, as in other forms of public-private governance, is ensuring that accountability and other public values are protected when private actors perform functions that are fundamentally public. This Article argues that, as third-party verification is incorporated into regulatory frameworks, it must be carefully regulated itself. Regulatory agencies must assume the role of "auditing the auditors" through making and enforcing rules that govern who can serve as a verifier, how regulated entities select verifiers, and how verifications are performed. With well-designed rules and strong governmental oversight, third-party verification has the potential to cost-effectively improve the implementation of social regulation.

## Introduction

Regulatory failure makes headlines. Outbreaks of food borne illness show that regulators have failed to act on information they have or should have had about poor food safety practices.[1] Investigative reporting on water pollution enforcement reveals that, although more than half of polluters are significantly out of compliance, fewer than three

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[1] *See* Michael Moss, *Peanut Case Shows Holes in Food Safety Net*, N.Y. Times, Feb. 9, 2010, at A1; Rory Harrington, *FDA Failed over Salmonella Outbreak, Says New Chief*, FoodNavigator-USA.com (May 27, 2009), http://www.foodnavigator-usa.com/Legislation/FDA-failed-over-salmonella-outbreak-says-new-chief.

percent of violations result in fines or other sanctions.[2] From the nation's largest oil spill, we have learned that the agency responsible for regulating offshore drilling failed to inspect as frequently as legally required.[3]

The explanation is often the same: regulatory agencies lack the capacity to adequately implement and enforce the law.[4] Most basically, there are not enough inspectors or resources to perform the basic task of detecting violations. For example, of the 9.1 million food shipments imported into the United States in 2006, the Food and Drug Administration (FDA) inspected only 115,000 shipments and sent only 20,000 samples for laboratory analysis.[5] Facilities regulated under the Clean Water Act might only be inspected once every few years, and evidence suggests that noncompliance is the norm rather than the exception.[6] Continuing and growing shortfalls in federal and state budgets make change to this status quo unlikely.

Third-party verification, the regulatory approach described and analyzed in this Article, seems appropriate for an era of growing regulatory demands and diminishing governmental resources. As used herein, the term "third party" refers to an external private auditor or consultant who is paid by the regulated entity.[7] "Third-party verification," in turn, denotes a system in which governmental agencies rely on these third parties to verify regulatory compliance.[8] With third-party verification, regulated entities are required to contract with a "verifier" or "verification body" to make a regulatory compliance determination.[9] The

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[2] Charles Duhigg, *Clean Water Laws Are Neglected, at a Cost in Suffering*, N.Y. Times, Sept. 13, 2009, at A1.

[3] Nat'l Comm'n on the BP Deepwater Horizon Oil Spill and Offshore Drilling, Deep Water: The Gulf Oil Disaster and the Future of Offshore Drilling 82–85 (2011).

[4] *See, e.g.*, Clifford Rechtschaffen, *Enforcing the Clean Water Act in the Twenty-First Century: Harnessing the Power of the Public Spotlight*, 55 Ala. L. Rev. 775, 776 & n.10 (2004) (noting that many state governments lack the resources necessary to maintain water quality control programs).

[5] Kenneth A. Bamberger & Andrew T. Guzman, *Importers as Regulators: Product Safety in a Globalized World*, *in* Import Safety: Regulatory Governance in the Global Economy 193, 197–98 (Cary Coglianese et al. eds., 2009).

[6] Rechtschaffen, *supra* note 4, at 781–83; James Salzman et al., *Regulatory Traffic Jams*, 2 Wyo. L. Rev. 253, 283–84 (2002).

[7] The term "third party" is defined and used here as it is in the literature on third-party certification. *See infra* notes 255–259 and accompanying text.

[8] *See infra* note 26 and accompanying text.

[9] In existing regulatory programs, "verification body" tends to be used to refer to a company or organization, while "verifier" refers to an individual. In this Article the two terms will generally be used interchangeably.

verifiers are generally private entities that have been approved, or "accredited," to perform this task by the government or by a government-approved "accreditation body." Third-party verification may substitute for direct compliance monitoring by the governmental agency.

Third-party verification has already been incorporated into climate change and food safety regulatory frameworks, and it has potentially broad application across many fields of social regulation.[10] The market-based regulatory approaches that have been used in climate change regulation, including emissions trading and taxation schemes, are highly dependent on reliable compliance data. Similarly, the global structure of production chains for food, drugs, and other consumer products makes compliance difficult to ascertain by traditional routes. In these situations, third-party verification has become a regulatory approach of choice. And it is not just these new areas of regulation that would benefit from more reliable information and greater compliance.[11] Third-party verification could be used more broadly in efforts to enhance regulatory compliance and avert regulatory failure.

Nonetheless, cautionary tales abound. Requiring annual reports that must be certified by independent accountants, financial regulation has relied extensively on a system much like third-party verification.[12] Hired by the companies they audit, auditors have sometimes lacked independence and contributed to such financial disasters as the savings and loan crisis of the 1990s and the collapse of Enron in the early 2000s.[13] In addition, third-party *verification* closely resembles third-party

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[10] *See infra* notes 25–72 and accompanying text (describing how third-party verification is already incorporated into regulatory regimes); *see also* Eugene Bardach, *Social Regulation as a Generic Policy Instrument*, *in* Beyond Privatization: The Tools of Government Action 197, 198 (Lester M. Salamon ed., 1989) (distinguishing social and economic regulation); Peter J. May, *Social Regulation*, *in* The Tools of Government: A Guide to the New Governance 156, 161 box 5-1 (Lester M. Salamon ed., 2002) (listing the original dates of the enactment of "Major Social Regulatory Laws" in the United States); Cass R. Sunstein, *Administrative Substance*, 1991 Duke L.J. 607, 609 (identifying health, safety, broadcasting, discrimination, and the environment as areas of social regulation and distinguishing social regulation from economic regulation).

[11] Victor B. Flatt & Paul M. Collins, Jr., *Environmental Enforcement in Dire Straits: There Is No Protection for Nothing and No Data for Free*, 85 Notre Dame L. Rev. 55, 86 (2010).

[12] Mark W. Olson, Former Chairman, Pub. Co. Accounting Oversight Bd., Financial Reporting Council Ken Spencer Memorial Lecture: The Audit Profession and the Evolution to Independent Oversight (Mar. 11, 2009), http://pcaobus.org/News/Speech/Pages/03112009_OlsonFinancialReportingCouncil.aspx (arguing that independent audits are an important aspect of the modern securities law regime).

[13] *See, e.g.*, Patricia A. McCoy, *Realigning Auditors' Incentives*, 35 Conn. L. Rev. 989, 990 (2003) (stating that the basic problem afflicting the accounting industry is that "accounting firms work for the companies they audit"); Geoffrey P. Miller, *Catastrophic Financial*

*certification*, used in voluntary schemes to substantiate marketing claims about, for example, the sustainability of forest products or the legality of labor practices in foreign manufacturing plants.[14] Some scholars have questioned the competence and accountability of the third-party certifiers in voluntary certification schemes.[15]

Third-party verification represents a partial privatization of the public function of enforcing regulatory law.[16] It is a form of "public-private governance" in which private actors play critical roles in spheres that are commonly viewed as governmental in nature.[17] Scholars have recognized that while there are "longstanding and complex interactions" between public and private actors, recent privatization trends raise important new questions.[18] On the one hand, the new privatization may jeopardize the fulfillment of public purposes and commitments; on the other, it may enable innovation, efficiency, and quality in the provision of governmental services.[19] Like other forms of public-private governance, the growing use of third-party verification in regulatory implementation embodies this tension.

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*Failures: Enron and More*, 89 Cornell L. Rev. 423, 423–25 (2005) (discussing questionable accounting and questionable accountants in recent catastrophic financial collapses).

[14] On voluntary certification schemes, see *infra* notes 98–137 and accompanying text. Although this Article focuses on third-party verification in the context of mandatory governmental regulation, many of its observations and arguments also apply to third-party certification in voluntary programs.

[15] *See, e.g.*, Errol Meidinger, *The Administrative Law of Global Private-Public Regulation: The Case of Forestry*, 17 Eur. J. Int'l L. 47, 71–72 (2006); Dara O'Rourke, *Monitoring the Monitors: A Critique of Corporate Third-Party Labour Monitoring*, *in* Corporate Responsibility and Labour Rights: Codes of Conduct in the Global Economy 196, 197 (Rhys Jenkins et al. eds., 2002).

[16] Martha Minow, *Public and Private Partnerships: Accounting for the New Religion*, 116 Harv. L. Rev. 1229, 1230 (2003) (defining privatization to include "the range of efforts by governments to move public functions into private hands and to use market-style competition"); *see also* Jody Freeman, *Extending Public Law Norms Through Privatization*, 116 Harv. L. Rev. 1285, 1286–87 (2003) (discussing various forms of privatization).

[17] William J. Novak, *Public-Private Governance: A Historical Introduction*, *in* Government by Contract: Outsourcing and American Democracy 23, 23–25 (Jody Freeman & Martha Minow eds., 2009) (describing public-private governance and placing it in historical context).

[18] Minow, *supra* note 16, at 1229–30; *see also* Michael P. Vandenbergh, *The New Wal-Mart Effect: The Role of Private Contracting in Global Governance*, 54 UCLA L. Rev. 913, 916 (2007) [hereinafter Vandenbergh, *New Wal-Mart*] (analyzing private contracting as a new form of governance); Michael P. Vandenbergh, *The Private Life of Public Law*, 105 Colum. L. Rev. 2029, 2038 (2005) [hereinafter Vandenbergh, *Private Life*] (discussing the roles of private actors in the principal functions traditionally assigned to public agencies).

[19] Minow, *supra* note 16, at 1242–46; *see* Freeman, *supra* note 16, at 1295–98; Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. Rev. 543, 549 (2000).

Through analysis of third-party verification, this Article sets forth a promising new approach to regulatory implementation that holds important lessons for public-private governance. Third-party verification has the potential to harness private resources in a way that significantly enhances regulatory compliance. To achieve this end, however, government must be able and willing to create regulatory structures that protect and promote public goals. The regulatory structures recommended here, such as strong standards for the accreditation of private actors and their performance, provide an exemplary framework for other types of public-private partnerships in which private actors perform traditionally public functions.

Part I of this Article introduces third-party verification with a discussion of regulatory programs in which it is used.[20] Part II identifies reasons to support the incorporation of third-party verification into social regulation.[21] These reasons are similar to the reasons supporting privatization in other contexts: to tap private resources and expertise, improve governmental performance, and cut governmental costs.[22] Part III identifies reasons for concern about third-party verification, which include not only the challenge of maintaining public accountability when private actors play public roles but also potential problems of verifier independence, verifier competence, and cost.[23] Part IV sets forth recommendations for how third-party verification systems should be structured and regulated to enable them to effectively serve public purposes.[24]

## I. Regulation by Third-Party Verification

In the final decades of the twentieth century, a large body of social regulation emerged in the United States to prevent and address social harms, particularly harms to the environment, human health, and safety. In traditional social regulation, governmental enforcement agents monitor the behavior of regulated entities to detect noncompliance with rules and assess sanctions at their discretion.[25] In regulation by third-party verification, independent verifiers provide an expert opinion to the regulatory agency concerning whether the compliance information provided by a regulated entity is accurate and supports a

[20] *See infra* notes 25–72 and accompanying text.
[21] *See infra* notes 73–191 and accompanying text.
[22] *See infra* notes 73–191 and accompanying text.
[23] *See infra* notes 192–314 and accompanying text.
[24] *See infra* notes 315–427 and accompanying text.
[25] *See* Bardach, *supra* note 10, at 197.

finding that the regulated entity is in compliance.[26] The government retains the authority to exercise oversight and apply sanctions for noncompliance.[27]

Several prominent examples of the regulatory use of third-party verification have emerged in the past several years.[28] As described in this Part, third-party verification is used in mandatory greenhouse gas reporting programs in Europe, California, and Massachusetts. Third-party verification is also slated to play an important role in the FDA's regulation of food imports under the U.S. Food Safety Modernization Act of 2011.[29] Notably, regulatory approaches bearing many similarities to third-party verification have long been used in a variety of less visible regulatory programs.

### A. *Climate Change Regulation*

Third-party verification has been widely incorporated into climate change regulation. Third-party verification is required of regulated entities reporting greenhouse gas emissions under the European Union Emissions Trading Scheme (EU ETS), the California Global Warming Solutions Act,[30] and the Massachusetts Climate Protection and Green Economy Act.[31] Under each of these programs, regulated entities must contract with a private verification firm that is responsible for reviewing the entity's greenhouse gas emissions report and submitting to the government a determination as to whether the report is accurate and oth-

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[26] *Cf.* Clark C. Havighurst, *Foreword: The Place of Private Accrediting Among the Instruments of Government*, Law & Contemp. Probs., Autumn 1994, at 1, 2 (defining accreditation as "the formal expression by a private body of an authoritative opinion concerning the acceptability, under objective quality standards fairly applied, of the services rendered by a particular institutional provider").

[27] *See* Freeman, *supra* note 16, at 1326 n.177 (noting, in a discussion of government accountability, that the government is capable of imposing sanctions in a third-party verification scheme).

[28] *See infra* notes 30–72 and accompanying text.

[29] Michael R. Taylor, Deputy Comm'r for Foods, U.S. Food & Drug Admin., Remarks at the China International Food Safety and Quality Conference and Expo, Implementation of the U.S. Food Safety Modernization Act: Building a Partnership for Prevention (Nov. 2, 2011), http://www.fda.gov/Food/FoodSafety/FSMA/ucm278215.htm.

[30] California Global Warming Solutions Act of 2006, Cal. Health & Safety Code §§ 38500–38599 (West 2006 & Supp. 2011).

[31] Climate Protection and Green Economy Act of 2008, Mass. Gen. Laws ch. 21N, §§ 1–9 (2008 & Supp. 2009). The Climate Protection and Green Economy Act ("CPGEA") is contained within the Global Warming Solutions Act. Global Warming Solutions Act, 2008 Mass. Acts 298 (2008) (codified in scattered sections of Mass. Gen. Laws ch. 21); *see* Ken Kimmell & Laurie Burt, *Massachusetts Takes on Climate Change*, 27 UCLA J. Envtl. L. & Pol'y 295, 302–04 (2009).

erwise in conformity with the law. Each of these regulatory frameworks also has procedures for accrediting the third-party verifiers and guidance for how the verification is to be performed.

The EU ETS, initiated in 2005, regulates the carbon dioxide emissions of over 11,000 stationary sources in thirty European states.[32] Responsible for ensuring the accuracy of the EU ETS emissions reports submitted annually by each source, member states have the authority to require that sources use third-party verifiers and establish procedures for accrediting verifiers.[33] A regulated entity then contracts with an accredited verifier and provides the verifier with access to all data and other information necessary to verify its annual emissions report.[34] Once the verification process is complete, the verifier prepares a verification report that makes a judgment as to whether the emissions report is free of material misstatements and other material nonconformities.[35] Regulated entities submit the verification opinion with their annual emissions report to the responsible member state regulatory agency.[36]

California and Massachusetts also require third-party verification in their regulatory frameworks for greenhouse gas emissions reporting.[37] Under California's mandatory reporting rule, sources must con-

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[32] *Emissions Trading System (EU ETS)*, Eur. Comm'n: Climate Action, http://ec.europa.eu/clima/policies/ets/index_en.htm (last updated Nov. 15, 2010).

[33] Commission Decision 2004/156, Establishing Guidelines for the Monitoring and Reporting of Greenhouse Gas Emissions Pursuant to Directive 2003/87/EC of the European Parliament and of the Council, arts. 1–2, 2004 O.J. (L 59) 1, 1 (EC). The Commission adopted a revised version of these guidelines on July 18, 2007. Commission Decision 2007/589, arts. 2–3, 2007 O.J. (L 229) 1, 3 (EC) [hereinafter Commission Decision].

[34] *See generally* [U.K.] Dep't of Energy & Climate Change, EU Emissions Trading Scheme: The Quick Guide for Operators on Preparing for Annual Verification (2008) (outlining the annual verification process for operators in the United Kingdom), *available at* http://www.decc.gov.uk/en/content/cms/emissions/eu_ets/euets_phase_ii/monitoring/monitoring.aspx (click on "The quick guide for operators on preparing for annual verification" and then click "download").

[35] Commission Decision, *supra* note 33, § 10.4.2(d). The materiality threshold in the EU ETS is two percent or five percent depending on the type of regulated entity. *Id.* § 10.4.2(a). In other words, if the difference between the annual emissions report and the verifier's findings is less than two percent, then the misstatement would not be considered material. *Id.*

[36] *Id.* § 10.4.2(e).

[37] *Greenhouse Gas Emissions Verification*, Cal. Envtl. Prot. Agency Air Res. Bd., http://arb.ca.gov/cc/reporting/ghg-ver/ghg-ver.htm (last updated Nov. 14, 2011) (explaining that California regulations require parties to verify greenhouse gas reporting data); *Overview of the Global Warming Solutions Act (GWSA)*, Mass.gov, http://www.mass.gov/dep/air/climate/gwsa.htm (last visited Nov. 16, 2011) (explaining that the 2009 amendments to the Global Warming Solutions Act require parties to verify greenhouse gas reporting data).

tract with an accredited verification body every year or every three years (depending on their sector and size) to provide a verification opinion after they have submitted their emissions data reports.[38] Similar to the EU ETS, a positive verification opinion is given if the emissions data report is both free of material misstatements and conforms to the rule's requirements.[39] Verification bodies are accredited directly by the California Air Resources Board (ARB), the governmental agency responsible for implementing and enforcing the rule.[40] The Massachusetts reporting rule requires that regulated entities have their emissions reports verified every three years.[41] Verifiers must be accredited by the Climate Registry and the American National Standards Institute (ANSI), and receive recognition from the Massachusetts Department of Environmental Protection.[42]

### B. *Food Safety Regulation*

The Food Safety Modernization Act of 2011 employs third-party verification to achieve its regulatory goals for the safety of imported food.[43] The Act requires the FDA to refuse admission of food articles that are not accompanied by a "certification or other assurance" that the food meets the applicable requirements of the Act.[44] The Act also charges the FDA with establishing a system for recognizing accreditation bodies that will accredit "third-party auditors" to conduct such certification.[45] When contracted to do so by an importer, the third-party auditors would be responsible for performing an audit to determine the food's compliance with the Act and issuing a certification to ac-

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[38] Regulation for the Mandatory Reporting of Greenhouse Gas Emissions, Cal. Code Regs. tit. 17, §§ 95100–95133 (2007), *available at* http://www.arb.ca.gov/regact/2007/ghg2007/frofinoal.pdf.

