New Governance Securities Regulation in Theory and Practice

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ABSTRACT

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This dissertation examines the current use of, and potential for, new governance-style structures in securities regulation in the United States and Canada. It is among the first to examine securities regulation from a new governance perspective. The two main subjects of the dissertation – the “reform undertaking,” or monitorship; and more principles-based securities regulation – respond in particular to the difficult problems of corporate compliance, corporate ethical culture, and limited regulatory capacity.

New governance scholarship emphasizes the importance of pragmatic, decentralized, dynamic, leaning-by-doing structures, based on broad participatory dialogue, in developing more effective methods for problem-solving. Taken as a whole, this dissertation offers a review of both the potential significance of new governance methods for difficult problems in securities regulation, and also the distance between theory and effective implementation. The first two chapters offer mostly theoretical proposals for responding to the problems of corporate culture and industry complexity, and are cautiously optimistic about the potential of monitorships and principles-based regulation as strategies. The third chapter and the appendix (a co-authored piece that is not formally part of the dissertation) are devoted to understanding the reasons why actual practice seems to have fallen short of theory. The latter two are not accounts of the failure of new governance approaches to operate as intended. Rather, they focus on the failure by securities regulators (and the reasons for failure) in implementing new governance initiatives in a serious way.

This dissertation is a snapshot of the imperfect reception of new governance ideas by regulators who, on their surface, seemed to have been well-suited to working with them. The successes and failures of these initiatives are specific to this context. However, there are lessons to be drawn for new governance scholarship generally concerning the difficulty of building in adequate capacity, of ensuring a truly participatory dialogic process, and of generating effective structures that will systematize regulatory learning. The dissertation emphasizes the importance of understanding the particular historical, philosophical, and structural contexts under which any regulator operates, and the ways in which they will influence, and even call for customization of, new governance methods.
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Above all I dedicate this dissertation, with deep love and gratitude, to my family: to Donna, to Sasha, to Moss, and to Nina Liv. I could not be more fortunate.
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INTRODUCTION

This dissertation examines the current use of, and potential for, new governance-style structures in securities regulation in the United States and Canada. The innovations described here represent efforts by regulators to foster responsible firm behavior, while not discouraging innovation or establishing overly prescriptive regulatory requirements. The two main subjects of this dissertation – the “reform undertaking” or monitorship, and more principles-based securities regulation (PBR) – are attempts to consider how new governance methods could help respond to the vexing problems of compliance, culture, and regulatory capacity in securities regulation.

Taken together, they represent an informal case study on the application of new governance theory. The value of this dissertation is as a contextual application of new governance to this socially significant and very dynamic arena. It is an application of new governance thinking,
grounded in an appreciation for the particular dynamics and institutional processes of this regulatory regime. But studying securities regulation also generates distinct insights about new governance theory. This dissertation represents a snapshot of the imperfect reception of new governance ideas by regulators who, on their surface, seemed to have been well-suited to working with them. The successes and failures of these initiatives are specific to this context. However, there are lessons to be drawn for new governance scholarship generally regarding the difficulty of building in adequate capacity, of ensuring a truly participatory dialogic process, and of generating effective structures that will systematize regulatory learning.

The dissertation emphasizes the importance of understanding the particular historical, philosophical, and structural contexts under which any regulator operates, and the ways in which these factors will influence new governance methods, and even at times demand their customization.

**Dissertation Overview**

This research has its roots in my practice experience representing financial firms facing regulatory and criminal sanctions for securities law violations. That work exposed me to the limits of regulation, especially enforcement action, in responding to difficult problems of corporate compliance and ethical culture. Problems of ethical corporate culture seem often to be polycentric, multiple, pervasive yet diffuse, and causally
contested. Yet during my time in practice, enforcement staffers at the
United States Securities and Exchange Commission (SEC) were explicitly
asserting that enforcement action could spur widespread institutional reform.
In view of the shortcomings of other available strategies, I considered the
monitorship to be a potentially promising new governance-informed
mechanism for effecting that change.

My practice experience also gave me a sense of the almost
unimaginable complexity, global interconnectedness, and speed of
innovation that characterize modern financial markets, all of which further
complicate the regulatory task.¹ I advocate below for more principles-based
securities regulation (PBR) not only as a response to limited regulatory
capacity and fast-paced innovation, but also on the basis that, when properly
implemented, it can promote better corporate compliance. PBR incorporates
industry learning, orients itself around core regulatory goals, and forces
firms to engage in endogenous, compliance-oriented thinking.

The dissertation comprises three chapters, plus this introduction.
The first chapter, entitled Toward a New Model for Securities Law

¹ See, e.g., Steven L. Schwarcz, Regulating Complexity in Financial Markets, 87
WASH. U. L. REV. 1 (2009), 2-3 (describing complexity as the “greatest financial
market challenge of the future”).
Enforcement,” considers “reform undertakings”, or monitorships. This is the practice of requiring a firm or corporation, as a term of a settlement agreement with SEC Enforcement staff, to agree to a series of structural reform recommendations and to engage an independent third party monitor, at its own expense, to oversee those reforms. The chapter argues that the monitorship is a novel response to a crisis of corporate governance. It is also a response to the demonstrated inadequacy of existing mechanisms (either sanctions or Sentencing Guidelines-derived credit-for-compliance and credit-for-cooperation models) to respond adequately to that crisis. The chapter claims that the SEC’s model is incomplete, but that if properly implemented could have the potential to spur institutional reform not only in corporate governance, but also within Enforcement practice itself. Based on the monitorship form, the chapter develops a larger theoretical argument that forward-looking, reform-minded, new governance-style enforcement improves on more traditional, retrospective, nontransparent approaches as mechanisms for addressing systemic problems in corporate ethical culture. It proposes that in its ideal form (that is, using properly skilled third party monitors who can promote meaningful firm-level dialogue, supported by

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2 57 ADMIN. L. REV. 757 (2005) [hereinafter “Chapter 1”]. In this introduction, page references to Chapters 1, 2, and 3 refer to the global dissertation page numbers on the upper right corner of each page.

3 The term that I use in this introduction, following the somewhat plainer terminology used in the Appendix, introduced infra at note 4, is “monitorships.” Chapter 1 uses the term “reform undertaking”.

effective comparative analysis by a regulator), the monitorship is a useful elaboration on existing new governance theory because it tries to embed a decentralized, data-driven, highly participatory process within an enforcement context.\(^4\)

The second chapter, entitled *New Governance, Compliance, and Principles-Based Regulation*,\(^5\) applies the lens of new governance theory to examine proposals in British Columbia, Canada and in the United Kingdom for more principles-based securities regulatory regimes. The chapter argues that the British Columbia approach is significant in that its outcome-oriented, collaborative, pragmatic, and open-ended methods share features with new governance approaches to regulation and public problem-solving. It argues that PBR is especially noteworthy with regard to firm compliance

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\(^4\) Although not included in the dissertation, a related empirical paper is part of this general body of work, and has been included as an Appendix: Cristie Ford & David Hess, *Can Corporate Monitorships Improve Corporate Compliance?* 34 J. CORP. L. 679 (2009) [hereinafter “Appendix”]. This study considers the use of corporate monitorships in the regulatory and prosecutorial context, with a view to determining whether reform undertakings and their criminal equivalent, deferred prosecution agreements, are meeting the potential that Chapter 1, above, describes. Based primarily on interviews with individuals directly involved in monitorships, the paper looks at the entire monitorship process. This includes the selection of the monitor, how the monitor conducts his or her work, and what happens after a monitorship. The paper finds that decisions at critical points during this process routinely lead to monitorships that are significantly less ambitious than the government pronouncements behind them, and seem unlikely to achieve their broader goals on any consistent basis. The reforms we suggest include selecting monitors on different criteria, crafting the scope of monitorships more explicitly at the negotiation stage, strengthening the incentives to make the monitorship more than a cosmetic exercise, and institutionalizing learning post-monitorship.

\(^5\) 45 AM. BUS. L.J. 1 (2008) [hereinafter “Chapter 2”].
processes, because it seeks to engage firms in their own endogenous learning about compliance. Moreover, the chapter proposes that new governance is a necessary complement to PBR. It provides a rational, systematic means through which industry learning and the input of third party stakeholders can fill in the content of otherwise vague principles. The chapter identifies and develops provisional responses to some of the challenges arising from applying new governance theory to the specific context of securities regulation. Those challenges include justifying the imposition on industry of the costs of articulating the content of principles ex post (as opposed to rules, which impose costs on regulators/legislators ex ante); reconciling light touch regulation with a new governance-style “rolling best practices rulemaking” regime; ensuring that industry has incentives to innovate not only around new business products but around compliance processes; and addressing capacity issues arising from requiring even smaller industry actors to interpret principles for themselves.