[39] Cal. Code Regs. tit. 17, § 95131(c)(2)(B) (2010). The materiality threshold under the California rule is five percent. *See id.* § 95102(113).

[40] Cal. Air Res. Bd., California Air Resources Board Greenhouse Gas Verification Program: Requirements for Accreditation of Verification Bodies and Verifiers (2011), *available at* http://www.arb.ca.gov/cc/reporting/ghg-ver/accreditation_oversight.pdf (explaining that the ARB accredits verification bodies).

[41] Reporting of Greenhouse Gas Emissions, 310 Mass. Code Regs. 7.71 (2009), *available at* http://www.mass.gov/dep/service/regulations/310cmr07.pdf.

[42] Mass. Dep't of Envtl. Prot., Information Sheet on Verification Body Accreditation (2010), *available at* http://www.mass.gov/dep/air/climate/ghgvba.pdf.

[43] *See* FDA Food Safety Modernization Act, Pub. L. No. 111-353, 124 Stat. 3885 (2011).

[44] 21 U.S.C.A. § 381 (West 1999 & Supp. 2011).

[45] *Id.* § 384d(b)(1)(A)(i).

company each food shipment imported into the United States by the importer.[46]

The Act states that third-party auditors can be foreign governments, agencies of a foreign government, foreign cooperatives, or any other third party that the FDA deems appropriate, including individuals.[47] The law instructs the FDA to write "model accreditation standards" setting forth the rules for third-party audits and food certifications.[48] The law also provides that third-party auditors must make records of their audits available upon request;[49] that auditors must inform the FDA immediately if they discover conditions that could cause or contribute to a serious risk to public health;[50] and that auditors will lose their accreditation if they certify a food that is linked to an outbreak of food borne illness.[51]

### C. *Other Programs*

The role of private actors in determining compliance with social regulation is actually older and more varied than the high-profile examples above suggest. States and localities have developed a variety of regulatory programs in which private inspectors do work akin to third-party verification. For example, in Massachusetts, state law requires regulated entities to hire private consultants licensed by the state to oversee hazardous waste site remediation projects.[52] The consultant, referred to as "a licensed site professional" (LSP), performs the core regulatory function of assessing whether completed remediation work conforms to the standards set forth in state regulations.[53] In the process, the LSP categorizes the cleanup site into one of several hazard tiers, approves the scope of work based on a site investigation, evaluates and selects a remedial action alternative, and ultimately certifies that the cleanup is complete.[54] LSPs also perform much of the remediation work, problematically blurring the boundaries between regulators and regulated.[55]

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[46] *See id.* § 381.

[47] *Id.* § 384d(a)(3).

[48] *Id.* § 384d(b)(2).

[49] *Id.* § 384d(c)(3)(B).

[50] 21 U.S.C.A. § 384d(c)(4)(A) (West 1999 & Supp. 2011).

[51] *Id.* § 384d(c)(6)(A)(i).

[52] Miriam Seifter, *Rent-a-Regulator: Design and Innovation in Privatized Governmental Decisionmaking*, 33 Ecology L.Q. 1091, 1096–97 (2006).

[53] *Id.* at 1107.

[54] *Id.* at 1109–11.

[55] *See id.* at 1111.

Many other little-known examples of third-party verification exist at the state, federal, and international levels. In Massachusetts, third-party inspectors also assess compliance with underground storage tank laws.[56] In Rhode Island, third-party auditors inspect school lunch programs to assess conformity with governmental requirements.[57] In California, third parties evaluate the energy efficiency programs of regulated utilities to determine whether they meet energy-saving goals.[58] In California and other states, private smog-check stations test whether automobiles meet pollution emissions standards.[59] In many cities, private building inspectors assess whether new construction and renovations meet the local building code.[60]

At the national level, the U.S. Environmental Protection Agency (EPA) uses a system of third-party verification to regulate fuels and additives under the Clean Air Act.[61] Fuel producers and importers contract with independent certified public accountants to conduct "attest engagements" to verify compliance with standards for reformulated gasoline, sulfur content, and renewable fuel content.[62] After the regulated entity has submitted an annual report to the EPA, the accountant conducts an "audit of records" to determine whether a company's internal records support its reported data and representations regarding compliance.[63] The EPA allows and encourages changes to annual reports based on the results of the attest engagement, and such changes are often made.[64]

Practices similar to third-party verification have also been prevalent in the health care sector. The Department of Health and Human Ser-

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[56] *Third-Party UST Inspector Frequently Asked Questions*, MASS.GOV, http://www.mass.gov/dep/toxics/ust/tpifaq.htm#1 (last visited Dec. 27, 2011).

[57] *School Cafeteria Inspections*, STATE OF R.I.: DEP'T OF HEALTH, http://www.health.state.ri.us/foodprotection/about/inspections/cafeteria/ (last visited Dec. 27, 2011).

[58] Noah Kaufman & Karen Palmer, *Energy-Efficiency Program Evaluations: Opportunities for Learning and Inputs to Incentive Mechanisms* 1 (Resources for the Future, Discussion Paper RFF DP 10-16, 2010), *available at* http://www.rff.org/documents/rff-dp-10-16.pdf.

[59] *Smog & Emission Checks in California*, DMV.ORG, http://www.dmv.org/ca-california/smog-check.php#When_to_Smog_and_Where_to_Go (last visited Oct. 30, 2011).

[60] *E.g.*, Matt Galnor, *Jacksonville May Hire Private Company for Building Inspections*, JACKSONVILLE.COM (May 4, 2010, 5:45 PM), http://m.jacksonville.com/news/metro/2010-05-04/story/jacksonville-may-hire-private-company-building-inspections.

[61] Memorandum from Ruth Mead et al., ERG, to Suzanne Kocchi and Kong Chiu, U.S. EPA Headquarters, Washington D.C. 10–11 (Feb. 10, 2009) [hereinafter ERG Memo], *available at* http://www.epa.gov/climate/climatechange/emissions/archived/downloads/tsd/Verification%20approaches%20memo%20(2-10-09)%20Final.pdf.

[62] *Id.*

[63] *Id.*

[64] *Id.* at 11.

vices relied for many years on the nongovernmental Joint Commission on Accreditation of Healthcare Organizations to verify that health care providers for Medicare complied with the government's "conditions of participation" relating to health and safety.[65] Notably, government has historically played a minimal regulatory role in health care, leaving not just licensure but also the development of quality standards for hospitals and other health care institutions in the hands of the industry.[66]

At the international level, the Kyoto Protocol's Clean Development Mechanism (CDM) also relies on a type of third-party verification. The CDM enables greenhouse gas emissions reductions projects to earn credits that can be sold to industrialized countries to meet their binding emissions reductions targets.[67] The independent third-party auditors that verify the quantity of emissions reductions in a CDM project are referred to as "Designated Operational Entities."[68] They are accredited and overseen by the CDM Executive Board, and they may be fined or suspended for substandard work.[69] Before the Kyoto Protocol, third-party verification was used in some national joint implementation programs under the United Nations Framework Convention on Climate Change, which similarly sought to enable industrialized countries' governments to invest in emissions reduction projects in developing countries.[70]

Finally, it is worth noting that governments frequently rely on other types of third parties to promote law abidance in a wide range of settings. Restaurant owners must ensure the respect of no-smoking and underage drinking laws, social workers must report suspected cases of child abuse, and employers must determine whether prospective em-

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[65] Michael J. Astrue, *Health Care Reform and the Constitutional Limits on Private Accreditation as an Alternative to Direct Government Regulation*, Law & Contemp. Probs., Autumn 1994, at 75, 77 (explaining that the responsible agency within the Department of Health and Human Services has resisted becoming a regulator itself and has been receptive to the use of private accrediting agencies).

[66] Freeman, *supra* note 19, at 610; Eleanor D. Kinney, *Private Accreditation as a Substitute for Direct Government Regulation in Public Health Insurance Programs: When Is It Appropriate?*, Law & Contemp. Probs., Autumn 1994, at 47, 50.

[67] *Clean Development Mechanism (CDM)*, United Nations Framework Convention on Climate Change, http://unfccc.int/kyoto_protocol/mechanisms/clean_development_mechanism/items/2718.php (last visited Dec. 27, 2011).

[68] The Offset Quality Initiative, *Assessing Offset Quality in the Clean Development Mechanism*, Sustainable Dev. L. & Pol'y, Winter 2010, at 25, 28–29 (stating that some third-party verifiers under the CDM have been criticized for a lack of capacity and competency).

[69] *See id.*

[70] Gabriela Llobet, *"Trust but Verify": Verification in the Joint Implementation Regime*, 31 Geo. Wash. J. Int'l L. & Econ. 233, 235–37(1998).

ployees are legally eligible to work.[71] With responsibilities like these, private actors routinely act as "gatekeepers" to supplement governmental enforcement efforts.[72]

## II. Reasons to Endorse

### A. *Embracing Public-Private Governance*

In third-party verification, private third-party verifiers essentially act in the place of governmental agents to conduct inspections and make regulatory compliance determinations. Governmental agencies, in turn, take on new roles in coordinating and overseeing these private actors. As a form of public-private governance, third-party verification may further the goals of social regulation.

The term "public-private partnership" has been used to describe the wide array of arrangements through which public and private actors together do the work of governing society. As explained by one scholar, "many public services and functions are produced by a highly interdependent network of public-private partnerships woven together by history, practice, and mission, and constrained by direct regulation, contract, and informal agreement."[73] Indeed, the public and private may become so intertwined that categorizing a function as public or private may cease to be useful.[74]

The study of public-private partnerships forms part of the body of scholarship known as "new governance."[75] In coining the term "new governance," one scholar chose "governance" rather than "government" to emphasize that addressing public problems relies on the collaboration of "a wide array of third parties in addition to government."[76] The word "new" refers not to the novelty of collaborative approaches, which are actually quite old, but to the idea that these approaches require a new degree of attention to understand the challenges and op-

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[71] Janet A. Gilboy, *Compelled Third-Party Participation in the Regulatory Process: Legal Duties, Culture, and Noncompliance*, 20 L. & Pol'y 135, 137–39 (1998).

[72] Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. Econ. & Org. 53, 53 (1986).

[73] Freeman, *supra* note 16, at 1288; *see also* Minow, *supra* note 16, at 1236 (using the term "public-private partnerships" to describe this phenomenon).

[74] Freeman, *supra* note 19, at 550–51.

[75] *See* Lester M. Salamon, *The New Governance and the Tools of Public Action: An Introduction*, *in* The Tools of Government, *supra* note 10, at 1, 2; Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 Minn. L. Rev. 342, 343–44 (2004).

[76] Salamon, *supra* note 75, at 8.

portunities they present.[77] New governance is contrasted with "old governance," in which regulation is more centralized and government acts in a top-down, coercive fashion.[78]

Another scholar has also used the term "third-party government" to capture the extent to which a wide variety of third parties in partnership with the government carry out government programs and deliver publicly funded services.[79] Private banks issue loans backed by the government.[80] Government pays for health care provided by private hospitals accredited by private accreditation boards.[81] Private companies receive public funds to run schools, prisons, and other social service programs.[82] The U.S. military increasingly relies on private companies to run training camps, provide security services, and even conduct intelligence operations.[83] These public-private relationships are often formalized in government contracts.[84]

The varied roles of private actors in regulation have been a focus of the new governance literature.[85] Although governmental regulation may be caricatured as being imposed from the top down by regulators onto regulated entities, both regulatory standard-setting and enforcement processes are infused with public-private partnerships.[86] A number of private organizations have long been involved in establishing standards related to the safety of commercial products and services.[87] Not uncommonly, these privately set standards are relied on by the government and incorporated into public law.[88]

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[77] *Id.*

[78] Kenneth W. Abbott & Duncan Snidal, *Strengthening International Regulation Through Transnational New Governance*, 42 Vand. J. Transnat'l L. 501, 520–21 (2009).

[79] Salamon, *supra* note 75, at 2.

[80] *See id.*

[81] Kinney, *supra* note 66, at 47.

[82] Minow, *supra* note 16, at 1229.

[83] Laura A. Dickinson, Outsourcing War and Peace: Preserving Public Values in a World of Privatized Foreign Affairs 3–4 (2010); Martha Minow, *Outsourcing Power: Privatizing Military Efforts and the Risks to Accountability, Professionalism, and Democracy*, *in* Government by Contract, *supra* note 17, at 110, 110–114.

[84] Jody Freeman & Martha Minow, *Reframing the Outsourcing Debates*, *in* Government by Contract, *supra* note 17, at 1, 1.

[85] Vandenbergh, *Private Life*, *supra* note 18, at 2037 (stating that the two areas of focus in private governance scholarship are (1) privatization of public services and (2) privatization of regulatory activity).

[86] *See id.* at 2037–38.

[87] Ross E. Cheit, Setting Safety Standards: Regulation in the Public and Private Sectors 5–6, 12, 21–28 (1990).

[88] *Id.* at 31; Freeman, *supra* note 19, at 639–40.

Environmental law provides important examples of private involvement in enforcement. Private environmental groups may supplement governmental enforcement by monitoring regulated entities and filing "private attorney general" actions to impose legal penalties in cases of noncompliance.[89] Also, private companies perform a regulatory role when they police the environmental and labor law compliance of firms with whom they do business.[90]

Although concerns abound about the privatization of public functions, Freeman usefully observes that public-private partnerships may also lead to the "publicization" of relevant private activity.[91] In other words, private actors can be induced to commit themselves to traditionally public goals and behave according to traditional norms of public action such as accountability, due process, and rationality.[92] Freeman argues that an enhanced private role in governance need not imply a weak state. Rather, "public/private engagement may enhance state power while simultaneously augmenting private power."[93] Whether privatization leads to publicization and the continued strength of the state depends on how the public-private partnerships are structured.

Third-party verification can easily be viewed as one of the many ways in which public and private entities can work together to achieve public goals. Notably, in the regulatory role of monitoring to detect noncompliance, third-party verifiers may have an advantage over agency inspectors. As private parties that lack the sanctioning power of a governmental regulator, third-party verifiers are likely to approach the regulated entity in a cooperative, peer-to-peer manner that may induce greater information sharing.[94] This may be particularly appropriate in

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[89] *See* Mark Seidenfeld & Janna Satz Nugent, *"The Friendship of the People": Citizen Participation in Environmental Enforcement*, 73 Geo. Wash. L. Rev. 269, 283–84 (2005); Barton H. Thompson, Jr., *The Continuing Innovation of Citizen Enforcement*, 2000 U. Ill. L. Rev. 185, 192–93.

[90] *See infra* notes 101–109 and accompanying text.

[91] Freeman, *supra* note 16, at 1285.

[92] *See id.*

[93] Freeman, *supra* note 19, at 671.

[94] A long-running debate in the regulatory enforcement literature has been whether a coercive, deterrence-based approach or a cooperative, persuasive approach is more effective. *See generally* Ian Ayres & John Braithwaite, Responsive Regulation: Transcending the Deregulation Debate (1992) (advocating the use of both approaches together); Eugene Bardach & Robert A. Kagan, Going by the Book: The Problem of Regulatory Unreasonableness, at ix–x (1982); Robert L. Glicksman & Dietrich H. Earnhart, *Depiction of the Regulator-Regulated Entity Relationship in the Chemical Industry: Deterrence-Based vs. Cooperative Enforcement*, 31 Wm. & Mary Envtl. L. & Pol'y Rev. 603 (2007) (arguing that the relationship between regulator and regulated entity is multidimensional and the ideal types of punitive and cooperative do not capture this complexity); David L. Markell, *The Role of Deterrence-*

the enforcement of new types of regulation such as greenhouse gas reporting requirements.[95] Moreover, the process of third-party verification is generally structured to promote communication and correction when instances of noncompliance are found.[96] In contrast to a traditional inspection by an agency official, the interaction with third-party verifiers may be perceived by regulated entities less as a judgment day and more as an opportunity to learn and improve.[97]

### B. *Harnessing Auditing Industry Expertise*

Another advantage of third-party verification is that a great deal of expertise to inspect and make compliance determinations exists in the private sector. A large private inspection industry has developed through voluntary auditing practices as well as voluntary certification schemes.[98] In these initiatives, private entities are often hired to monitor and assess compliance with a wide array of standards set by either the government or private organizations.[99] This large and growing corps of private inspectors has been aptly termed the "third-party assurance industry."[100]

Many companies voluntarily commission third parties to conduct audits for internal operational purposes.[101] For example, in the environmental arena, companies may seek a general compliance audit[102] to

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*Based Enforcement in a "Reinvented" State/Federal Relationship: The Divide Between Theory and Reality*, 24 Harv. Envtl. L. Rev. 1 (2000) (arguing that although the EPA endorses deterrence-based enforcement, states tend to endorse cooperative approaches).

[95] *See* Salzman et al., *supra* note 6, at 261, 281 (supporting the proposition that much noncompliance is involuntary, due to factors such as the complexity and ambiguity of regulations).

[96] *See infra* notes 373–375 and accompanying text.

[97] *See* Clifford Rechtschaffen, *Deterrence vs. Cooperation and the Evolving Theory of Environmental Enforcement*, 71 S. Cal. L. Rev. 1181, 1250–51 (1998).

[98] *See* Margaret M. Blair et al., *The New Role for Assurance Services in Global Commerce*, 33 J. Corp. L. 325, 329 (2008).

[99] *See id.*

[100] *See id.* at 329–30 (tracing the origins of the third-party assurance industry and many of its most important firms back to the 1800s when marine insurance companies hired private inspectors to make sure that ships carrying insured goods were seaworthy).

[101] *See* Neil Gunningham & James Prest, *Environmental Audit as a Regulatory Strategy: Prospects and Reform*, 15 Sydney L. Rev. 492, 495 (1993) (distinguishing between operational audits, which include compliance and management audits, and transactional audits).

[102] An "'[e]nvironmental Audit' is a systematic, documented, periodic and objective review by regulated entities of facility operations and practices related to meeting environmental requirements." Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations, 65 Fed. Reg. 19,618, 19,625 (Apr. 11, 2000). The term "environmental audit" emerged in the 1980s with reference to the financial audit. Christine Parker, *Regulator-Required Corporate Compliance Program Audits*, 25 Law & Pol'y 221, 223

determine their overall compliance status with environmental laws, or a narrower compliance audit regarding a specific aspect of their operations such as land contamination, equipment performance, or monitoring system design.[103] Companies are motivated to conduct voluntary compliance audits to reduce their risk of enforcement liability.[104] Companies may also commission a "management audit" to assess an environmental management system.[105]

Third-party audits are also commissioned in the course of many legal transactions. Companies purchasing other companies may employ third-parties to assess their regulatory compliance.[106] Lending institutions and insurance agencies may similarly use independent auditors to evaluate a potential client.[107] In addition, governmental agencies have sometimes required that regulated entities contract with a third party to conduct compliance or management audits as part of enforcement ac-

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(2003) (stating that the term "audit" is designed to import the features of a financial audit). For a theorization of the phenomenon of audit, see generally Michael Power, The Audit Society: Rituals of Verification (1997); Michael Power, *Expertise and the Construction of Relevance: Accountants and Environmental Audit*, 22 Acct., Orgs. & Soc'y, 123, 126 (1997).