The third chapter, entitled *Principles-Based Securities Regulation in the Wake of the Global Financial Crisis*, re-examines and ultimately restates the case for PBR in light of the recent financial crisis. The chapter argues that PBR, as properly understood, remains a viable and even necessary policy option, which offers solutions to the real-life and

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Theoretical challenge that the financial crisis presents to contemporary financial markets regulation. That said, the recent financial crisis illustrates how such outcome-oriented and devolved models can slide into self-regulation in the absence of robust regulatory oversight, engagement, and commitment to a publicly and systemically oriented role. The chapter argues that the response to the crisis should not be to re-embrace more rules-based regulatory approaches. Financial markets are too fast-moving and complex to be regulated in a command-and-control manner, and the risk of Enron-style “loophole behavior” associated with rules is too great. Instead, the chapter draws on the lessons of the financial crisis to identify three critical success factors for effective PBR: considerable regulatory capacity (along four main parameters); an effective strategy for dealing with complexity (including the possibility of incorporating “prophylactic rules” at strategic junctures); and adequate independence of mind and diversity of perspectives among regulators (meaning potentially a move away from an expertise-based, technocratic model toward a more broadly participatory one).

Securities and Financial Regulation as Object of Study

This doctoral work is among the first to examine securities regulation from a new governance perspective. The particular focus of this

7 A recent addition to the field is Robert F. Weber, New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models
work is on regulation, as opposed to civil liability or private ordering.

Securities regulation is the product of a distinct history, a particular regulatory philosophy, and a specific set of regulatory and industry characteristics. At first glance, the field is not beset by some of the difficulties in other regulatory arenas around, for example, stakeholder capacity or bureaucratic turf protection. Yet, the same factors that allow securities regulation to avoid those difficulties may make the securities regulators susceptible to settling for a potentially superficial, incomplete, and unreflective version of new governance-style mechanisms.

The goals of securities regulation are to ensure investor protection through disclosure of information, and to ensure efficient and effective capital markets. In terms of regulatory philosophy, securities regulation is

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8 Existing securities laws in the United States and Canada are broadly similar, although securities regulation is a provincial matter in Canada, not a federal one. Where there are distinctions, the American regime is the template for this section, reflecting its earlier historical development and the fact that the Canadian regime has generally emulated the American one, not the other way around. Regarding the goals of securities regulation, see, e.g., Securities Act of 1933, 15 U.S.C. § 77b (b): in rulemaking in the public interest, the Commission shall consider “protection of investors, [and] whether the action will promote efficiency, competition, and capital formation”; Ontario Securities Act, R.S.O. 1990, c. S.5, s. 1.1: “The purposes of this
marked by a preference for allowing markets to govern themselves to the greatest extent possible while preventing market manipulation, fraud, and other deception. Disclosure obligations on public companies that seek to raise capital in the markets are the foundation of the system. Since its inception more than seventy-five years ago, U.S. federal securities regulation has used information-forcing (that is, mandatory disclosure) as its primary regulatory tool for responding to information asymmetries between public companies' management and members of the investing public. The disclosure requirements themselves are generally broadly phrased, event-associated, and unidirectional. They are aimed at ensuring that adequate company-specific information reaches the investing public. This reflects deep support for the market mechanisms that underlie securities regulation and the basic autonomy of the public companies that raise capital in those markets. Modern securities regulators have never tried to gather and evaluate substantive information themselves, or to manage public markets. The fact that securities regulation is disclosure-oriented, rather than merit-

Act are, (a) to provide protection to investors from unfair, improper or fraudulent practices; and (b) to foster fair and efficient capital markets and confidence in capital markets"; British Columbia Securities Commission, Annual Report 08/09 (2009), available at http://www.bcsc.bc.ca/uploadedFiles/BCSC_Annual_Report_2008_2009.pdf, at 10: "Our mission is to protect and promote the public interest by fostering: A securities market that is fair and warrants public confidence; A dynamic and competitive securities industry that provides investment opportunities and access to capital".
based, makes it an interesting precursor to structurally-oriented and decentralized modern regulatory approaches, such as the new governance approach.

The disclosure regime for public companies is buttressed by closer regulatory oversight of industry professionals: they are the investment banks, broker-dealers and investment advisors, exchanges and market makers, and gatekeepers that work the market machinery. On this front, contemporary securities regulation has operated from its inception in a pluralistic regulatory environment, within which independent industry organizations assumed key regulatory functions. Relative to administrative agencies that were free to develop command-and-control regimes from

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9 This is unlike the earlier “blue sky” laws in Kansas and elsewhere, which required anyone selling securities in the relevant state to first receive a permit from the state bank commissioner, who had broad discretion not to issue one if he did not approve of the merits of the offering. Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 23 (4th ed. 2001). Between 1912 and 1924, several Canadian provinces also adopted merit-based regulatory schemes modeled on the Kansas statute. Mark Gillen, Securities Regulation in Canada 85 (3d ed. 2007).

10 Mandatory disclosure in securities regulation was a 1930s-era innovation, not a recent one, and therefore predates recent work on the breakdown of the public/private divide, but the modern frame can be helpful descriptively. Consider, e.g., Peter Grabsky, Using Non-governmental Resources to Foster Regulatory Compliance, 8 Governance 527, 531-32 (1995) (describing several “technologies of compliance coproduction” ranging from conscription, through delegation, mandatory disclosure, and incentive structures, and to abdication).

whole cloth, the SEC has always had to contend with alternate sources of recognized authority operating within its core regulatory mandate. Even after modern securities regulators were established by legislation, powerful pre-existing self-regulatory organizations (SROs), particularly the New York and Toronto Stock Exchanges, retained the authority to regulate their members and adopt and enforce rules regarding members’ business conduct. Some devolution of regulatory authority to industry SROs was

12 See Charles F. Sabel & William H. Simon, Destabilization Rights: How Public Law Litigation Succeeds, 117 HARV. L. REV. 1012, 1021-22 (2004) (describing a command-and-control orientation, in the public litigation context, as having three characteristics: “First, an effort to anticipate and express all the key directives needed to induce compliance in a single, comprehensive, and hard-to-change decree. Second, assessment of compliance in terms of the defendant’s conformity to detailed prescriptions of conduct in the decree. These prescriptions tend to be process norms that dictate conduct as a means to the attainment of goals, rather than performance norms that directly mandate and measure goal achievement. And third, a strong directive role for the court or a special master in the formulation of the remedial norms”).

13 Dealers’ associations have also been significant self-regulatory players, though they began more as industry clubs than as standard-setting or oversight bodies. Both the National Association of Securities Dealers (NASD) in the United States and the Investment Dealers Association (IDA) in Canada were established after those countries’ modern securities regimes were established, but both built on pre-existing industry associations – respectively, the Investment Bankers Association and the Bond Dealers Section of the Toronto Board of Trade. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE, 3D ED. (2003), 183-89; Investment Industry Regulatory Authority of Canada, “Our History”, http://www.iicro.ca/English/About/OurRole/Pages/OurHistory.aspx. Both associations have since been subsumed, along with the regulatory arms of the NYSE and the TSX, into new regulatory organizations: the Financial Industry Regulatory Authority (FINRA), and the Investment Industry Regulatory Authority of Canada (IIROC). U.S. Securities and Exchange Commission, Release No. 34-56145, “Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc.”
virtually inescapable. In this sense, securities regulators have long and fairly exceptional experience with a more porous, pluralistic, and dialogic method of regulation. The tone of the relationships has not always been cooperative – far from it – but over time, the regulators and SROs have adopted more or less negotiation-oriented postures toward one other. Conceptually and strategically, the presence of organized industry voices may also have differentiated the SEC’s approach to market participant regulation, as compared to the disclosure-oriented backdrop of public company regulation where no such dialogic counterparty existed.