[103] *See* Gunningham & Prest, *supra* note 101, at 495.

[104] *See id.* at 507; *cf.* Nancy Kubasek et al., *Mandatory Environmental Auditing: A Better Way to Secure Environmental Protection in the United States and Canada*, 18 J. Land Resources & Envtl. L. 261, 264 (1998). On the question of whether the law should encourage environmental audits by protecting audit reports from disclosure in legal proceedings and immunizing violations that were discovered and disclosed from legal penalty, see David A. Dana, *The Perverse Incentives of Environmental Audit Immunity*, 81 Iowa L. Rev. 969 (1996) (discussing why environmental audit immunity might be "environmentally harmful"); Jay P. Kesan, *Encouraging Firms to Police Themselves: Strategic Prescriptions to Promote Corporate Self-Auditing*, 2000 U. Ill. L. Rev. 155 (arguing for a balanced approach that would grant regulators access to audit information, limit third-party access to such information, and "provide mitigated penalties for firms engaging in good-faith self-policing").

[105] An environmental management system (EMS) consists of a set of policies and programs that are established within a company to manage environmentally relevant aspects of the company's operations. *See* Magali A. Delmas, *Barriers and Incentives to the Adoption of ISO 14001 by Firms in the United States*, 11 Duke Envtl. L. & Pol'y F. 1, 3–4 (2000); Stepan Wood, *Environmental Management Systems and Public Authority in Canada: Rethinking Environmental Governance*, 10 Buff. Envtl. L.J. 129, 134–35 (2003) (explaining an EMS as consisting of planning, implementing, checking, corrective action, and review); *see also* George Van Cleve, *The Changing Intersection of Environmental Auditing, Environmental Law and Enforcement Policy*, 12 Cardozo L. Rev. 1215, 1229 (1991) (explaining that the EPA defined and distinguished compliance audits and management audits in its 1986 Policy on the Inclusion of Environmental Auditing Provisions in Enforcement Provisions).

[106] Vandenbergh, *Private Life*, *supra* note 18, at 2045–50 (explaining that private environmental assessment is common in corporate acquisition agreements).

[107] *See id.* at 2045.

tions.[108] Although in this case the audit is mandatory rather than voluntary, the audit process is similar.[109]

Companies that buy goods from other companies may impose certain social or environmental requirements on suppliers, and require the suppliers to contract third-party social audits to ensure conformity with those requirements.[110] This is particularly prevalent when companies in developed countries source products from companies in developing countries. One scholar documents the presence of a "vast network of private agreements that impose environmental and other standards, whether collectively or unilaterally adopted."[111] By his analysis, private environmental contracting is widespread in major sectors such as the discount and variety retail, home improvement retail, automobile manufacturing, and lumber and wood production sectors.[112] Similarly, in the garment and sportswear industries, many buyers impose conditions on suppliers relating to child labor and other factory practices.[113] Each year, tens of thousands of social audits are commissioned by hundreds of brand-name companies and retailers in these sectors.[114]

Voluntary certification schemes have also contributed to the development of the third-party assurance industry.[115] Certification schemes, in which a label or recognition is awarded if certain standards are met, are varied. They have developed for products such as organic food, facilities or operations such as sustainable forest operations, and

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[108] Terrell E. Hunt & Timothy A. Wilkins, *Environmental Audits and Enforcement Policy*, 16 Harv. Envtl. L. Rev. 365, 394 (1992); Van Cleve, *supra* note 105, at 1229–31.

[109] *See* David L. Markell, *States as Innovators*, 58 Alb. L. Rev. 347, 406–08 (1994) (describing how the state of New York required egregious violators to hire agency-approved auditing firms to conduct comprehensive environmental audits of the violator's operations on an ongoing basis).

[110] These requirements often grow out of voluntary corporate codes established by retailers. *See, e.g.*, Stepan Wood, *Voluntary Environmental Codes and Sustainability*, *in* Environmental Law for Sustainability 229, 230 (Benjamin J. Richardson & Stepan Wood eds., 2006) (defining voluntary environmental codes as "commitments undertaken by one or more polluters or resource users, in the absence of an express legal requirement to do so, prescribing norms to regulate their behaviour in relation to their interaction with the environment").

[111] Vandenbergh, *New Wal-Mart*, *supra* note 18, at 916.

[112] *See id.* at 926–27.

[113] *See* Clean Clothes Campaign, Looking for a Quick Fix: How Weak Social Auditing Is Keeping Workers in Sweatshops 56, 69, 79–80 (2005), *available at* http://www.cleanclothes.org/resources/national-ccc/1166-looking-for-a-quick-fix.

[114] *Id.* at 12, 58–59 (presenting additional information about the numbers of audits conducted by particular companies).

[115] Wood, *supra* note 110, at 261 (identifying a trend toward third-party verification, and stating that "[a] huge industry of auditors, certifiers and accreditation bodies has emerged to serve these expanding certification needs").

organizations such as environmental management systems.[116] Certification schemes may be established by industry, public interest organizations, or the government. Although such schemes are increasingly prevalent, they tend to suffer from credibility problems as consumers and others doubt that certified products and facilities truly meet the scheme's standards.[117] Many schemes were initially weak in the area of monitoring and enforcement.[118] Third-party certification emerged as a way of giving credibility to certification programs and is considered a "best practice" used in the most rigorous programs.[119]

The forest products label from the Forest Stewardship Council (FSC), for example, uses third-party verification extensively.[120] To be certified, a forest products company must contract with an accredited third-party certification body to assess its conformity with FSC's principles, criteria, and standards.[121] The FSC contracts with a private company, Accreditation Services International (ASI), to serve as the program's accreditation body.[122] ASI audits certification bodies to assess their performance and determine whether their status as a certification body will be maintained.[123] The Marine Stewardship Council, created in 1997 to provide certification to sustainable fisheries, uses a similar system of third-party certification.[124]

The Energy Star Program, established by the EPA in 1992 to provide a labeling system for products that meet certain voluntary energy efficiency standards, recently adopted a third-party certification sys-

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[116] *See id.* (distinguishing certification for products from certification for organizations).

[117] *See* Clean Clothes Campaign, *supra* note 113, at 12 (noting that labor rights activists initially questioned the motives and effectiveness of social audits); Gunningham & Prest, *supra* note 101, at 512 (stating that companies face the danger that audits "will degenerate into public relations exercises for industry").

[118] *See* Wood, *supra* note 110, at 260 (stating that "[u]ntil recently many, and perhaps most voluntary environmental codes made no provision for monitoring or reporting of performance").

[119] Aseem Prakash & Matthew Potoski, The Voluntary Environmentalists: Green Clubs, ISO 14001, and Voluntary Regulations 59 & n.26 (2006); *see also* Wood, *supra* note 110, at 261 (stating that "[t]he ultimate form of external verification of code implementation is third-party certification").

[120] *See* Meidinger, *supra* note 15, at 70–73.

[121] *What Is Certification?*, Forest Stewardship Council U.S., http://www.fscus.org/faqs/what_is_certification.php (last visited Dec. 27, 2011).

[122] *See FSC Accreditation Program*, Forest Stewardship Council, http://www.fsc.org/accreditation.html (last visited Dec. 27, 2011).

[123] *See id.*

[124] *Third Party Certification*, Marine Stewardship Council, http://www.msc.org/about-us/standards/third-party-certification (last visited Dec. 27, 2011).

tem.[125] As of 2011, Energy Star requires that products carrying the label be certified by third parties.[126] Previously, manufacturers self-declared to the EPA that their products met the Energy Star requirements.[127] With the new third-party certification requirement, product testing must be conducted in an accredited laboratory and the results must be certified and submitted to the EPA by an accredited certification body.[128] Laboratories and certification bodies may be accredited either directly by the EPA or by an EPA-recognized accreditation body.[129] The EPA's Water Sense program, which provides a label for high-performing, water-efficient products, similarly requires third-party verification.[130]

In the arena of climate change regulation, the Climate Registry is a voluntary nonprofit collaboration founded in 2007 by North American states, provinces and territories.[131] It sets standards to calculate, verify, and publicly report greenhouse gas emissions in a single regis-

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[125] *See History of Energy Star*, Energy Star, http://www.energystar.gov/index.cfm?c=about.ab_history (last visited Dec. 27, 2011) (describing the history of the Energy Star program, and noting that labeled products include major appliances, office equipment, lighting, and home electronics).

[126] *Third-Party Verification Required for Energy Star Products*, Consulting-Specifying Engineer (Aug. 26, 2010), http://www.csemag.com/search/search-single-display/third-party-verification-required-for-energy-star-products/0314063836.html.

[127] *See id.*

[128] *See Conditions and Criteria for Recognition of Certification Bodies for the EnergyStar Program* 2, Energy Star, http://www.energystar.gov/ia/partners/downloads/mou/Conditions_and_Criteria_for_Recognition_of_Certification_Bodies.pdf (last visited Dec. 27, 2011) (stating that the certification body must agree in writing to "[c]onfirm that all data in the test report originated from an EPA-recognized laboratory with an appropriate scope of accreditation" and "[r]eport to EPA certified products and at a minimum the key data elements enumerated in the applicable EnergyStar product specification(s)"); *id.* at 4 (stating that the certification body must agree in writing to ensure that "[v]erification testing [is] performed at an EPA-recognized, third-party laboratory"); *see also Conditions and Criteria for Recognition of Laboratories for the EnergyStar Program* 1–2, Energy Star, http://www.energystar.gov/ia/partners/downloads/mou/Criteria_Laboratories.pdf (last visited Dec. 27, 2011) (establishing requirements for accredited laboratories).

[129] *See Accreditation Body Resources*, Energy Star, http://www.energystar.gov/index.cfm?c=third_party_certification.tpc_accred_bodies (last visited Dec. 27, 2011) (noting that EPA-recognized accreditation bodies "provide accreditation for laboratories and certification bodies"). By May 2011, the EPA had recognized about twenty-five accreditation bodies around the world. *See EPA-Recognized Accreditation Bodies*, Energy Star, http://www.energystar.gov/index.cfm?c=partners.epa_recognized_accreditation_bodies (last visited Dec. 27, 2011).

[130] U.S. EPA, Product Certification System 1 (2011), *available at* http://www.epa.gov/watersense/docs/cert_system_508.pdf; *WaterSense Product Certification*, U.S. EPA, http://www.epa.gov/watersense/partners/certification.html (last visited Dec. 27, 2011).

[131] *See About*, The Climate Registry, http://www.theclimateregistry.org/about/ (last visited Dec. 27, 2011); *Board of Directors*, The Climate Registry, http://www.theclimateregistry.org/about/board-of-directors/ (last visited Dec. 27, 2011).

try.[132] Companies and organizations that report their annual emissions and have them verified by an accredited third party earn the right to use the "Climate Registered" logo.[133] ANSI accredits third-party verifiers in the United States, and similar national standards organizations accredit certifiers in Canada and Mexico.[134] ANSI receives and reviews the application, conducts site visits to the applicant's facility to collect further information, and makes the accreditation decision.[135] ANSI also conducts surveillance of accredited verifiers to check continued conformity with accreditation requirements.[136] The Climate Registry maintains an oversight panel to monitor ANSI's accreditation process.[137]

### C. *Moving Toward Full Compliance*

Third-party verification is a type of "gatekeeper" strategy that serves as an alternative to traditional monitoring and enforcement strategies. By providing for the compliance status of all regulated entities to be verified, it offers a pathway toward full compliance. Also, in the process, it provides more complete information about the regulatory performance of regulated entities. Full compliance—and complete compliance data—is critical to the success of some forms of regulation and socially desirable in many others.

Traditional regulatory enforcement is based primarily on deterrence theory, which posits that a regulated entity will comply with the law when the expected cost of noncompliance exceeds the benefit gained by the violation.[138] The cost of noncompliance may be incurred in the form of civil or criminal sanctions, as well as in other ways such as damage to reputation and legal costs.[139] For the regulated entity, the

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[132] *See Mission*, The Climate Registry, http://www.theclimateregistry.org/about/mission/ (last visited Dec. 27, 2011).

[133] *Membership Options*, The Climate Registry, http://www.theclimateregistry.org/how-to-join/membership-options/ (last visited Dec. 27, 2011).

[134] ERG Memo, *supra* note 61, at A-1.

[135] *Id.* at A-2.

[136] *Id.*

[137] *Id.*

[138] *See* Rechtschaffen, *supra* note 97, at 1186–87; *see also* Joel A. Mintz, Enforcement at the EPA: High Stakes and Hard Choices 101–06 (1995) (contending that the EPA's enforcement programs are deterrent in nature).

[139] Timothy F. Malloy, *Regulation, Compliance and the Firm*, 76 Temp. L. Rev. 451, 462 (2003).

relevant measure of cost is "expected cost," which implies a discounting to reflect the fact that the probability of detection is less than one.[140]

When sanctions are not sufficiently severe or when there is a low probability of detection, deterrence is weakened.[141] These problems have indeed plagued regulatory enforcement. Governmental agencies charged with implementing social regulation tend to lack the resources to conduct sufficiently frequent inspections and collect reliable compliance data. Regulatory inspections are often sporadic, perhaps occurring only every few years. For example, the FDA inspects on average only twenty-four percent of regulated facilities each year.[142] A 2007 report by the EPA Office of the Inspector General found that the EPA "did not have current and complete data on either the regulated entities or changes in their compliance status."[143] While industry is often required to self-monitor and report to the government on a regular basis, this data is of questionable quality.[144]

In many regulatory programs, states have the primary responsibility for enforcement and are overburdened.[145] States reportedly conduct about ninety percent of all environmental regulatory inspections and file eighty to ninety percent of environmental enforcement actions.[146] Yet the resources for regulatory inspections at the state level have not grown at the same rate as the number of regulated facilities.[147] In the area of Clean Water Act enforcement, for example, the number of regulated facilities doubled over a recent ten-year period in which state enforcement budgets remained essentially flat.[148] Additional pressures

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[140] *Id.* at 461–62 & n.32.

[141] *Id.*

[142] Elena Fagotto, *Governing a Global Food Supply: How the 2010 FDA Food Safety Modernization Act Promises to Strengthen Import Safety in the US*, 3 Erasmus L. Rev. 257, 266 (2010).

[143] U.S. EPA Office of Inspector Gen., Evaluation Report No. 2007-P-00027, Overcoming Obstacles to Measuring Compliance: Practices in Selected Federal Agencies 1 (2007).

[144] *See* U.S. Gen. Accounting Office, GAO/RCED-93–21, Environmental Enforcement: EPA Cannot Ensure the Accuracy of Self-Reported Compliance Monitoring Data 2–5(1993); Bradley C. Karkkainen, *Information as Environmental Regulation: TRI and Performance Benchmarking, Precursor to a New Paradigm?*, 89 Geo. L.J. 257, 294, 335–36 (2001).

[145] Duhigg, *supra* note 2; Markell, *supra* note 94, at 32.

[146] Markell, *supra* note 94, at 32.

[147] Duhigg, *supra* note 2; *see also* Salzman et al., *supra* note 6, at 283 (noting both state primacy and state weakness).

[148] Duhigg, *supra* note 2; *see also* EPA Office of Compliance, CWA Action Plan Implementation Priorities: Changes to Improve Water Quality, Increase Compliance and Expand Transparency 3 (2011), *available at* http://www.epa.gov/oecaerth/resources/publications/civil/programs/cwa/actionplan-implpriorities.pdf (stating that the universe of point sources has grown from roughly 100,000 to over a million).

on state budgetary resources make this trend likely to continue or worsen.[149]

Moreover, deterrence may be ineffective because the assumptions of deterrence theory fail. Deterrence theory assumes that regulated entities voluntarily choose whether to comply or not based on a rational, profit-maximizing calculus of costs and benefits.[150] But regulations are complex and sometimes difficult to interpret.[151] Regulated entities may unintentionally fail to comply because they do not understand what the law requires.[152] A cooperative theory of enforcement offers an alternative predicated on the idea that regulated companies are not just rational profit maximizers but also moral actors that are usually committed to complying with the law.[153] A cooperative approach to enforcement emphasizes education and persuasion rather than punitive sanctions.[154]

Third-party verification is a gatekeeper strategy that builds on the insights of the cooperative theory of enforcement and offers an alternative to deterrence-based enforcement. As defined by one scholar, gatekeepers are "private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers."[155] Reliance on gatekeepers is a useful strategy when deterrence is ineffective or impracticable.[156] Accountants and lawyers, for example, are "natural gatekeepers for fraudulent securities transactions that require audits or legal opinions in order to close."[157] As with third-party verification in the regulatory context, these third parties may prevent misconduct by withholding their approval.[158]

Importantly, the mere knowledge that a third party will inspect their activities can change the behavior of regulated firms. When managers expect outside observers, they tend to change how they perform

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[149] Will Reisinger et al., *Environmental Enforcement and the Limits of Cooperative Federalism: Will Courts Allow Citizen Suits to Pick Up the Slack?*, 20 Duke Envtl. L. & Pol'y F. 1, 21–23 (2010).

[150] *See supra* notes 134–136 and accompanying text.

[151] Salzman et al., *supra* note 6, at 261–62.

[152] *See id.*

[153] Glicksman & Earnhart, *supra* note 94, at 616–17; Rechtschaffen, *supra* note 97, at 1188, 1191.

[154] Rechtschaffen, *supra* note 97, at 1190 & n.28.

[155] Kraakman, *supra* note 72, at 53.

[156] *See id.* at 56 (discussing limits of direct deterrence, such as high costs, to detect or prosecute noncompliance).

[157] *Id.* at 54.

[158] *Id.* (explaining that a gatekeeper strategy, like direct deterrence, is an ex ante enforcement strategy).

their jobs and how they relate to other managers in ways that favor adherence.[159] As such, the performance of an individual or group improves when it is singled out for observation and study by an outsider.[160] Also in the third-party verification process, there are opportunities for third-party verifiers to educate and persuade the regulated entity to comply.