As a result of the SEC’s streamlined, disclosure-oriented approach to investor protection and the involvement of industry SROs in regulating market professionals, the history of securities regulation is distinct from the history generally told about the New Deal administrative state. In particular, securities regulation did not experience the same bureaucratic


seizing-up thought to have marked other areas of regulation.\textsuperscript{16} Throughout most of its history, including the 1970s – when other federal agencies in the United States were in states of profound organizational crisis – the SEC was generally perceived as a uniquely (though not completely) successful regulator.\textsuperscript{17} This distinguishes this area of regulation from those in which a new governance approach was the product of a desperate need to move beyond stalemated interest group advocacy and hidebound bureaucratic processes.\textsuperscript{18}

These factors taken together do not amount to a resounding conclusion that that securities regulation is the ideal environment for

\begin{flushleft}
\footnotesize
\textsuperscript{16} A useful history of the SEC is entirely beyond this project’s scope; cf. SELIGMAN, supra note 13, but on this point see, e.g., THOMAS K. MCCRAW, PROPHETS OF REGULATION, Chapter 5 (1984) (describing the “statecraft” of the SEC).

\textsuperscript{17} See, e.g., James O. Freedman, Crisis and Legitimacy in the Administrative Process, 27 STAN. L. REV. 1041, 1068-72 (1975) (identifying reasons for the SEC’s success and regard while other agencies were perceived to be in crisis); Robert A. Prentice, The Inevitability of a Strong SEC, 91 CORNELL L. REV. 775, 800 (2006) (stating that “most commentators consider the SEC an extremely successful regulator”). Of course, even prior to the most recent financial crisis, the story of the SEC’s perceived success and the factors contributing to its effectiveness (or not), has been more variable than these sweeping endorsements acknowledge. See, e.g., Donald C. Langevoort, The SEC as a Lawmaker: Choices about Investor Protection in the Face of Uncertainty, 84 WASH. U. L. REV. 1591 (2006).

\textsuperscript{18} See, e.g., Michael C. Dorf & Charles F. Sabel, A Constitution of Democratic Experimentalism, 98 COLUM. L. REV. 267, 322 (1998) (proposing that “collaboration arising from urgency is why direct deliberation … emerges first where the breakdown of traditional institutions is most conspicuous and its consequences most menacing: family-support services, policing, and military contracting”).
\end{flushleft}
adopting new governance methods. However, they do bracket some of the problems bedeviling new governance in other areas. For example, industry actors in the securities and financial markets tend to be sophisticated, and quite likely to have the resources and capacity to participate meaningfully in decentralized decision-making processes. This makes it less complicated to advocate for a PBR regime that devolves substantial decision-making authority to industry and the SROs, to apply their own contextual knowledge to the task of filling in the content of high level regulatory requirements. It also helps that regulators like the SEC and its Canadian equivalents had been structured ab initio around a disclosure-based regime and pre-existing SRO authority, which implicitly accords descriptive and self-analytical space to private actors. Arguably, this makes securities regulators better disposed toward, and more experienced at identifying multiple ways to interact effectively with private parties, rather than reflexively trying to control them.

The fact that securities regulation has not typically been a forum for overt interest group contestation also elides some of the difficult problems

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19 The fact that each of the aspects identified here can also be problematic, as discussed below, is one of this introduction’s primary observations. Specifically, taken together they may amount to an environment lacking in opportunities for truly broad-based stakeholder participation and the interrogation of fundamental assumptions. See infra at 18-25.

20 But see the caveat with regard to augmenting the capacity of small and medium-sized firms in Chapter 2, infra at 166-72.
of deep disagreement and significant capacity disparities within a discursive process. Unlike conversations around public housing, for example, the actual mechanics of securities regulation are not the subject of the same highly charged, overtly political contests over scarce resources and power relationships.\textsuperscript{21} Politicization and ideological loading tend to make productive conversations difficult, and to prevent cross-cutting accommodations and pragmatic problem-solving.

Other attributes of securities markets affirmatively make new governance methods attractive for regulating them. For example, consider the speed of innovation, the complexity of many of the products being sold, the sophisticated nature of many industry actors and their considerable resources relative to their regulators, and the global nature of financial markets and institutions – all of which had made transnational regulatory competition for capital markets activity a much-discussed reality by the time of the Bloomberg Report in early 2007.\textsuperscript{22} Specifically, a more principles-based approach, characterized by the central articulation of broad goals and the decentralized, pragmatic, incremental application of those principles in specific contexts is a thoughtful response to the challenge of managing

\textsuperscript{21}This is not to suggest that so-called “technical” standards do not have broader political or social implications; only that conversations around securities regulation have not tended to be cast in those broader terms. Cf. Lisa Alexander, \textit{Stakeholder Participation in New Governance: Lessons From Chicago’s Public Housing Reform Experiment}, 16 \textit{Geo. J. on Poverty L. \\& Pol’y} 117 (2009).