In addition to promoting greater compliance among regulated entities, third-party verification could furnish more and better data about compliance and regulatory performance. Verification of regulatory compliance would occur at predetermined, regular intervals, creating more complete and reliable compliance information. Like current governmental enforcement, third-party verification would often rely on the self-monitoring data produced by the regulated entity. But now, this data would be independently verified to detect inconsistencies and ensure completeness. Third parties would provide systematic and objective reviews of whether legal requirements are being met.[161]

In these ways, a well-designed third-party verification system can be expected to result in both greater compliance and better compliance data. With better data about compliance, regulatory agencies would have more information to determine what types of regulation are effective and how to spend their regulatory resources.[162] If the information is released to external stakeholders, such as consumers and investors, in a manner that enables them to distinguish between good and bad performers, then these stakeholders may also be able to reward and punish firms through their marketplace decisions.[163] Reliable data would also

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[159] *See* Prakash & Potoski, *supra* note 119, at 60 (explaining that third-party inspections "mitigate shirking by creating incentives for managers within the firm to adhere to program obligations").

[160] *Id.* at 61–62, 181.

[161] Neil A. Gunningham, *Towards Effective and Efficient Enforcement of Occupational Health and Safety Regulation: Two Paths to Enlightenment*, 19 Comp. Lab. L. & Pol'y J. 547, 566 (1998) (stating that audits could provide "systematic, documented, periodic, and objective reviews of whether OHS requirements are being met and whether systems are being adhered to"); Paul R. Kleindorfer, *Market-Based Environmental Audits and Environmental Risks: Implementing ISO 14000*, 22 Geneva Papers on Risk & Ins. 194, 203 (1997) ("[The] use of third parties, together with an informed public, has the potential to increase the efficiency and service quality of monitoring and inspection services as compared to the more bureaucratic procedures within the government.").

[162] *Cf.* Flatt & Collins, *supra* note 11, at 55 ("Those charged with drafting and enforcing our environmental laws have had to work with little or no information about whether or not these programs are actually working properly.").

[163] Robert H. Cutting et al., *Enforcement Data: A Tool for Environmental Management*, 36 Envtl. L. Rep. 10,060, 10,063–65 (2006) (summarizing the potential effects of reliable data on consumers, investors, and regulators); Prakash & Potoski, *supra* note 119, at 181

allow the public to independently analyze how well regulatory programs are working.[164]

### D. *Meeting the Needs of New Regulation*

As regulation increasingly targets new types of activities and uses market-based approaches, regulatory data needs are growing in complexity and magnitude. The regulation of imported products, for example, reaches activities that are transnational in scope.[165] Toys, clothes, food, drugs, and other products that may cause harm are now produced in a global economy, and their regulation requires information about how products were made and handled in other countries. Yet governmental inspectors in the traditional model of social regulation are unlikely to have either the resources or the authority to collect such information.

Greater data needs are also associated with the use of market-based regulatory instruments. One of the reasons that technology-based standards were often employed in the early years of environmental law is that they were relatively easily enforced.[166] Compliance could generally be verified by ascertaining the installation and functionality of a pollution control technology and by conducting a spot check to show that the applicable performance standard was met. Records that verified periodic sampling and technology maintenance could provide further confirmation of compliance.

Modern regulatory ambitions, however, have moved past technology-based standards and towards market-based regulation. Market-based regulation seeks to change behavior through market-based sig-

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("With public disclosures of audit results, stakeholders can monitor compliance with club standards and then accordingly reward and punish firms and the green clubs themselves.").

[164] *See* Flatt & Collins, *supra* note 11, at 68–72, 85–86 (describing the difficulties of acquiring and analyzing enforcement data from the EPA); *cf.* Wesley A. Magat & W. Kip Viscusi, *Effectiveness of the EPA's Regulatory Enforcement: The Case of Industrial Effluent Standards*, 33 J.L. & Econ. 331, 334 (1990) (noting that the authors focused on Clean Water Act enforcement in that article because "[o]nly for water pollution was it possible to find" the data regarding pollution discharges and enforcement actions necessary for the study).

[165] *See* Cary Coglianese, *Preface* to Import Safety, *supra* note 5, at vii.

[166] *See* Daniel H. Cole & Peter Z. Grossman, *When Is Command-and-Control Efficient? Institutions, Technology, and the Comparative Efficiency of Alternative Regulatory Regimes for Environmental Protection*, 1999 Wis. L. Rev. 887, 931–32 (noting that ease of enforcement was one reason for preferring command-and-control regulation over economic control mechanisms).

nals rather than prescriptive directives.[167] Examples of market-based environmental regulation include economic instruments, such as emissions trading systems and pollution taxes, as well as information regulation, such as corporate environmental reporting requirements.[168]

Enforcement of an emissions trading system requires a complete accounting of pollution emissions, something that companies have rarely been required to produce.[169] For the regulatory agency to determine whether a regulated facility is in compliance at the end of a reporting period, it must be able to ascertain that the facility has enough allowances to cover all the pollution emitted during the reporting period.[170] In the absence of accurate monitoring data, the integrity of the allowance market—and the regulatory program as a whole—will be compromised.[171] The fair assessment of an emissions tax also depends on a complete and accurate count of emissions.

Information regulation may also be hobbled or derailed by unreliable data. Information regulation requires regulatory entities to disclose information on environmental performance to workers, consumers, shareholders, or the public in general.[172] Disclosure empowers these external actors to exert pressure for improved performance through the market and other social channels.[173]

An oft-discussed example of information regulation in U.S. law is the Toxics Release Inventory (TRI) program, created by the Emergency Planning and Community Right to Know Act.[174] The TRI re-

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[167] Robert Stavins, *Market-Based Environmental Policies: What Can We Learn from U.S. Experience (and Related Research)?, in* Moving to Markets in Environmental Regulation: Lessons from Twenty Years of Experience 19, 19 (Jody Freeman & Charles D. Kolstad eds., 2007).

[168] For a well-constructed and comprehensive categorization of environmental regulatory instruments, see Neil Gunningham & Peter Grabosky, Smart Regulation: Designing Environmental Policy 37–91 (1998).

[169] Lesley K. McAllister, *The Enforcement Challenge of Cap-and-Trade Regulation*, 40 Envtl. L. 1195, 1198 (2010) (noting that an agency must have accurate data regarding a facility's emissions over a given period of time in order to properly administer a cap-and-trade program).

[170] *Id.*

[171] *Id.*

[172] David W. Case, *The Law and Economics of Environmental Information as Regulation*, 31 Envtl. L. Rep. 10,773, 10,775 (2001).

[173] *Id.*; *see also* Gunningam & Prest, *supra* note 101, at 519 (explaining that the fear of bad publicity is likely to motivate improvement).

[174] 42 U.S.C. §§ 11000–11050 (2006); Case, *supra* note 172, at 10,775 (citing the TRI as the most widely analyzed example of information regulation); Daniel J. Fiorino, *Rethinking Environmental Regulation: Perspectives on Law and Governance*, 23 Harv. Envtl. L. Rev. 441, 448 (1999) (explaining that TRI reporters do not want to be known as the leading polluters in their communities).

quires that large polluters annually report the total amount of specified toxic chemicals transferred off-site or released into the air, water, or land.[175] Regulated entities estimate these amounts, which are not generally subject to verification.[176] Although it is often hailed as an effective program, the TRI has been limited by the unreliability of its data.[177] Facilities have in many cases reported declines in their toxic releases, but the reasons have been unclear. In some cases, reported declines might be due to changes in how facilities estimate their emissions, rules for which are not clearly established.[178] In other cases, facilities may be substituting toxic chemicals that are not required to be reported for toxic chemicals that are.[179] A 2004 study by environmental organizations suggested that toxic releases were underreported by about fifteen percent and that the releases of some toxins may be as much as five times higher than reported.[180]

### E. *Shifting the Costs of Enforcement*

Third-party verification shifts some of the costs of regulating onto the regulated entities. It thus holds promise in conserving scarce regulatory resources.[181] Presently, the status quo of regulatory enforcement is that the government funds the agencies that inspect and sanction the regulated community.[182] With a third-party verification system, the di-

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[175] Fiorino, *supra* note 174, at 448.

[176] Wendy E. Wagner, *Commons Ignorance: The Failure of Environmental Law to Produce Needed Information on Health and the Environment*, 53 Duke L.J. 1619, 1668–69 (2004).

[177] *See id.*; *see also* Karkkainen, *supra* note 144, at 331–38.

[178] *See* Kathryn E. Durham-Hammer, *Left to Wonder: Reevaluating, Reforming, and Implementing the Emergency Planning and Community Right-to-Know Act of 1986*, 29 Colum. J. Envtl. L. 323, 338 (2004).

[179] *Cf.* Karkkainen, *supra* note 144, at 332 (explaining that, because TRI does not account for the relative toxicity of pollutants, facilities can game the TRI system by "substituting lower-volume, higher-toxicity pollutants").

[180] Envtl. Integrity Project & Galveston-Houston Ass'n for Smog Prevention, Who's Counting? The Systematic Underreporting of Toxic Air Emissions 2, 4 (2004), *available at* http://airalliancehouston.org/files/WhosCountingReport.pdf.

[181] The Massachusetts Hazardous Waste Remediation Program provides an example of how reliance on third parties may reduce government costs. Before the program was implemented, the agency estimated it would require 519 staff members to administer a remediation program directly without third parties and 324 staff with them. A study of the program in 2005 showed that the actual staffing was only 165. Seifter, *supra* note 52, at 1099 n.37, 1103.

[182] *See* Prakash & Potoski, *supra* note 119, at 1 (explaining that, under the twentieth-century "command-and-control" theory of regulation, governments promulgate regulations setting standards for firm performance, monitor whether firms comply with those standards, and punish firms that do not comply).

rect costs of inspection and compliance assessment would instead be borne by the regulated companies. Regulated companies would thus be made to internalize part of the cost of regulatory enforcement.[183]

In traditional social regulation, regulatory agencies often try to shift the costs of regulation through regulatory fees.[184] Agencies impose fees on regulated entities to help defray the agency's regulation-related expenses and otherwise serve regulatory purposes.[185] Most commonly, regulated entities are required to pay permit or license fees that are designed to cover the costs of implementing and enforcing a permitting scheme.[186]

Although such fees are commonly assessed by federal and state agencies, they often do not cover the full costs that the agency incurs to monitor and enforce regulations.[187] Regulated entities and policymakers may resist the imposition of such fees and contest their amount.[188] Moreover, political and administrative factors may prevent fees from being updated to adequately support regulatory activity.[189] For these reasons, the shifting of the regulatory costs presently occurs in a sporadic and unsystematic way. Third-party verification would be a more reliable and consistent way to shift the regulatory costs associated with inspection and compliance determination.

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[183] Gunningham, *supra* note 161, at 566 (stating that such an internalization of inspection costs is desirable from the standpoint of economic theory); *see also* Wagner, *supra* note 176, at 1632 n.33 (identifying the costs needed for society to address problems caused by private actors as a category of social costs that should be internalized).

[184] *See, e.g.*, Rechtschaffen, *supra* note 4, at 794–95.

[185] Administrative Office of the U.S. Courts—California E-Waste Recycling Fee, Case No. B-320998, at 7 (U.S. GAO May 4, 2011), http://www.gao.gov/decisions/appro/320998.pdf (citing San Juan Cellular Tel. Co. v. Pub. Serv. Comm'n, 967 F.2d 683, 685 (1st Cir. 1992)).

[186] *Id.*; *see also* Nat'l Cable Television Ass'n v. United States, 415 U.S. 336, 340–41 (1974) (explaining that regulatory fees are assessed against an identifiable class of persons as part of a regulatory scheme to defray the cost of regulating the particular business or activity engaged in by such persons and distinguishing regulatory fees from taxes).

[187] *See, e.g.*, Rechtschaffen, *supra* note 4, at 795.

[188] *See, e.g.*, Phil Taylor, *Battle Brews over Interior Bid to Increase Regulatory Fees for Offshore Drilling Projects*, N.Y. Times (Jan. 21, 2011), http://www.nytimes.com/gwire/2011/01/21/21greenwire-battle-brews-over-interior-bid-to-increase-reg-81926.html (noting that the oil industry and Republican lawmakers opposed the Bureau of Ocean Energy Management, Regulation and Enforcement's recent proposal to raise administrative fees).

[189] *See, e.g.*, Office of the Legislative Auditor, State Of Minn., Report No. 02-02, Minnesota Pollution Control Agency Funding 35–36 (2002), *available at* http://www.auditor.leg.state.mn.us/ped/pedrep/0202all.pdf; Office of the Legislative Auditor Gen., State of Utah, Report No. 2010–04, A Limited Review of State Agency Regulatory Fees 7 (2010) (noting that some agencies may oppose increasing regulatory fees because those fees are considered volatile and they would rather rely on stable money from the state's general fund).

Of course, oversight of a third-party verification system still requires governmental resources. Third-party verification, however, enables regulatory agencies to focus their attention on a relatively small number of accredited verifiers rather than the large universe of regulated entities.[190] Regulators may establish rules regarding how accreditation and verification should be conducted and then direct enforcement resources towards ensuring compliance with these rules.[191]

## III. Reasons for Concern

### A. *Privatizing a Core Governmental Function*

Although regulation is replete with public-private partnerships, assessing legal compliance with governmental standards is arguably a core governmental function that should not be privatized. Of the two primary policy-related functions that regulatory agencies perform—setting standards and enforcing them—privatization is less prevalent and arguably less appropriate in the latter.[192] Private entities have long been involved in setting standards, particularly for goods and services sold in the marketplace. In his 1990 study, one scholar found that private standard-setting organizations had produced tens of thousands of private standards, of which only several thousand were likely to have significant public-interest implications.[193] The private role in public standard-setting is also extensive and is especially visible in public adoption of private standards and negotiated rulemaking.[194] Congress and administrative agencies have often delegated standard-setting responsibilities to private organizations and then adopted these standards for regulatory programs.[195]

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[190] Gunningham, *supra* note 161, at 565 (observing the "compelling pragmatic reasons" for passing regulatory oversight to third parties in jurisdictions that lack "adequate inspectoral resources").

[191] *See infra* notes 315–427 and accompanying text.

[192] *See* Kinney, *supra* note 66, at 49 (distinguishing the legislative standard-setting function from the adjudication compliance determination function and noting that it is less common for Congress or an agency to delegate the compliance determination function); Sidney A. Shapiro, *Outsourcing Government Regulation*, 53 Duke L.J. 389, 400 (2003) (highlighting standard-setting and enforcement as the two policy-related functions that agencies perform).

[193] Cheit, *supra* note 87, at 5–6 (noting that many private standards regulate uniformity or interchangeability in commercial products and lack significant public interest implications).

[194] Freeman, *supra* note 19, at 639–43 (describing private standard-setting), 653–57 (describing negotiated rulemaking); Vandenbergh, *Private Life*, *supra* note 18, at 2037–38.

[195] *See* Kinney, *supra* note 66, at 47.

With respect to making compliance determinations and enforcing public standards, the private role has been more limited. Of course, the regulated entities themselves are important actors in this area. Under many regulatory laws, they are obligated to conduct certain monitoring, recordkeeping, and reporting activities, and the information generated through these activities is critical to the enforcement process. Also, regulated entities regularly communicate and negotiate with agencies regarding possible instances of noncompliance.[196] There comes a point in the enforcement process, however, when the agency is called upon to decide whether an entity is in compliance, and this decision is the agency's responsibility.

Scholars have identified ways in which enforcement may be outsourced, but their practical application has been limited. One is that an agency can hire private actors to conduct enforcement.[197] Government routinely contracts with private entities to provide government services, such as trash collection, prison operation, and schooling.[198] Yet instances of contracting private entities for enforcement services remain rare.[199] Another private role in enforcement that is often highlighted is that of the "private attorney general."[200] Here, however, a governmental entity—the court—rather than the private party makes the compliance determination.[201] Moreover, the law often precludes private attorney general actions where the government has already enforced or is in the process of enforcing the law against the defendant.[202] In this way, the regulatory agency has the opportunity to maintain control over the enforcement of its regulations.

There may be good reasons that government delegation of the compliance-determination function is less common than delegation of the standard-setting function. Enforcing rules and standards is arguably "fundamentally public" or "inherently governmental."[203] Determining

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[196] Freeman, *supra* note 19, at 660–61; Shapiro, *supra* note 192, at 414.

[197] Shapiro, *supra* note 192, at 414.

[198] Minow, *supra* note 16, at 1229–30, 1232; Shapiro, *supra* note 192, at 414.

[199] Shapiro, *supra* note 192, at 414 (noting that the government typically uses private entities to provide services rather than for regulatory functions).

[200] Freeman, *supra* note 19, at 661–62; Vandenbergh, *Private Life*, *supra* note 18, at 2038.

[201] *See* Michael Waterstone, *A New Vision of Public Enforcement*, 92 Minn. L. Rev. 434, 437 (2007) (noting that private attorney general actions require courts to determine the litigants' rights, and arguing that the new governance paradigm is a viable alternative to private attorney general actions in the civil rights context).

[202] Seidenfeld & Nugent, *supra* note 89, at 284.

[203] *See* Minow, *supra* note 16, at 1234 (using the phrase "fundamentally public"); Stan Soloway & Alan Chvotkin, *Federal Contracting in Context: What Drives It, How to Improve It, in*

whether a regulated entity is in compliance involves the exercise of a great deal of discretion. Compliance is often a "fluid, negotiable matter" rather than an "objectively-defined unproblematic state."[204] While some regulatory requirements may involve bright-line rules where noncompliance can be easily determined, many standards are more subjective and require substantial interpretation to apply. Moreover, the Supreme Court has held that an agency's decision not to pursue an enforcement action is presumptively unreviewable.[205] As argued by one scholar, activities that are highly discretionary should either be kept within public agencies or accompanied by rigorous publicization.[206]

Moreover, the public process of regulatory compliance assessment as it is traditionally practiced has symbolic importance. The image of the governmental inspector who shows up to look for regulatory violations is powerful. Like criminal investigation and prosecution, it sends the message that the government "stands in for the community and private victims."[207] In addition, negative compliance determinations result in punitive sanctions that communicate the importance and meaning of law. Scholars of regulatory enforcement have recognized the importance of both specific and general deterrence.[208] Specific deterrence refers to how a sanction prevents future noncompliance by the entity sanctioned. General deterrence describes how a punitive sanction against one actor can deter noncompliant behavior by many other actors. With third-party verification, it seems likely that there would be fewer violations prosecuted, potentially undermining the "expressive function" of deterrence-based enforcement.[209]

Aside from the argument that enforcement is fundamentally public, one may be concerned about delegating enforcement to private

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Government by Contract, *supra* note 17, at 192, 220 (describing a 1992 policy letter issued by the Office of Management and Budget that attempted to delineate inherently governmental functions).

[204] *See* Keith Hawkins, Environment and Enforcement: Regulation and the Social Definition of Pollution 126 (1984).

[205] Heckler v. Chaney, 470 U.S. 821, 832–33 (1985); *see also* Bryan Clark & Amanda C. Leiter, *Regulatory Hide and Seek: What Agencies Can and Can't Do to Limit Judicial Review*, 52 B.C. L. Rev. 1687, 1688–90 (2011) (dicussing how agencies shield decisions from judicial review).

[206] Freeman, *supra* note 16, at 1343.

[207] Minow, *supra* note 16, at 1234.

[208] *E.g.* Glicksman & Earnhart, *supra* note 94, at 615 n.50; David Markell, *"Slack" in the Administrative State and Its Implications for Governance: The Issue of Accountability*, 84 Or. L. Rev. 1, 22 (2005).

[209] *See* Glicksman & Earnhart, *supra* note 94, at 622–23 (citing Clifford Rechtschaffen & David L. Markell, Reinventing Environmental Enforcement and the State/Federal Relationship 235–37 (2003)); *see also* Mintz, *supra* note 138, at 9–10.

parties because agencies learn from assessing compliance. The agency gains and maintains expertise about how its regulations are received by the regulated community and how they are functioning in practice. This knowledge in turn can be fed back into the regulatory and legislative process. By this argument, third-party verification threatens a loss of public capacity and expertise. Some scholars raise the possibility that pervasive contracting out of governmental functions could even undermine the oversight capacity of government.[210] As government does less of the work of governing, expertise could move to the private sector to the extent that agencies would be unequipped to meaningfully oversee their contractors.

### B. *Accountability*

A key problem in public-private partnerships is accountability.[211] Accountability is usefully defined as the extent to which actors are "answerable" and "sanctionable."[212] Being answerable means having to respond with information and explanation to potentially difficult and uncomfortable questions.[213] Being sanctionable means that punishment can be imposed for improper actions or inadequate responses.[214]

In traditional social regulation, regulatory agency officials are answerable and sanctionable in a variety of ways. They are legally accountable through suit in the judiciary, and politically accountable through the election of the executive.[215] In addition, administrative law has incorporated a host of less formal mechanisms to make public officials more accountable, such as public hearings, notice-and-comment rulemaking, and administrative appeal procedures.

Many of these well-established routes to accountability are less functional when applied to public-private partnerships. Although public actors remain accountable in the same ways, private actors are not

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[210] Freeman & Minow, *supra* note 84, at 5.

[211] Minow, *supra* note 16, at 1259 (stating that the urgent question is how to ensure accountability to the public).

[212] *See* Andreas Schedler, *Conceptualizing Accountability*, *in* The Self-Restraining State: Power and Accountability in New Democracies 13, 14 (Andreas Schedler et al. eds., 1999); *see also* Minow, *supra* note 16, at 1260 (stating that accountability means "being answerable to authority that can mandate desirable conduct and sanction conduct that breaches identified obligations").

[213] Schedler, *supra* note 212, at 14.

[214] *Id.* at 15–16.

[215] *See* Freeman, *supra* note 16, at 1326–27.

equally bound or constrained.[216] The multiple nodes of authority created in a public-private partnership may make it difficult to discern which actor was responsible for a particular decision or action.

Indeed, some interested parties might favor public-private partnerships precisely because they limit accountability.[217] Third-party verification places additional actors between regulated entities and the public in ways that may allow polluters more opportunities to withhold information about their activities and evade responsibility. Most obviously, companies would not need to routinely open their doors and their books to the government. Private verifiers would take the place of governmental inspectors. Moreover, if the verifier is merely required to provide the government with a yes-or-no report of conformity with the law, the amount of information available to the government and ultimately to the public would be greatly reduced. The chain of accountability would be longer, with the concerns of the public becoming more distant from the potentially harmful activity.[218]

In thinking about how to create accountability in public-private partnerships, it is necessary to look beyond the traditional means. As Freeman explains, accountability should be considered in terms of "measures that spring not exclusively from top-down oversight by legislatures, executive branch agencies, and courts, but from a variety of participants—public and private."[219] Partnerships must be carefully designed to ensure that the involvement of private actors does not compromise public accountability.

Two essential elements for accountability in third-party verification are active governmental oversight and transparency. As stated by one scholar, government agencies that use private means "should evaluate those private means and report on and take responsibility for the re-

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[216] Although the focus in this Section is public accountability, an important private accountability mechanism for actors in a third-party verification system may be private litigation. When third-party verifiers cause harm to a regulated entity or another private party, the verifier may incur contract or tort liability. Financial auditors are similarly subject to private litigation. *See* Neil Gunningham, *Environmental Auditing: Who Audits the Auditors?*, Envtl. & Plan. L.J., Aug. 1993, at 229, 234. *See generally* Peter H. Schuck, *Tort Liability to Those Injured by Negligent Accreditation Decisions*, Law & Contemp. Probs., Autumn 1994, at 185 (detailing tort liability for the institutions that make accreditation decisions in the health care sector).

[217] *See* Meidinger, *supra* note 15, at 82.

[218] Parker, *supra* note 102, at 235 ("[T]he concerns of ordinary consumers and investors (whose interests the regulators are ultimately supposed to be protecting) become more and more remote.").

[219] Freeman, *supra* note 16, at 1327.

sults."[220] Third-party verifiers should be answerable to and sanctionable by the governmental agency for which they are making compliance determinations.[221] Active governmental oversight means that agency officials closely monitor whether verifiers and accreditors are following the rules of the program and how the system is functioning, in both formal and informal ways.

Transparency, in turn, allows the public to oversee the government. Transparency means "public disclosure of key decisions and the information necessary to assess those decisions."[222] Such disclosure places pressure on regulatory agencies to act appropriately because their decisions and actions will be subject to public scrutiny.[223] As noted by another scholar, transparency and public participation are useful institutional proxies for accountability.[224]

There are good reasons to be concerned about whether third-party verification systems will be adequately supervised by the government and transparent to the public. The same resource deficiencies that limit governmental monitoring of regulated entities in traditional social regulation can be expected to limit governmental oversight in third-party verification systems.[225] Moreover, overseeing a third-party verification system will require agencies to develop new capabilities. Monitoring the performance of accreditation and verification bodies requires different skills than monitoring the activities of regulated entities themselves.[226] Part of the challenge will be one of management—to make sure the system is running smoothly and that all parts of it are operating as well as possible.[227]

Making third-party verification systems transparent also presents challenges. Voluntary regulatory programs and initiatives that rely on the auditing industry to conduct inspections have often lacked trans-

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[220] Minow, *supra* note 16, at 1260.

[221] It is worth noting that a lack of government oversight can make system constitutionally suspect. *See* Timothy Stoltzfus Jost, *Confidentiality and Disclosure in Accreditation*, Law & Contemp. Probs., Autumn 1994, at 171, 174–75 (discussing challenges to the constitutionality of governmental reliance on private accreditation in health care).

[222] Minow, *supra* note 16, at 1263.

[223] Gunningham & Prest, *supra* note 101, at 519.

[224] Meidinger, *supra* note 15, at 81.

[225] Gunningham, *supra* note 216, at 231–32.

[226] *See* Van Cleve, *supra* note 105, at 1221–22.

[227] *See* Salamon, *supra* note 75, at 38 (referring to this problem as the "management challenge"); *see also* Errol Meidinger, *Private Import Safety Regulation and Transnational New Governance*, *in* Import Safety, *supra* note 5, at 233, 250 (stating that orchestrating the involvement of private actors in food safety regulation will require "more improvisational, adaptive, and cooperative strategies" than governmental agencies are accustomed to).

parency.[228] In the case of voluntary environmental audits, for example, audit reports are rarely made public. Regulated entities have argued for and received protection for the confidentiality of the information collected and generated in a voluntary audit.[229] Many U.S. states have passed audit privilege and immunity laws providing that companies need not disclose regulatory violations found in an audit so long as they correct the violations in a timely manner.[230] In many states, the privilege applies not just to the documents that constitute the audit report but also to oral testimony about the report's contents.[231] As some scholars have observed, these statutes impose a "veil of secrecy over a company's environmental compliance that conflicts with the policy of public disclosure that pervades environmental regulation."[232] Although no audit privilege and immunity law exists at the federal level, the EPA issued a policy statement protecting companies that report violations pursuant to the policy from audit report disclosure in most situations.[233]

There is also little transparency in the inspection activities of the auditors hired by commercial buyers to check on their suppliers.[234] It is very difficult for consumers and other members of the public to get information not only about the harms that arise from the production of consumer products but also about the standards buyer firms set for their suppliers, how supplier firms enforce those standards, and to what extent supplier firms comply.[235] A study of social auditors in the clothing industry found that audit methodology and results are generally kept confidential.[236] It is unusual for companies to share the results of voluntary audits with interested parties such as workers, consumers, or environmental groups.[237]

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[228] *See* Sanford E. Gaines & Cliona Kimber, *Redirecting Self-Regulation*, 13 J. Envtl. L. 157, 176 (2001) ("[M]any of the mechanisms in self-regulation programmes designed to trigger self-assessment and self-reflection are not sufficiently transparent either in their processes or in their final result to make the programmes socially accountable.").

[229] *See* Kubasek et al., *supra* note 104, at 271.

[230] *See* Dana, *supra* note 104, at 971.

[231] John-Mark Stensvaag, *The Fine Print of State Environmental Audit Privileges*, 16 UCLA J. Envtl. L. & Pol'y 69, 124 (1997).

[232] Eric W. Orts & Paula C. Murray, *Environmental Disclosure and Evidentiary Privilege*, 1997 U. Ill. L. Rev. 1, 28.

[233] Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations, 65 Fed. Reg. 19,618, 19,618 (Apr. 11, 2000), *available at* http://www.epa.gov/oecaerth/resources/policies/incentives/auditing/auditpolicy51100.pdf (stating that EPA will not routinely request audit reports).

[234] *See* Vandenbergh, *New Wal-Mart*, *supra* note 18, at 961–62.

[235] *Id.*

[236] *See* Clean Clothes Campaign, *supra* note 113, at 61.

[237] *See id.*

In voluntary labeling schemes that rely on third-party certification, the degree of transparency varies but is often weak. In his study of forest certification programs, one scholar states that, although all programs embrace the value of transparency, public information regarding certification inspections is generally limited partly because it is viewed as confidential business information that could hurt the firm if made public.[238] Further, forestry companies may favor certification schemes precisely because hiring certifiers may help them avoid "having the public or nosy government inspectors intruding into their operations."[239] Other scholars find that many voluntary environmental programs operate "behind closed doors" and lack public scrutiny.[240] ISO 14001, the most widespread standard for environmental management systems, requires public disclosure of the organization's environmental policy but does not require disclosure of any information related to the organization's environmental performance.[241]

Indeed, the private inspection industry has historically maintained strict confidentiality of information provided to them.[242] Private auditors have viewed themselves essentially as peer reviewers with the role of helping their clients.[243] In the accreditation of health care institutions, for example, information generated "was for the benefit of the reviewed institution and was nobody else's business."[244] Accreditation bodies such as ANSI also tend to be obscure institutions in the eyes of the public.[245] The International Organization for Standardization (ISO), of which ANSI and other national standard-setting bodies are part, does

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[238] Meidinger, *supra* note 15, at 81.

[239] *Id.* at 82.

[240] Prakash & Potoski, *supra* note 119, at 58.

[241] *ISO 14000 Essentials*, Int'l Org. for Standardization, http://www.iso.org/iso/iso_14000_essentials (last visited Dec. 27, 2011) (noting that ISO 14001 "does not specify levels of environmental performance," but instead "gives the generic requirements for an environmental management system"). In contrast, the European Eco-Management and Audit Scheme mandates extensive public environmental performance reporting. *See* Commission Regulation 1221/2009, 2009 O.J. (L 342) 1, 2 (EC) ("Organisations should produce and make publicly available periodic environmental statements providing the public and other interested parties with information on their compliance with applicable legal requirements relating to the environment and their environmental performance.").

[242] Jost, *supra* note 221, at 171 ("[A]ccrediting bodies have maintained strict confidentiality of information provided to them and of information generated in the accreditation process.").

[243] *Id.*

[244] *Id.*

[245] *See* Wood, *supra* note 105, at 199 (suggesting that standardization bodies are obscure). *But see* Freeman, *supra* note 16, at 1328 (stating that many standard-setting bodies are "longstanding professional associations with considerable credibility").

not make its standards publicly available either when they are in development or after they are finalized.[246] Only members of the ISO are involved in their development, and once standards are finalized, they must be purchased for use.[247]

Where third-party verification is used in regulation, strong transparency and accountability should apply. The government and the public have a direct interest in the quality and accuracy of the verification.[248] The government will require information about the activities of verification and accreditation bodies to assure their accountability.[249] The public will require information about the roles of all actors in the system to keep agencies publicly accountable. The disclosure of information about as many aspects of the system as possible should be the norm, with only those exceptions necessary for confidential business information.[250]

In part, what seems to be required is to change or at least expand the "communicative energy" of verification.[251] The default in the third-party assurance industry is for the verifier to address his report to his client.[252] In many programs that produce audit reports there has been a disjuncture between a rich account given to the client and a bland up-or-down summary opinion given to external parties.[253] Where the inspection serves regulatory purposes, the regulated entity must provide rich information to the agency and the public to meet the demand for accountability.[254]

Moreover, the use of third-party verification calls for new forms of transparency and public participation. For example, although government may not have been transparent in the past about the performance of its inspection units or inspectors, it should seek ways to be transparent

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[246] David A. Wirth, *The International Organization for Standardization: Private Voluntary Standards as Swords and Shields*, 36 B.C. Envtl. Aff. L. Rev. 79, 90 (2009); *see also* Tim Buthe, *The Politics of Food Safety in the Age of Global Trade: The Codex Alimentarius Commission in the SPS Agreement of the WTO*, *in* Import Safety, *supra* note 5, at 88, 97–98 (describing ISO membership and the standard-setting process).

[247] Wirth, *supra* note 246, at 90–92.

[248] Gunningham, *supra* note 216, at 230.

[249] *Cf.* Jost, *supra* note 221, at 172.

[250] *See id.* at 173 (explaining that regulated entities have legitimate interests in some level of confidentiality for sensitive information like financial data, information that suggests negligence, and critical statements made by employees or other citizens). A difficult issue lies in the area of how much verification information should be available to private parties that want to sue the regulated entity for private harms. *See id.*

[251] *See* Parker, *supra* note 102, at 235.

[252] *See id.*

[253] *Id.*

[254] *See id.*

about the performance of the accreditation and verification bodies involved in regulatory verification. Government might also develop new public participation mechanisms like petitions to challenge a verification decision or require that accreditation bodies and verification bodies submit publicly disclosed reports of their activities each year.

### C. *Verifier Independence*

To render an objective evaluation of a regulated entity's compliance status, a verifier should be independent of the regulated entity. The fact that a verifier must be a third party provides an initial degree of independence. The verifier cannot be the regulated entity itself (referred to as first-party verification or self-verification) or an entity within the firm's industry or business community (referred to as second-party verification).[255] By definition, a third party is external to—and thus formally independent from—the firm.[256]

Yet formal independence does not necessarily ensure objectivity. The third-party assurance industry is "rife with potential for abuse" because the companies subject to evaluation usually arrange and pay for inspections.[257] Companies seeking positive verification reports have incentives to offer payoffs of various kinds, and the third-party verifiers have incentives to accept them.[258] Also, assuming the existence of a market in verifier services, companies have the opportunity to shop around for a favorable verifier and put pressure on verifiers for a favorable outcome.[259]

Past crises in financial accounting have highlighted the difficulty of ensuring auditor independence under these conditions.[260] In the sav-

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[255] *See* Prakash & Potoski, *supra* note 119, at 59; Wood, *supra* note 110, at 242–43. Although there is general agreement on the meaning of first-party and third-party verification, commentators give different meanings to the term second-party. *Compare* Prakash & Potoski, *supra* note 119, at 59 (defining a second party as "a manager from a different unit of the same company or a different firm within the same industry"), *with* Wood, *supra* note 110, at 242 (defining second-party verification as "where conformity is verified by a party with a business interest in the subject organisation" such as a creditor or customer).

[256] Prakash & Potoski, *supra* note 119, at 59.

[257] Blair et al., *supra* note 98, at 334.

[258] *Id.*

[259] Gunningham, *supra* note 216, at 230–31 ("[A]t least some corporations will attempt to hire auditors who can assure the production of a favourable report card."); *see also* Prakash & Potoski, *supra* note 119, at 60 (explaining that because firms hire auditors, auditors have incentives to provide favorable audits).

[260] *See* Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 Vill. L. Rev. 1167, 1167 (2003); McCoy, *supra* note 13, at 989–90; Miller, *supra* note 13, at 423–25.

ings-and-loan crisis of the late 1980s, accredited financial auditors failed to identify serious financial irregularities.[261] In Enron's 2001 collapse, auditor failure was also implicated and Enron's auditor, Arthur Anderson, went out of business soon after.[262] Despite formal independence, financial auditors have sometimes distorted numbers in ways that mask a company's true financial condition.

The literature on financial accounting has recognized that unconscious biases as well as conscious motivations can affect an auditor's judgment. As some argue, three structural aspects of accounting create substantial opportunities for unconscious bias.[263] First, accounting standards are often ambiguous and "[b]ias thrives wherever there is the possibility of interpreting information in different ways."[264] Second, an "attachment bias" results from the fact that the auditor has strong business reasons to please the client and equates his own interests with those of the client.[265] Third, an "approval bias" kicks in where an auditor is asked to approve a company's numbers rather than arrive at these numbers independently.[266] Moreover, human nature makes auditors more apt to harm the faceless investor than the familiar client and to discount the future negative consequences of giving an undeserved positive audit opinion more than the immediate negative consequences of not doing so.[267]

Conceptualized differently, the problem of auditor independence in the financial sector stems from the auditor having two masters: the client and the shareholders.[268] Working on behalf of the client, the auditor is expected to be a "certifier" that accepts and approves the financial information the client puts forward for disclosure to the public.[269] The public, on the other hand, expects the auditor to act as a "detective"

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[261] Miller, *supra* note 13, at 428–29.

[262] *See* Macey & Sale, *supra* note 260, at 1167 & n.1.