\textsuperscript{22} See Chapter 2, \textit{infra} at 118, note 3.
complexity, the speed of innovation, and the polycentric and multiple nature of corporate ethical culture. Endogenous problem-solving and the incorporation of internal firm knowledge into a dialogic monitorship process makes sense, especially where the goal is to effect sustainable change to something as organic as corporate culture. Incorporating industry knowledge – and learning from it through benchmarking and comparative analysis – also makes sense when regulatory resources and mandates are not sufficient, and not intended to be sufficient, to independently gather and act on the information that firms have. Management-based, risk-based, and outcome-oriented regulation are all plausible strategies, compatible with new governance thinking on regulating sophisticated and diverse industry actors in an efficient, effective, and systematic manner.\footnote{The distinctions and attributes of these separate approaches is beyond the scope of this introduction but see, e.g., Julia Black & Robert Baldwin, \textit{Really Responsive Regulation}, (distinguishing between and considering the relative strengths of responsive regulation, smart regulation, and risk-based regulation); also Cristie Ford, \textit{Principles-Based Securities Regulation}, Report submitted to the Expert Panel on Securities Regulation, Ministry of Finance, Canada, \textit{available at http://www.expertpanel.ca/eng/reports/research-studies/principles-based-securities-regulation-ford.html}, at *4-5* (distinguishing between management-based and outcome-oriented regulation).} Finally, strict, rigid prohibitory rules (e.g., banning derivatives) do not make sense in a world characterized by regulatory competition and powerful, highly mobile global firms.
Significantly, our collective understanding of many of these environmental conditions has taken on a darker hue in the wake of the recent financial crisis. Many of the problems underlying the financial crisis (including, prominently, regulatory gaps and regulatory failure) existed through the pendency of this dissertation, although their gravity was not widely recognized prior to the autumn of 2008. The third chapter in this dissertation responds to the financial crisis by identifying critical success factors for PBR, and by expanding the analytical lens to incorporate prudential regulation of shadow banks in the form of the June 2004 Basel II Capital Accords\(^{24}\) and the associated (and entirely voluntary) Consolidated Supervised Entities (CSE) Program at the SEC.\(^{25}\) The third chapter also begins to examine the possibility that many of the attributes of securities regulation that make it a hospitable environment for new governance regulation can be double-edged swords in terms of ensuring regulatory effectiveness. They include the disparate power and access to information of industry relative to its regulators; the effect of regulatory competition and therefore the opportunities for regulatory arbitrage by a highly mobile


industry; the longstanding embrace of self-regulation of market participants, which during moments of deregulatory sentiment can lead to policy and regulatory abdication of responsibility; and industry complexity, innovation, and speed on such a scale as to cast the very possibility of regulation (let alone disclosure-based regulation) into question.

**NEW GOVERNANCE SCHOLARSHIP IN CONTEXT**

The term “new governance” is something of a big tent that captures several discrete but related approaches.\(^{26}\) Within new governance, we can identify a subset of “experimentalist” scholars.\(^{27}\) Susan Sturm’s important work on institutional change also falls within the broad new governance cluster.\(^{28}\) New governance also likely incorporates, or at least bears a strong relationship to, versions of reflexive law,\(^{29}\) responsive regulation and/or

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enforced self-regulation,\textsuperscript{30} co-regulation,\textsuperscript{31} and management-based regulation.\textsuperscript{32}

My focus in this dissertation is on new governance in relation to regulation. That is, it focuses on designs that assume a systemic ordering role for a public bureaucratic structure, rather than on private interparty arrangements, courts, or other institutional forms. I am particularly concerned with how new governance forms, in the context of securities regulation, can effect positive change to corporate or firm compliance and ethical culture; and how new governance forms can help respond to the problems of complexity and speed that characterize the securities markets. As noted above, some elements of existing securities regulation – particularly the fact that it is underpinned by a bottom-up, decentered, information-forcing process that incorporates non-state actors in problem-


solving and standard-setting – seem instinctively compatible with new governance.