[263] Max H. Bazerman et al., *Why Good Accountants Do Bad Audits*, Harv. Bus. Rev., Nov. 2002, at 97, 98.

[264] *Id.* at 98.

[265] *Id.* at 99; *see also* Amy Shapiro, *Who Pays the Auditor Calls the Tune?: Auditing Regulation and Clients' Incentives*, 35 Seton Hall L. Rev. 1029, 1040 (2005) (discussing the attachment bias and explaining that working for a client creates a tendency for an auditor to make judgment calls that favor a client).

[266] Bazerman et al., *supra* note 263, at 99–100.

[267] *Id.*

[268] *See* Shapiro, *supra* note 265, at 1031 (arguing that the auditor problem is a problem of two masters and that the law needs to be written "so that auditors recognize proper incentives and serve only one master, a master whose own interests are aligned with those of the investing public").

[269] *Id.* at 1032 (stating that certification indicated an approval of the client's information, not an "exacting assessment of its quality").

who rigorously assesses the information and discovers any problems with it. The same problem has been observed in voluntary certification schemes. Third-party certifiers "are thus placed in an inherently difficult position, since they are in effect public fiduciaries employed by the very private actors whose activities they are supposed to assess and monitor."[270] In some situations, financial auditors and third-party certifiers are so eager to serve their clients that they engage in "creative compliance" to help their client find ways to formally comply with rules while achieving ends the rules were intended to prevent.[271]

The problem of auditor independence in financial audits is exacerbated when auditing firms provide their clients with additional "non-audit" consulting and tax services.[272] As providers of these services, audit firms are even more likely to equate their interests with those of the client. In addition, if the audit firm displeases the client in a financial audit, it may lose not just the audit engagement but the additional business as well. On the other hand, the practice of co-supplying audit and non-audit services is very common and allows beneficial "knowledge spillovers" as the auditor brings knowledge of the client's business from one engagement to the next.[273]

The same issues of auditor and certifier independence can be expected to appear in systems of third-party verification. Verifiers, like financial auditors, have pecuniary interests and unconscious biases that make them favor their clients. Also, the verifier has two masters with different interests. The regulated entity wants the verifier to confirm and approve the data it puts forward to show compliance. The regulator wants the verifier to carefully and objectively examine the data. Verifiers, too, might be tempted to help clients engage in creative compliance.

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[270] Errol E. Meidinger, *The New Environmental Law: Forest Certification*, 10 Buff. Envtl. L.J. 211, 284 (2002).

[271] *Id.* at 286–87; *see also* O'Rourke, *supra* note 15, at 200, 202 (describing how auditors of garment factories in Asia gave managers tips about how to circumvent overtime laws). On creative compliance with environmental laws, see generally Daniel A. Farber, *Taking Slippage Seriously: Noncompliance and Creative Compliance in Environmental Law*, 23 Harv. Envtl. L. Rev. 297 (1999). On creative compliance in financial auditing, see generally Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 Vand. L. Rev. 1411, 1478–79 (2007); Doreen McBarnet, *After Enron Will "Whiter Than White Collar Crime" Still Wash?*, 46 Brit. J. Criminology 1091 (2006).

[272] Keith A. Houghton & Christine A. Jubb, *The Market for Financial Report Audits: Regulation of and Competition for Auditor Independence*, 25 L. & Pol'y 299, 308–09 (2003).

[273] *Id.* at 309; *see also* Kleindorfer, *supra* note 161, at 203 (explaining that there may be "economies of scope between discovery of problems and repair of problems").

And unless prohibited, verifiers would likely seek non-verification work from their verification clients that may result in conflicts of interest.

The primary counterargument to concerns about auditor objectivity is that third parties that fail to be objective will develop bad reputations and fail to attract new clients.[274] Moreover, auditors that lack objectivity may ultimately be deaccredited by an oversight organization, if one exists, and unable to market their services. Without clients or lacking accreditation, they will go out of business.

Unfortunately, the empirical evidence from the financial industry does not strongly support this contention. The evidence suggests instead that third parties may indeed shirk their responsibility to be objective despite risks to their reputation.[275] As one scholar explains with regard to the financial accounting industry, the "immediate and future payoffs to the auditors from cooperating with management in questionable accounting practices exceed the discounted possibility of judgments and sanctions."[276] In other words, the benefits of shirking are definite and immediate while the drawbacks are contingent and delayed.

A variety of reforms have been proposed to promote auditor independence in financial accounting. Some recommend a three-pronged reform.[277] First, auditing firms should be prohibited from providing any additional consulting or tax services to the companies they audit.[278] Second, financial auditors should have fixed, limited contract periods during which they cannot be terminated and contractual provisions cannot be changed.[279] Moreover, there would be a mandatory rotation of audit firms as clients would be prohibited from rehiring the same auditing firm at the end of the contract.[280] Finally, auditors would be barred from taking jobs with the firms they audit for at least five years.[281] At least one commentator has advocated that the pretension of auditor independence be abandoned and that the Securities and Ex-

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[274] Prakash & Potoski, *supra* note 119, at 60.

[275] *See id.*

[276] McCoy, *supra* note 13, at 990; *see also* Shapiro, *supra* note 265, at 1040 ("[R]eputation is constantly pitted against the need to gain and retain business.").

[277] Bazerman et al., *supra* note 263, at 102.

[278] *Id. But see* Houghton & Jubb, *supra* note 272, at 309 (arguing that the joint supply of audits and additional services brings certain benefits relating to efficiency and the availability of audit expertise).

[279] Bazerman et al., *supra* note 263, at 102.

[280] *Id.*; *see also* McCoy, *supra* note 13, at 1008–09. *But see* Houghton & Jubb, *supra* note 272, at 311–12 (arguing that audit firm rotation threatens audit quality).

[281] Bazerman et al., *supra* note 263, at 102.

change Commission repeal the regulation that requires that annual reports be independently audited.[282]

The independence problem may be somewhat easier to address in third-party verification systems for regulatory compliance. Many of the deficiencies in the independence of auditors in the financial accounting industry result from the lack of a strong, governmentally sanctioned system of rules and standards to regulate the accreditation of auditors and the practice of auditing.[283] A strong regulatory system can make and enforce rules regarding accreditation and reaccreditation requirements, the mandatory rotation of verifiers, and restrictions on side consulting. In addition, the presence of an effective regulatory body can do a great deal to make the loss of a good reputation a more definite and immediate threat. With the presence of strong oversight by a regulatory agency, the third-party verifier is likely to feel the strength of this other master.

It is also possible that, in regulatory fields requiring technical expertise, verifiers may empathize with the goals of social regulation and the regulatory agencies that administer it. In other words, in some cases the verifier might have a certain built-in respect for and interest in pleasing this master. More generally, verifiers as an industry might understand that their field of work issues from the regulatory agency's decision to rely on a third-party verification system, and they might want the regulatory agency to have confidence that a third-party verification system is valuable and trustworthy in this capacity. The industry might thus develop certain self-regulating mechanisms that encourage and promote the objectivity of verifications.[284]

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[282] Sean M. O'Connor, *Strengthening Auditor Independence: Reestablishing Audits as Control and Premium Signaling Mechanisms*, 81 Wash. L. Rev. 525, 582–84 (2006).

[283] The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified at 15 U.S.C. § 7201–7266 and scattered sections of 18 U.S.C.), instituted a regulatory system with the establishment of an independent Public Company Accounting Oversight Board responsible for overseeing auditors through registration of public accounting firms, the establishment of standards, and inspections. The Securities and Exchange Commission oversees the Board. Shapiro, *supra* note 265, at 1056–64.

[284] *But see* Friederike Albersmeier et al., *The Reliability of Third-Party Certification in the Food Chain: From Checklists to Risk-Oriented Auditing*, 20 Food Control 927, 930 (2009) (noting that "it cannot be assumed that every certifier . . . pursues the same objectives as the certification company," or the industry as a whole).

### D. *Verifier Competence*

Audit quality arguably depends mostly on two factors: auditor independence and auditor competence.[285] In the context of regulatory compliance, the competence of third-party verifiers should be at least comparable to the competence of regulatory agency inspectors. Third-party verifiers should possess both technical expertise and professional judgment.[286]

In some ways, a third-party verification system would have advantages in promoting competence over a traditional government inspectorate. As highlighted above, such a system could draw upon the expertise that already exists in the private sector.[287] Agencies could establish a variety of rules to ensure that verifiers possess certain skills and abilities. Verifiers would have to meet the requirements of an accreditation system and periodically be reaccredited. Oversight activities could check the performance of verifiers in real time. Where verifiers fail, deaccreditation would be a remedy. Deaccreditation of an incompetent verifier would likely be much easier to accomplish than dismissal of an incompetent governmental inspector.

A contested issue has been the extent to which the skill set of the general accountant translates to regulatory auditing fields. Financial accounting firms have, for example, suggested that they are well situated to serve as environmental auditors.[288] They have pointed out that financial and environmental audits are alike in that both seek to verify compliance against standards and utilize standardized methodologies and auditing techniques.[289] On the other hand, financial accountants generally lack expertise in other relevant areas such as environmental science and environmental law. One scholar raises the concern that as environmental compliance becomes more like accounting, accountants will enter the field and scientific expertise will be subordinated to auditing expertise.[290]

Another scholar's observations of two garment factory audits in Asia illustrate how accountants may not be competent to perform social

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[285] *See* Houghton & Jubb, *supra* note 272, at 303.

[286] *Id.* at 302.

[287] *See supra* notes 98–137 and accompanying text.

[288] *See* Power, *supra* note 102, at 127; *see also* Jeroen Kruijd et al., PricewaterhouseCoopers, Building Trust in Emissions Reporting: Global Trends in Emissions Trading Schemes (2007) ("There are many parallels between the need for trust in these [emissions trading] compliance frameworks and . . . financial accounting and auditing . . . .").

[289] Power, *supra* note 102, at 134.

[290] *Id.* at 139–40.

audits.[291] The auditors he studied were financial accountants from a major global firm, PricewaterhouseCoopers, who had received short-term training in social auditing.[292] According to these observations, the resulting audit reports "glossed over problems with freedom of association and collective bargaining, overlooked serious violations of health and safety standards, and failed to report common problems in wages and hours."[293] As noted in an investigative report by an advocacy group in the garment sector, the vast majority of social audits are conducted by global firms whose staff is generally unskilled and inexperienced at social auditing.[294]

A related concern is that third-party verification might be reduced to mere checklists that are mechanically applied and fail to capture the true compliance situation of a regulated entity.[295] In the checklist model of auditing, the audit "is carried out based on a formal checklist, which is executed point by point by the auditor."[296] Designed to promote standardization and uniformity in the audit, checklists may give insufficient attention to the particularities of different sectors and facilities.[297] A more flexible and tailored alternative is risk-based auditing in which the auditor determines which activities being audited present the greatest risk of error and fraud, and he then focuses his attention on those activities.[298]

Verifiers might also seek to rely on proxies for compliance that are easy to observe. One discussion of compliance audits in Australia notes that compliance audits are often focused on "the [management] systems elements of the compliance program, rather than its compliance performance."[299] Instead of gathering information about how compliance processes actually work, many auditors relied primarily on existing documentation of the management system and interviews of senior management.[300]

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[291] *See* O'Rourke, *supra* note 15, at 197–206.

[292] *Id* at 197.

[293] *Id.* at 207.

[294] Clean Clothes Campaign, *supra* note 113, at 15.

[295] *See* Albersmeier et al., *supra* note 284, at 930. *But see* Philippe De Moor & Ignace De Beelde, *Environmental Auditing and the Role of the Accountancy Profession: A Literature Review*, 36 Envtl. Mgmt. 205, 207 (2005) ("Checklists are generally considered to be an important instrument when conducting an environmental compliance audit.").

[296] Albersmeier et al., *supra* note 284, at 930.

[297] *See id.*

[298] *Id.*

[299] Parker, *supra* note 102, at 224–25.

[300] *Id.* at 230; *see also* De Moor & De Beelde, *supra* note 295, at 214 (observing that there has been a shift in environmental auditing from focusing on environmental impacts

Another dynamic that undermines a competent audit is the tendency of auditors who are paid a set fee to minimize their audit costs.[301] One scholar found that auditors of Asian garment factories spent about one day in each factory, with a factory floor inspection lasting only thirty or forty-five minutes and that the required worker interviews were often conducted incompletely and with haste.[302] The advocacy group's report on garment industry audits concluded that "[s]ocial audits are usually too short, too superficial and too sloppy to identify certain types of code violations."[303]

### E. *Costs to Government and Regulated Entities*

Third-party verification holds promise for reducing the governmental cost of regulating by shifting costs to industry. It does not, however, eliminate all costs to the government, and it imposes new costs on industry. An important question is whether third-party verification is more cost-effective than direct governmental monitoring. This Section analyzes these cost-related considerations.

Although there may be a shifting of costs with third-party verification, government still incurs a variety of administrative costs. These costs include implementing and enforcing the many rules and standards pertaining to the third-party system itself. As detailed below, those rules would relate to how verifiers are accredited, how regulated entities select verifiers, how verifications are performed, and how verifiers and regulated entities report and disclose information.

Governmental oversight of third-party verification may entail substantial costs. The government will need, in essence, to audit the verifiers and their verifications. It can do this in a variety of ways, including inspecting verifiers, accompanying verifiers on their inspections of regulated entities, and conducting independent inspections of regulated entities. The cost associated with accrediting and overseeing verifiers may be reduced when the regulatory agency delegates this task to an accreditation body. The accreditation body could receive, process, and respond to verifier applications. Also, the agency may be able to outsource some oversight tasks by requiring that accreditation bodies monitor the verifiers that they accredit.

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to focusing on environmental management systems and suggesting that this shift has been a positive development for accountants because they are familiar with the "evaluation of information and control systems" from their experience as financial auditors).

[301] *See* Albersmeier et al., *supra* note 284, at 930.

[302] O'Rourke, *supra* note 15, at 198, 201, 203.

[303] Clean Clothes Campaign, *supra* note 113, at 15.

To the extent that costs shift from the government to the regulated community, an important question is how high these costs will be.[304] Private regulatory inspection services may be costly—so much so that regulated entities given the choice of whether to be audited by a third party or inspected by a regulatory agency might well choose the latter.[305] Moreover, as one scholar discusses, the costs of privatization may grow in proportion to the extent to which the private actors playing public roles must abide by public norms, such as due process and oversight.[306] In more concrete terms, hiring third-party verifiers is likely to be cheaper for regulated entities if those third-party verifiers are not required to do things such as prepare reports of their activities and respond to information requests from the government and the public about particular verified facilities. Yet such costs may be necessary to the accountability of a third-party verification system.

A troubling aspect of imposing additional costs on regulated entities is the potentially disproportionate effect on small businesses.[307] Larger firms are likely to have more internal resources to understand and respond to these new requirements than small firms. A similar dynamic has been observed with voluntary labeling programs that require third-party certification. For example, small agricultural producers may find it too costly to certify organic, and forestry operations in developing countries may find it too costly to certify with the Forest Stewardship Council.[308] Mechanisms to subsidize the third-party verification costs of smaller companies may be necessary, which could add to the governmental costs of the program.[309]

Finally, the use of third-party verification may not be cost-effective. Regulation is cost-effective if it produces a given level of benefit, or the

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[304] In promulgating the California Greenhouse Gas Reporting Rule, the California Air Resource Board estimated the costs of third-party verification. For small facilities such as cement plants and hydrogen plants the annual verification cost was estimated at $2000 to $8000. For large manufacturers with multiple facilities, oil refineries, and electric utilities, the cost was estimated at $10,000 to $40,000. ERG Memo, *supra* note 61, at 23 tbl.3.

[305] *See* Gunningham, *supra* note 161, at 566–67.

[306] Freeman, *supra* note 16, at 1339; *see also* Shapiro, *supra* note 192, at 419.

[307] Eric W. Orts, *Reflexive Environmental Law*, 89 Nw. U. L. Rev. 1227, 1300 (1995).

[308] *See* Richard N.L. Andrews, *Environmental Regulation and Business "Self-Regulation,"* 31 Pol'y Sci. 177, 183 (1998) (stating that third-party certification "may be warranted for some larger firms with large benefits at stake but may be prohibitive for smaller firms").

[309] *See* Allison F. Gardner, *Beyond Compliance: Regulatory Incentives to Implement Environmental Management Systems*, 11 N.Y.U. Envtl. L.J. 662, 701–02 (2003) (suggesting that the EPA provide some sort of subsidy to the smaller regulated entities and observing that this is another cost in addition to the costs of oversight of third-parties that would have to be borne by an agency).

desired regulatory outcome, at the least cost for governmental agencies and regulated entities.[310] Privatization of governmental functions is often justified on the basis of being cost-effective. Privatizations of schools, prisons, and other government services are undergirded by the idea that private actors can generate higher-quality outcomes at the same or lower cost because they have greater flexibility in running their operations and are subject to competition.[311] To maximize profits, they are driven to innovate in ways that lower costs or improve service quality.[312]

Third-party verification may not initially appear to be more cost-effective than traditional forms of social regulation. Indeed, third-party verification may prove to be more costly overall than having governmental officials inspect and determine compliance. It may still be cost-effective, however, if it provides a higher level of benefits than the present regulatory system and if those benefits are desired.[313] As argued above, compliance is often only infrequently assessed and regulatory failure is common. Moreover, agencies are ill-equipped to collect the kinds of data needed to effectively implement new forms of regulation.[314] Third-party verification would arguably lead to better information and regulatory outcomes that would justify its additional costs. With the efficiencies promoted by competition, third-party verification seems likely to be more cost-effective than adding the government capacity that would be necessary to provide the same level of regulatory outcomes.

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[310] Christopher K. Leman, *The Forgotten Fundamental: Successes and Excesses of Direct Government*, *in* Beyond Privatization, *supra* note 10, at 53, 68 (defining cost-effectiveness to mean the ability to achieve a given level of benefit at a minimum cost). The term efficiency is often used to mean cost-effectiveness. *See, e.g.*, Gunningham & Grabosky, *supra* note 168, at 26 (stating that efficiency refers to achieving regulatory goals at minimum cost); Sharon Dolovich, *How Privatization Thinks: The Case of Prisons*, *in* Government by Contract, *supra* note 17, at 128, 134, 139 (distinguishing between efficiency as cost-benefit calculus and efficiency as cost-minimization); May, *supra* note 10, at 178–79 (using the term efficient to denote cost-effectiveness and defining it as producing a given level of benefit at least cost for governmental agencies and for regulated entities); Salamon, *supra* note 75, at 69 (defining cost-effectiveness as "the ability to achieve a given level of benefit most efficiently, that is, at a minimum cost").

[311] *See* Freeman, *supra* note 16, at 1296–97; Minow, *supra* note 16, at 1242–43.

[312] Donald F. Kettl, Sharing Power: Public Governance and Private Markets 14–15 (1993).

[313] *See* Freeman, *supra* note 16, at 1296 (observing that the question of the level at which a good is provided is implicit in an assessment of efficiency).

[314] *See supra* notes 143–150 and accompanying text (explaining that agencies frequently lack the resources to collect adequate data).

## IV. Regulation of Third-Party Verification

This Article has argued that there are a variety of reasons both to endorse and be concerned about third-party verification as a regulatory approach. In general, however, whether a certain form of privatization deserves support will depend on whether it is structured in a manner that delivers the promised benefits of privatization while preserving public values. As one scholar explains, the trend toward public-private partnerships in the provision of public services is "undeniable," and "[s]keptics should not simply decry this reality, but deal with it by demanding public accountability."[315] According to another scholar, instruments for extending public norms to private actors are plentiful, including "direct regulation, conditioned funding, contract, and tort liability, among other things."[316] The task that remains, then, is to examine how third-party verification can be structured to reap its benefits while avoiding problems.

This Part recommends and analyzes an approach of direct regulation of third-party verification that responds to the important concerns highlighted above about accountability, verifier independence and competence, and costs. It recommends that regulatory agencies that incorporate third-party verification into their regulatory programs establish clear and enforceable rules about the accreditation of verifiers, the selection of verifiers by regulated entities, the performance of verifications, and the disclosure and reporting of verification information. It also urges strong regulatory oversight of the system and attentiveness to issues of cost-effectiveness. Examples are drawn primarily from the California Air Resources Board's Regulation for the Mandatory Reporting of Greenhouse Gas Emissions, which is the most rigorously regulated system of third-party verification yet established. When helpful, examples from other third-party verification and certification programs are also discussed.

### A. *Accreditation Rules*

A system of accreditation for verifiers regulates who may work as a verifier. It establishes a minimum level of training and expertise, thus responding directly to concerns about competence. The possibility of deaccreditation also allows the agency to sanction verifiers, which serves the goal of accountability.

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[315] Minow, *supra* note 16, at 1236.

[316] Freeman, *supra* note 16, at 1351.

A key design question regarding accreditation is whether the government agency should itself accredit verification bodies or, instead, delegate this task to an accreditation body. With governmental accreditation, the agency controls who can act as a verification body. Alternatively, the agency could approve or recognize an accreditation body to assess candidate qualifications and make accreditation decisions. The regulatory agency could still establish the basic requirements and procedures for accreditation, or it might allow the accreditation agency to do so with an opportunity for agency approval. The agency might also choose to approve more than one accreditation body.

As part of the accreditation rules, a regulatory agency may require that its accreditation and verification bodies abide by relevant international standards or maintain membership in relevant international industry associations.[317] For accreditation bodies, the ISO published standard is ISO/IEC 17011, "Conformity assessment: General requirements for accreditation bodies accrediting conformity assessment bodies."[318] This standard establishes a uniform set of requirements that could be made applicable to the entities charged with accrediting verification bodies.[319]

Appropriate requirements for verification bodies may be found in ISO/IEC Guide 65, "General requirements for bodies operating product certification systems."[320] Guide 65 includes requirements that a certification (or verification) body should, for example, operate in a nondiscriminatory manner; take measures to ensure its independence from client firms; and have a legally enforceable agreement for the provision of services to client firms.[321] With specific applicability to greenhouse gas emissions verification bodies, ISO has developed ISO 14065:2007, "Greenhouse gases—Requirements for greenhouse gas validation and

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[317] *See, e.g.*, *Conditions and Criteria for Recognition of Laboratories for the EnergyStar Program*, *supra* note 128, at 1 (requiring Energy Star accredited laboratories to maintain accreditation under ISO/IEC 17025).

[318] *See* Press Release, Int'l Org. for Standardization, ISO/IEC Standard for "One-stop Accreditation" to Boost Cross-border Trade (Nov. 15, 2004), http://www.iso.org/iso/press release.htm?refid=Ref941; *see also* Conditions and Criteria for Recognition of Certification Bodies for the EnergyStar Program, *supra* note 128, at 1 (requiring EnergyStar certification bodies to maintain accreditation by a party operating in accordance with ISO/IEC 17011).

[319] Press Release, Int'l Org. for Standardization, *supra* note 318.

[320] *See ISO/IEC Guide 65:1996*, Int'l Org. for Standardization, http://www.iso.org/iso/iso_catalogue/catalogue_tc/catalogue_detail.htm?csnumber=26796 (last visited Dec. 28, 2011).

[321] *Conditions and Criteria for Recognition of Certification Bodies for the EnergyStar Program*, *supra* note 128, at 1 (reciting "[n]oteworthy elements" of Guide 65).

verification bodies for use in accreditation or other forms of recognition,"[322] and ISO 14066:2011, "Greenhouse gases—Competence requirements for greenhouse gas validation teams and verification teams."[323] The ISO 14065 standard specifies accreditation requirements for verification bodies that verify organizations' assertions or claims about the quantity of their greenhouse gas emissions.[324] ISO 14066 sets standards for the competence of greenhouse gas verification teams that can be used by companies, regulators, and verification bodies in assembling or evaluating such a team.[325]

The ARB directly accredits individual verifiers and verification bodies.[326] To become an individual verifier, the ARB requires a minimum education background that includes a bachelor's degree in "science, technology, business, statistics, mathematics, environmental policy, economics, or financial auditing" or sufficient relevant experience.[327] The applicant must have a minimum of two years of professional work experience in "emissions data management, emissions technology, emissions field enforcement, or other technical skills necessary to conduct verification."[328] An applicant must also complete a verification training course and receive a passing score on the exit exam.[329] Applicants qualify as "lead verifiers" if they meet the basic requirements and have also worked as a lead verifier in another greenhouse gas emissions reporting program, such as the California Climate Action Registry, or possess equivalent expertise.[330] Applicants may also qualify as sector-specific verifiers if they meet the basic requirements and complete a sector-specific training course offered by the ARB.[331]

Firms may apply to the ARB to become accredited verification bodies. For accreditation, the firm must have at least five full-time staff,

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[322] Press Release, Int'l Org. for Standardization, ISO 14065 Standard—New Tool for International Efforts to Address Greenhouse Gas Emissions (Apr. 17, 2007), http://www.iso.org/iso/pressrelease.htm?refid=Ref1054 [hereinafter ISO 14065 Press Release].

[323] Press Release, Int'l Org. for Standardization, New ISO Standard Aims to Build Confidence in the Global Carbon Market (July 21, 2011), http://www.iso.org/iso/press release.htm?refid=Ref1447 [hereinafter ISO 14066 Press Release].

[324] *See* ISO 14065 Press Release, *supra* note 322.

[325] *See* ISO 14066 Press Release, *supra* note 323.

[326] *See Greenhouse Gas Emissions Verification*, Cal. Envtl. Prot. Agency Air Res. Bd., http://www.arb.ca.gov/cc/reporting/ghg-ver/ghg-ver.htm (last modified Dec. 15, 2011).

[327] Cal. Code Regs. tit. 17, § 95132(b)(3)(A) (2010).

[328] *Id.* § 95132(b)(3)(B).

[329] *Id.* § 95132(b)(4).

[330] *Id.* § 95132(b)(2).

[331] *Id.* § 95132(b)(5).

including at least two accredited lead verifiers.[332] The firm must also show that it has at least one million dollars in liability insurance, policies to prevent conflicts of interest, and plans to support verification-related staff technical training.[333] Local air pollution agencies within California may also apply to become verification bodies. They need only show that they have at least two accredited lead verifiers on staff and that they have policies to prevent conflicts of interest.[334] California's accreditation program was developed using international best practices as laid out in ISO 14065 and ISO 14066.[335]

In the EU ETS, the process for accrediting verifiers varies by member state. Some member states have governmental accreditation bodies while others use private accreditation bodies.[336] Member states also have different policies regarding whether verifiers accredited by a different member state may conduct verifications within the state.[337] In establishing their procedures, member states commonly refer to European standard EN45011, which is equivalent to ISO/IEC Guide 65, and associated guidance documents issued by the European Co-operation of Accreditation (ECA), a non-profit association of accreditation bodies recognized by member states.[338]

In the Energy Star program, the EPA relies extensively on international standards and external accreditation bodies. Energy Star certification bodies must maintain accreditation under ISO/IEC Guide 65, and this accreditation should be conducted by a member of the International Accreditation Forum (IAF) operating in accordance with ISO/IEC 17011.[339] Under the EPA rules, EPA-recognized certifiers must also meet other conditions, such as demonstrating adequate staff,

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[332] *Id.* § 95132(b)(1).

[333] Cal. Code Regs. tit. 17, § 95132(b)(1) (2010).

[334] *Id.* § 95132 (b)(1)(F).

[335] *ARB Verification Program Review: Greenhouse Gas Emissions Verification Program at the California Air Resources Board* 2, Cal. Air Res. Bd., http://www.arb.ca.gov/cc/reporting/ghg-ver/verification_summary.pdf (last visited Dec. 28, 2011) [hereinafter *ARB Program Review*].

[336] ERG Memo, *supra* note 61, at A-2.

[337] *See* Eur. Env't Agency, Application of the Emissions Trading Directive by EU Member States 55 (2008), *available at* http://www.eea.europa.eu/publications/technical_report_2008_13.

[338] *See* ERG Memo, *supra* note 61, at A-2 (noting that member states commonly refer to EN45011 and ECA documents); *see also* European Co-operation for Accreditation, EA-6/03:2010, EA Document for Recognition of Verifiers Under the EU ETS Directive 7 (2010), *available at* http://www.european-accreditation.org/n1/doc/EA6-03.pdf (indicating that member states can recognize verifiers under EN45011).

[339] *Conditions and Criteria for Recognition of Certification Bodies for the Energy Star Program*, *supra* note 128, at 1.

maintaining records, allowing EPA audits, and participating in meetings with the EPA.[340] The labs that test products for Energy Star must be accredited by an EPA-recognized accreditation body that operates its accreditation program in accordance with ISO/IEC 17011 and maintains an affiliation with the International Laboratory Accreditation Cooperation (ILAC).[341] The EPA's Watersense program specifies similar requirements for its certification and accreditation bodies.[342]

### B. *Verifier Selection Rules*

A regulatory agency may also establish rules specifying when and how regulated entities may select an accredited verifier. Verifier selection rules ensure that the verifiers selected have the necessary expertise and independence to conduct a particular verification.

In its greenhouse gas reporting rule, the ARB requires the formation of a verification team.[343] The team must include at least two lead verifiers employed by the same verification body.[344] One is needed to conduct the verification and another to conduct an independent review of the verification.[345] The team may also include additional accredited and non-accredited technical and administrative staff.[346] For verifications at refineries, hydrogen plants, and cement plants, a sector-specific verifier must be part of the team.[347] The ARB restricts the extent to which verifiers can use subcontractors, specifying that neither the lead verifier nor the independent reviewer may be subcontracted.[348]

ARB has also developed rules to police conflicts of interest that verifiers may have in performing certain audits. As defined by ARB, a conflict of interest means "a situation in which, because of financial or other activities or relationships with other persons or organizations, a person or body is unable or potentially unable to render an impartial verification opinion."[349] The ARB requires that verifiers that seek to be

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[340] *Id.* at 1–2.

[341] *Conditions and Criteria for Recognition of Accreditation Bodies for EnergyStar Laboratory Recognition*, *supra* note 128, at 1.

[342] *WaterSense Product Certification*, *supra* note 130.

[343] Cal. Code Regs. tit. 17, § 95131(a) (2010). For a discussion of the importance of teamwork in environmental auditing, see De Moor & De Beelde, *supra* note 295, at 213.

[344] *See* § 95131(c)(1).

[345] *Id.*; *see also infra* notes 376–379 and accompanying text.

[346] *See* § 95131.

[347] *See* § 95131(a)(2).

[348] *See* §§ 95102(a)(204), 95131(c)(1).

[349] Cal. Envtl. Prot. Agency, Air Res. Bd., Verification of Greenhouse Gas Emissions Data Reports: Technical Guidance for Verifiers 23 (2011) [hereinafter Techni-

contracted by a particular regulated entity submit a self-evaluation of potential conflicts of interest to the ARB at least forty-five days before commencing a verification.[350]

In the self-evaluation, verifiers must reveal the nature of any services previously provided to the regulated entity by any member of the verification team and any other potentially relevant past, present, or future relationships.[351] The verifier uses criteria provided by the regulation to rate the conflict of interest as high, medium, or low.[352] In the case of a medium conflict of interest, the verifier must submit a mitigation plan to the ARB for the verification to move forward.[353] The verifier must also monitor potential conflicts of interest and report them to ARB throughout the period of the verification and for a year afterwards.[354] For example, the verifier would have to report to the ARB if a member of the verification team conducts any consulting for or becomes employed by the regulated entity within a year after the verification.[355]

Moreover, the ARB's conflict-of-interest rules require that verifiers refrain from any consulting during a verification. The verifier's responsibility is only to review emissions information.[356] The verifier must identify issues and errors in the emissions data report, but cannot consult on how to make changes to the data collection systems.[357] Verifiers should, for example, identify areas in which accuracy could be improved, but they are not permitted to consult on how to improve.[358] As the ARB states, "[i]dentifying weaknesses or areas of improvement is within the scope of verification services, but any specific recommenda-

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cal Guidance], *available at* http://www.arb.ca.gov/cc/reporting/ghgver/revised_verification_guidance.pdf.

[350] *See Greenhouse Gas Emissions Conflict of Interest / Notice of Verification Services (COI/NOVS) Form* 7, Cal. Air Res. Bd., http://www.arb.ca.gov/cc/reporting/ghg-ver/ghg-ver.htm/coi_novs.doc (scroll down and click hyperlink to "COI/NOVS form" under "Archived Information") (last visited Dec. 28, 2011).

[351] § 95133(e).

[352] *See id.* § 95133(b)–(d).

[353] *Id.* § 95133(d)(1)–(2); Technical Guidance, *supra* note 349, at 24.

[354] § 95133(g).

[355] *Frequently Asked Questions Regarding the GHG Mandatory Reporting and Verification Program* 48, Cal. Air Res. Bd. (2011), http://www.arb.ca.gov/cc/reporting/ghg-rep/updated_faq.pdf [hereinafter *ARB Frequently Asked Questions*].

[356] Cal. Air Res. Bd., California Mandatory GHG Emissions Reporting and Verification Webinar 32 (2009), *available at* http://www.arb.ca.gov/cc/reporting/ghg-ver/reporting_verification_webinar.pdf.

[357] *Id.*

[358] *See id.*

tion for remedying these would constitute consulting services and create a conflict of interest."[359]

Finally, the ARB has a mandatory verifier rotation rule that requires regulated entities to change their verification body at least once every six years.[360] The ARB explains that this requirement prevents verifiers from becoming too comfortable and familiar with a client's data reports and avoids conflict-of-interest issues that arise in a long-term business relationship.[361]

### C. *Verification Performance Rules*

By providing rules about how to perform verifications, a regulatory agency can exert great influence over the work of verifiers and the quality of verifications. Verification performance rules can frame and structure the verification and its outputs in ways that help ensure that they serve regulatory goals.[362]

The primary issue in fashioning verification rules is how detailed to make them. Detailed rules further the goals of consistency and quality by helping to ensure that verifications are performed in a similar and complete manner. Detail also reduces ambiguity, thereby limiting opportunities for bias. Detailed rules may, however, lead to the problem of "going by the book," wherein rules are applied that may not be suitable or appropriate with potentially unfair or wasteful implications.[363] Stated differently, the issue involves how much the agency should prescribe and how much the agency should leave to the verifier's professional judgment. Arguments on either side would be similar to those that have been made in the past regarding how much discretion should be given to government inspectors.[364]

The ARB prescribes in detail how verifications should be performed. The rule requires the verifier to prepare a verification plan that, at the minimum, includes the dates of proposed meetings and interviews with entity representatives; the dates of proposed site visits; proposed document and data reviews; and the expected date of com-

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[359] *ARB Frequently Asked Questions*, *supra* note 355, at 43.

[360] Cal. Code Regs. tit. 17, § 95130(a)(2), (b)(2) (2010).

[361] Technical Guidance, *supra* note 349, at 27.

[362] *See* Shapiro, *supra* note 265, at 1035 ("[T]he standard should be suited to—if not actually dictated by—the needs of the third party information user.").

[363] *See* Bardach & Kagan, *supra* note 94, at 34–39.

[364] *See generally id.* (discussing discretion in regulatory agencies); Kenneth Culp Davis, Discretionary Justice (1969) (same); Daniel J. Gifford, *Discretionary Decisionmaking in the Regulatory Agencies: A Conceptual Framework*, 57 S. Cal. L. Rev. 101 (1983) (same).

pletion of verification.[365] The rule also requires that an accredited verifier on the verification team make a site visit.[366] On the site visit, the verifier must ensure that all regulated emissions sources at the site are included in the emissions data report; learn about the data management systems used to process emissions information; and collect and review any other information deemed necessary.[367] Entities must collect and maintain information related to their emissions in a clear, transparent and complete manner,[368] and make all relevant information available to the verification team.[369]

The ARB instructs verifiers to use a risk-based approach to verification, in which the verifier strategically analyzes where risks of material misstatements exist and focuses its activities accordingly.[370] To this end, verifiers are required to prepare a sampling plan that contains a ranking of emissions sources by amount of emissions; a ranking of emissions sources by the presence of calculation uncertainty; and a qualitative narrative that synthesizes the information in the rankings and details specific risks.[371] The rule also requires that verifiers use "data checks" to ensure that emissions have been calculated in the manner specified by the regulation.[372] In other words, the verifier does not duplicate all the emissions calculations made by the regulated entity, but rather chooses certain calculations to check based on its sampling plan.

The rule allows regulated entities to improve or correct their emissions data reports in the course of verification.[373] In guidance, the ARB makes it clear that many issues that the verifier may find can be corrected before the verification deadline and a positive opinion can be issued.[374] Some issues, such as a failure by the regulated entity to collect necessary data, would not be correctable and would necessarily result in an adverse opinion.[375]

California also requires an "independent review" of the verification before it is submitted.[376] The independent reviewer is part of the verifi-

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[365] Cal. Code Regs. tit. 17, § 95130(b)(2) (2010).

[366] *Id.* § 95131(b)(4).

[367] *Id.*

[368] *Id.* § 95104(c).