Several new governance regulatory design elements play central roles in the particular examples considered in this dissertation. They include, first, a flexible regulatory structure that engages reciprocally with the local level – meaning that it is capable of being tailored to particular situations, and also that it is capable of catalyzing endogenous learning at the local level. This can be contrasted with the one-way disclosure requirements securities regulation imposes on public companies. In an optimal monitorship, for example, the highly participatory problem-solving method facilitated by the monitor tries to foster endogenous change to a problematic corporate ethical culture in a way that one-time sanctions cannot. Because securities law violations are inevitably the product of a unique set of circumstances, monitorships are promising as a sensitive instrument that can be tailored to the particular facts at hand. PBR is also a reciprocal structure. Rules-based, “one size fits all” compliance mandates tend to be poorly tailored to the particular risk profiles of individual firms, and this is even more the case in fast-moving and complex environments such as securities markets. PBR is a response to that reality. Similarly, the very process of understanding what the principles mean, in context, forces firms to get clear about the risks they are running and an appropriate management response to them. Both monitorships and PBR are structural
responses to managerial distraction or apathy, but they go further in that they try to foster a longer term, endogenous commitment to compliance.

Second, each dissertation chapter emphasizes the need for a consequential, broadly participatory discursive process as a basis for decision-making. Broad stakeholder dialogue is important because it fosters better and produces more credible (even legitimate) results. The monitorship example is founded on discussion as a method for catalyzing change and identifies the failure to ensure a meaningful participatory process as one of the potential shortfalls in actual monitorship practice. PBR, though pitched in a different register, is also premised on an ongoing conversation – this time between regulator and industry regarding the precise detailed content to be ascribed to broad, high level regulatory goals. More locally, the third chapter in this series identifies the need to ensure real diversity and independence of mind within the interpretive community that will add the “meat” of contextual application to the “bones” of regulatory principles. Active contestation is a vulnerable process and it needs to be fostered, protected, and prioritized if PBR is to function effectively.

Third, each of the chapters reflects on the relationship between the traditional regulatory enforcement function and a more pluralistic conception of governance. The dissertation does not engage directly with the theoretical conversation about the relationship between new governance
and traditional law, so much as it tries to link strategies at the level of practice. For example, the first chapter seeks to assert the continued usefulness of the enforcement function in new governance. It argues that enforcement serves a crucial accountability function with regard to "bad actor" firms in particular, and that enforcement staffs may actually be creative actors in the regulatory arena because of their flexible, outcome-oriented and team-based working structures. At the same time, the chapter tries to reach beyond the usual, adversarial regulator/industry dyad to incorporate other actors in the process. In the monitorship context, the third party is the monitor itself, who is appointed precisely to supply skills that the regulator does not possess, and to create a temporal and dialogic space separate from the enforcement function.

The second and third chapters also distinguish new governance from "soft law", and connect it to both ex ante compliance functions and ex post enforceability. From there, the second chapter considers the ways in which third parties such as industry associations and trade councils may be in a position to help disseminate information about best practices, and offset the capacity limitations of smaller firms that are trying to fill in the detailed

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33 But see Chapter 1, infra at 109-15 (on embedding new governance structures within the existing enforcement context); Chapter 2, infra at 157-61 (on the relationship between "rolling best practices rulemaking" and notice and comment rulemaking); Chapter 3, infra at 216, note 148 (identifying a broad discussion regarding the relationship between law and new governance).
content of high level PBR requirements. In the third chapter, the focus shifts from identifying specific third parties that can perform this role, to critiquing a more fundamental absence of intellectual diversity and of real opportunities for “outsider” perspectives to make their way into the interpretive community around securities regulation.

*Fourth*, each chapter is concerned with questions of regulatory capacity, learning and accountability mechanisms for regulators, and the need for regulators to work with a new set of skills within the new governance environment. In the end, these kinds of regulatory capacity issues are among the main worries that arise in these chapters. The first chapter explicitly incorporates a third party monitor into the process, on the basis that that person can bring qualities to the process that enforcement staffers cannot.\(^{34}\) The first chapter also emphasizes the need for regulators to engage comparative learning and benchmarking, in order to harvest the learning that comes from monitorships.\(^{35}\) The second chapter, written before the recent financial crisis, devotes several pages to trying to describe the “new regulator” that new governance requires; while the third chapter, written after the height of the financial crisis, identifies four ways in which

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\(^{34}\) It is less clear that monitors in practice actually bring those skills. Appendix, *infra* at 259-63.