[369] *Id.* § 95131(b)(6).

[370] *Id.* § 95131(b)(8); Technical Guidance, *supra* note 349, at 43. *See generally* Albersmeier et al., *supra* note 284 (discussing risk-based auditing).

[371] § 95131(b)(8); Technical Guidance, *supra* note 349, at 43–45.

[372] § 95131(b)(9); Technical Guidance, *supra* note 349, at 45–48.

[373] § 95131(b)(10).

[374] *See ARB Frequently Asked Questions*, *supra* note 355, at 49.

[375] *Id.*

[376] § 95131(c)(1).

cation team and must be a lead verifier employed by the accreditation body.[377] The independent reviewer may not participate in the site visit or otherwise be actively involved in the verification.[378] The review serves as a "final check" for errors in planning, data sampling, and judgments by the verification team.[379]

Some aspects of the audit process are inevitably left to professional judgment.[380] The rule defines professional judgment as "the ability to render sound decisions based on professional qualifications and relevant greenhouse gas accounting experience."[381] In guidance, ARB specifically recognizes that professional judgment is required of verifiers in collecting and reviewing information needed for verification and in deciding how many data checks are necessary.[382]

The European Commission specifies a verification methodology consisting of five steps.[383] The first two steps are strategic analysis and risk analysis, in which the verifier reviews documents and other information from the regulated entity to determine the scope and complexity of the verification and the areas of greatest risk.[384] The verifier then writes a verification plan that establishes a timeline for the verification and includes a data sampling plan.[385] The third step is the verification itself, which may or may not include a site visit.[386] Fourth, the verifier prepares an internal verification report that records and reviews all evidence collected and sets forth the verification opinion.[387] This internal verification report should also facilitate "a potential evaluation of the audit by the [member state regulatory agency] and accreditation body."[388] Finally, the verifier submits a verification report to the regulated entity that contains the verification methodology, findings, and opinion.[389] The regulated entity then submits this report with its annual emissions report to the member state regulatory agency.[390]

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[377] *Id.*
[378] *See id.*
[379] Technical Guidance, *supra* note 349, at 66.
[380] *Id.* at 13.
[381] § 95102(a)(161).
[382] Technical Guidance, *supra* note 349, at 13.
[383] Commission Decision, *supra* note 33, at 31–33.
[384] *Id.* at 31.
[385] *Id.*
[386] *Id.* at 32.
[387] *Id.*
[388] *Id.*
[389] Commission Decision, *supra* note 33, at 32–33.
[390] *Id.* at 32.

### D. *Reporting and Disclosure Rules*

A regulatory agency may also establish rules regarding the types of information that accreditation bodies, verification bodies, and regulated entities must report to the government. These rules should ensure that the government has access to all the information it requires to effectively oversee the third-party verification system.[391] These rules can also facilitate the disclosure of information to the public. As a general rule, the public should have access to at least the same types of information it would have about regulated entities under traditional social regulation as well as additional information about verification and accreditation bodies. Well-crafted disclosure rules can promote accountability and transparency.

The reporting required of regulated entities in third-party verification could resemble the self-reporting currently required under many regulatory laws. For example, the Clean Water Act requires polluters to regularly self-monitor and report their discharges.[392] The difference with third-party verification is that these self-monitoring reports would be verified by a third party.

Verifiers in such a system could be subject to a variety of reporting requirements. In addition to the positive or adverse determination itself, verifiers might be required to submit documents generated during the verification process to explain and support their determinations. The government might also require certain types of information from verifiers to conduct oversight during the course of the verification. As described above, verifiers could be required to report potential conflicts of interest before the verification begins. Verifiers might also be required to report the dates and times of specific verification activities so that government officials can accompany the verifier for oversight purposes.

Accreditation bodies, in turn, could be required to report regarding the processes used to accredit verifiers. In addition to reporting accreditation decisions, they could be required to provide the government with a report containing the information collected to support the accreditation decision. They might also report areas of weakness that raised concern, even if they did not preclude accreditation.

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[391] *Cf.* Jost, *supra* note 221, at 172 (stating, in the context of health care accreditation, that "[o]nce the accreditor becomes a regulator, however, the government may insist on access to information in the hands of the accreditor to assure its accountability").

[392] *See* 40 C.F.R. § 122.41(j)–(*l*) (2011) (explaining the Clean Water Act's self-reporting requirements).

As in traditional social regulation, compliance information collected by the government should generally be made available to the public. Exceptions would apply to protect confidential commercial or financial information.[393] In a third-party verification system, this would include reporting not just by regulated entities but also by verifiers and accreditors. Government agencies should also provide the public with user-friendly information about the responsibilities and qualifications of verifiers and accreditors.[394]

A system of third-party verification has great potential to produce greater transparency about compliance rates and regulatory performance. Because compliance will be more regularly and systematically assessed, statistics of compliance rates and comparisons of compliance among regulated entities will be more meaningful. Also, the actual data regarding regulatory performance will be verified by a third party and thus more reliable and useful in calculating the social impact of the regulated activity.

For example, if third-party verification were used on an annual basis to verify discharge monitoring reports under the Clean Water Act, and if the compliance data and verification determinations were made public, reliable information would be easily available about how many entities were in compliance that year, how similar facilities compared, and how much pollution had been discharged by any given group of polluters. As under the TRI, the government could facilitate such public disclosure by requiring regulated entities and verifiers to report in a computerized and standardized format.[395] Such reliable information, provided in an accessible format via the Internet, has great potential to impact citizens, consumers, and investors in ways that reinforce regulatory goals.[396]

Under the California greenhouse gas emissions reporting rule, regulated entities are responsible for submitting an emissions data report to the ARB, and verifiers are thereafter responsible for submitting

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[393] Jost, *supra* note 221, at 179 (noting that that FOIA contains exceptions for confidential commercial or financial information).

[394] *Cf.* Parker, *supra* note 102, at 237 (observing that the release of information about verifier qualifications and methodologies allows the public to form opinions about their value).

[395] *See* Karkkainen, *supra* note 144, at 261.

[396] *See* Daniel C. Esty, *Environmental Protection in the Information Age*, 79 N.Y.U. L. Rev. 115, 197–209 (2004); Douglas A. Kysar & James Salzman, *Foreword: Making Sense of Information for Environmental Protection*, 86 Tex. L. Rev. 1347, 1350–61 (2008) (arguing that a central concern of environmental law is the development of information for regulatory decisionmaking).

a positive or adverse verification opinion to the ARB . Both submissions become public information.[397] The verifier is also responsible for preparing several other documents to which the regulatory agency has access. Most importantly, the verifier is responsible for providing the regulated entity with a detailed verification report that summarizes the activities conducted by the verification team and findings that support the verification opinion.[398] Although the primary audience of the verification report is the regulated firm, the ARB states that it will look at the report "when conducting audits of verification bodies and when resolving issues that arose during verification."[399]

The ARB also instructs the verifier to keep an "issues log" that ultimately becomes part of the verification report. In the issues log, verifiers should note any issues that are not serious enough to necessitate an adverse opinion but may be indicative of emissions reporting problems.[400] For example, verifiers should note failures of record keeping; errors in the emissions data report; and other observed reporting weaknesses.[401] As the ARB explains, "The issues log is an important part of the 'evidence trail,' which supports the verification findings, increases transparency for the independent reviewer and ARB, and will be relied upon if there are disputes with operators over the verification findings."[402] California, however, does not seek to make verifiers the eyes and ears of the government in all ways. Verifiers are not required to report unrelated breaches of environmental law to the government.[403] Also, if a verifier thinks a regulated entity has knowingly submitted false information, the ARB instructs the verifier to first contact the regulated entity to try to resolve the matter.[404]

The Energy Star program provides an example of reporting requirements for accreditation bodies. In addition to reporting in ways that show that they meet the requirements for approval, the entities

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[397] Cal. Code Regs. tit. 17, § 95106 (2010) (stating that emissions data is public information); *see* Cal. Air Res. Bd., Frequently Asked Questions Regarding the Verification of GHG Emissions Data Reports 13 (2010) (stating that the verification opinion form is public information).

[398] § 95131(c)(2); Technical Guidance, *supra* note 349, at 54–55.

[399] Technical Guidance, *supra* note 349, at 55.

[400] *Id.* at 56.

[401] *ARB Frequently Asked Questions*, *supra* note 355, at 41–43.

[402] Technical Guidance, *supra* note 349, at 56.

[403] *ARB Frequently Asked Questions*, *supra* note 355, at 42 (stating that verifiers need not report unrelated breaches of environmental law, but cautioning that "professional duty requires the verifier to communicate violations that may cause safety or serious environmental concerns to the operator").

[404] *Id.*

that accredit Energy Star laboratories must meet with the EPA as requested to brief the EPA on their activities and to report any major changes in legal or ownership status; organization and management; policies and procedures; and any other matters that might affect their capacity.[405] Upon request, accreditation bodies must also provide the EPA with electronic copies of information about any laboratory, including corrective action plans and documents relating to the resolution of any deficiencies.[406]

### E. *Governmental Oversight and Enforcement*

The government should actively enforce its third-party verification system rules and otherwise oversee the system to ensure accountability.[407] An adequate oversight regime would likely include governmental audits of particular verifications and accreditations. The government might also require an accreditation body to audit a certain number of verification bodies each year. The resources for this could come from the accreditation fees paid by verifiers and thus be built into the system.[408] Oversight would need to be attentive to the possibility of creative compliance, with efforts to identify and close off any loopholes found by creative verifiers.[409]

The government agency should also retain independent enforcement capability and impose sanctions as deemed necessary to respond to noncompliance. In principle, the same enforcement strategies and tools typical to traditional social regulation would apply in a third-party verification system. The government would retain the authority to impose fines and other sanctions on noncompliant regulated entities, and it should gain new authority to impose fines and other sanctions on noncompliant verifiers and accreditors. At a minimum, the government agency would have the authority to revoke the accreditation of verifiers and the approval of accreditors.

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[405] *Conditions and Criteria for Recognition of Accreditation Bodies for Energy Star Laboratory Recognition*, *supra* note 128, at 1.

[406] *Id.* at 2.

[407] Oversight is also likely to be critical to the constitutionality of delegating regulatory authority to accreditation and verification bodies. When the constitutionality of the private accrediting system for hospitals was challenged in the 1980s, the United States Court of Appeals for the Third Circuit found it critical that a government agency retained the authority to revoke the authority of the accreditation body if it was not providing adequate assurance of compliance with federal standards. Havighurst, *supra* note 26, at 8.

[408] *Cf.* Meidinger, *supra* note 270, at 283 (discussing how resources of certification firms are limited and they are not able to do general oversight).

[409] *See id.* at 286.

Another important means of creating accountability is establishing procedures for citizens, public interest groups, and regulated entities to challenge decisions that they believe are contrary to law.[410] Interested parties have these types of rights in the regulatory process at present, and a third-party verification system should contain comparable accountability mechanisms. For example, the citizen suit should continue to be available either to compel a regulatory agency to perform a nondiscretionary duty or to directly enforce the law against a regulated entity. A possible mechanism for enhanced citizen oversight in a third-party verification system is a "challenge rule" that enables interested parties to administratively challenge a positive verification.

Under the California greenhouse gas reporting rule, the ARB has exercised oversight of verification bodies through audits. Verification audits include a review of the verification report and sampling plan, and may also include observations of the verifier during a site visit. ARB states that its verification audits are to ensure "quality, rigor and consistency across verification bodies."[411] The ARB has authority to assess fines and other sanctions on verification bodies as well as to rescind their accreditation.[412] After auditing all verification bodies in 2010, the ARB concluded that "verifiers exceeded expectations and provided high quality verification services" in almost all cases.[413] The ARB identified a few verification bodies as needing improvement in preparing for site visits, maintaining their objectivity during verifications, and providing detailed verification reports.[414]

The ARB has stated that adverse opinions by verifiers do not always lead to enforcement actions against regulated entities.[415] Rather, adverse opinions are evaluated on a case-by-case basis and the ARB will "work with" regulated entities to rectify the issues.[416] Also, if the verifier and regulated entity have a dispute, the regulated entity may petition the ARB to make a final decision on the verifiability of the emissions data report.[417]

In the Energy Star program, the EPA has delegated some aspects of oversight to its accreditation and certification bodies while retaining

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[410] *Cf.* Kinney, *supra* note 66, at 68.

[411] Technical Guidance, *supra* note 349, at 70.

[412] *See* Cal. Code Regs. tit. 17, §§ 95107, 95132(d) (2010).

[413] *ARB Program Review*, *supra* note 335, at 2–3.

[414] *Id.*

[415] *Emissions Data Verification Fact Sheet for GHG Emissions Reporters* 2, Cal. Air Res. Bd. (2010), http://www.arb.ca.gov/cc/reporting/ghg-ver/verification.pdf.

[416] *Id.*

[417] § 95131(c)(3)(A); Technical Guidance, *supra* note 349, at 68.

others. Accreditation bodies must conduct ongoing oversight of the labs they accredit through regular review of documents to monitor their impartiality.[418] To allow EPA oversight, the accreditation bodies are subject to a variety of reporting and recordkeeping requirements and must allow the EPA to witness laboratory testing assessments at its discretion.[419] The certification bodies that certify products for the Energy Star label are required to annually test at least ten percent of their certified product models to ensure they continue to meet standards.[420] Certification bodies, in turn, are subject to reporting and record keeping requirements and must allow the EPA to audit product certification and verification activities at its discretion.[421] Certification bodies must also establish procedures for and conduct "challenge testing," which allows companies to challenge their competitors' compliance with Energy Star.[422]

### F. *Cost-Effectiveness*

To respond to concerns about the cost-effectiveness of third-party verification, two questions should be considered. First, in which regulatory regimes should third-party verification be used? Second, how can third-party verification be more cost-effective in those regimes?

Third-party verification is not likely to be cost-effective in all social regulatory programs. The relevant criterion is whether the additional benefits that third-party verification provides outweigh the additional costs. This is likely to be the case for regulatory regimes in which the government is ill-equipped to collect the compliance information needed to run the program. California's greenhouse gas reporting rules and the imported food programs of the FDA are examples. Yet this criterion might also be met in traditional regulatory areas such as water pollution, worker health and safety, grazing allotments, and others. As discussed above, a wide variety of benefits accrue from having better information about compliance and regulatory performance.

Once a determination is made to use third-party verification, many options may be considered to minimize its costs. An important factor in reducing costs for regulated entities is the presence of a competitive

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[418] *Conditions and Criteria for Recognition of Accreditation Bodies for Energy Star Laboratory Accreditation*, *supra* note 128, at 2.

[419] *Id.*

[420] *Conditions and Criteria for Recognition of Certification Bodies for the Energy Star Program*, *supra* note 128, at 3.

[421] *Id.*

[422] *Id.* at 4–5.

market in verification services. If the accreditation is too difficult to attain or poorly administered, verifiers could be scarce and regulated entities may have trouble securing verification services in a timely fashion and at a reasonable cost. Also, if the bar for conflicts of interest is too high, potential verifiers may not want to offer verification services because doing so would eliminate too many other business opportunities. This situation calls for a balancing of interests. The rigor of the accreditation and conflict-of-interest rules must be balanced with the need to create sufficiently attractive market opportunities for verifiers. Similarly, where rotation of audit firms is required, the period of rotation can be chosen to balance concerns about auditor independence and cost-effectiveness. The six-year period used by California seems to be an example of such balancing.

Verification performance rules should also take into account cost-effectiveness. California, for example, does not require a full verification each year. Smaller emitters, such as cement plants and general stationary combustion facilities, are only required to have their reports verified every three years.[423] Although larger emitters, such as petroleum refineries and fossil-fuel fired power plants, must have their reports verified every year,[424] they may conduct a less-intensive verification in the second and third years after a positive full verification.[425] A less-intensive verification involves conducting data checks but does not require a site visit or the preparation of a new sampling plan.[426]

Well-designed reporting rules and information systems are important to lowering the government's administrative costs. Regulatory agencies should require that compliance data and verification opinions be submitted in digital formats that facilitate governmental oversight and the provision of data to the public. For example, the ARB developed an "online greenhouse gas reporting tool" that both receives information from regulated entities and verifiers, and generates reports for the public.[427]

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[423] Cal. Code Regs. tit. 17, § 95103(c)(2) (2010); Technical Guidance, *supra* note 349, at 9.

[424] *Id.* § 95103(c)(1).

[425] Technical Guidance, *supra* note 349, at 8.

[426] *ARB Frequently Asked Questions*, *supra* note 355, at 41.

[427] *See Online Greenhouse Gas (GHG) Reporting Tool*, Cal. Air Res. Bd., https://ghgreport.arb.ca.gov/eats/carb/ (last visited Dec. 28, 2011).

## Conclusion

With third-party verification, important debates about the privatization of governmental functions enter the sphere of regulatory implementation and enforcement. Is determining regulatory compliance a core governmental function that should only be conducted by public servants, or can private actors possibly do a better job?

Many compelling reasons exist to endorse third-party verification. It follows in a long and often very successful tradition of public-private partnerships. Moreover, decades of the use of third parties in voluntary audits and certification schemes have given rise to a large industry of private inspectors and auditors that could be brought into the service of public regulation. Third-party verification holds the promise of more complete information about compliance and regulatory performance, which is particularly critical in the implementation of new regulatory frameworks. Finally, third-party verification is a way to shift part of the cost of social regulation to industry and conserve scarce governmental resources.

At the same time, however, there are also important reasons for concern. The assessment of regulatory compliance is arguably a core governmental function given how critical it is to ensure that laws are observed and public safety is protected. As this approach becomes part of regulatory frameworks, the legitimate interests of the public in the accountability of public and private actors, the independence and competence of verifiers, and the cost-effectiveness of the system must be adequately protected and promoted.

The foregoing analysis of third-party verification focuses on key questions of public-private governance that other scholars have posed: How can government draw on the strengths of the private sector in stimulating competition and innovation without sacrificing public values?[428] How can government facilitate and direct a private role in public governance?[429] The answer lies in the establishment of clean and enforceable governmental rules that structure the public-private partnership. In the case of third-party verification, these rules should determine which private parties may act as verifiers; how regulated entities select verifiers; how verifiers carry out their tasks to determine compliance; and which types of information must be publicly disclosed by private actors. Although the appropriate rules will differ depending on the public-private partnership under study, the lesson remains the

[428] *See* Minow, *supra* note 16, at 1236.

[429] *See* Freeman, *supra* note 16, at 1289.

same. As privatization advances so too can—and should—the development of rules that subject relevant private behavior to meaningful public scrutiny and supervision.