\(^{35}\) Again, there is little evidence of systematic information gathering and analytical process taking place among regulators or prosecutors following monitorships. Appendix, *infra* at 272-74.
the regulatory capacity required to work with PBR was lacking in the financial or securities sector. The third chapter also emphasizes that PBR is not less resource intensive than traditional regulation would be. In each of these chapters, one of the crucial missing pieces seems to be the establishment of a functional clearinghouse mechanism for actively promoting regulatory learning and comparative analysis.

**TAKEAWAYS AND FUTURE RESEARCH AGENDA**

Taken as a whole,\(^3^6\) this dissertation offers a review of both the potential significance of new governance methods for difficult problems in securities regulation, and also the distance between theory and effective implementation. The first two chapters offer mostly theoretical proposals for responding to the problems of corporate culture and industry complexity, and are cautiously optimistic about the potential of monitorships and PBR as regulatory approaches. The third chapter and the appendix are devoted to understanding the reasons why actual practice seems to have fallen short of theory.

These latter sections are not accounts of the failure of new governance approaches, but rather of the failure to implement new governance-style regulatory initiatives in a serious way. For example, a new governance regulator pushes local actors or units to improve their outcomes

\(^3^6\) And with the Appendix, *infra*. 
by comparison to the experience of others, rather than trying to regulate via detailed, process-based, top-down regulatory requirements. In the monitorship and PBR environments (at least as PBR is reflected in Basel II capital requirements and the CSE Program at the SEC), securities regulators ultimately did neither. Detailed, process-based, top-down regulatory requirements were not imposed, but nor was enhanced data access negotiated, nor data analytical capacity developed. Both examples are marked by a serious failure of oversight and followup. The new governance process is also meant to be directed toward ongoing problem-solving, and built around highly participatory and carefully structured dialogue. Neither the monitorships nor the application of PBR, in the Basel II and CSE Program context, paid enough, or consistent enough, attention to their dialogic processes.\textsuperscript{37} As a matter of institutional design, new governance relies on reason-giving, transparent processes, benchmarking and outcome analysis, and structured processes for sharing information. None of these learning mechanisms were sufficiently built into the regulatory structures in either the monitorship or PBR regulatory contexts.

An initial reaction may be that the accounts contained here have turned out not to actually be new governance accounts at all. In most (though not all) cases, none of the parties engaged in the monitorships – the

\textsuperscript{37} Some monitorships were based on more adequate participatory and dialogic methods than others. \textit{See} Appendix, \textit{infra} at 268-69.
subject companies or firms, the enforcement staffers and prosecutors, and the monitors themselves—seemed to have much desire to force through a truly destabilizing reform effort, with the result that many monitorships were not designed to be much more than exercises in cosmetic compliance.\textsuperscript{38} PBR also suffered from the effects of regulatory arbitrage and the influence of a self-regulatory ideology in recent years. The result was that regulators were under-resourced. Significant regulatory gaps also existed around, among other things, the over-the-counter derivatives market and the prudential regulation of shadow banks. Indispensable accountability-ensuring elements were, in retrospect, absent.

This argument— that the monitorship failures and some of the regulatory failures underlying the recent financial crisis do not actually implicate new governance scholarship, because the structures as built were not full new governance structures— is hard to dispute.\textsuperscript{39} One of the main claims of the third chapter, in fact, is that PBR as properly understood is very different from the deregulation or self-regulation that has characterized


\textsuperscript{39} In particular, there are plausible reasons to dismiss Basel II and the CSE Program entirely on the basis that no regulatory regime could be expected to be effective when voluntary, and so drastically understaffed. My decision in Chapter 3 to talk about these programs in the context of principles-based regulation is an effort to acknowledge the clear on-paper resemblances, and to try to grapple with the underlying reasons—relevant to regulatory design generally—why those programs were permitted to develop so inadequately.
a lot of financial market regulation over the last decade or more. To portray
the recent financial crisis as a game-ending conceptual challenge to more
principles-based, decentralized, industry-driven approaches is to
mischaracterize, or misunderstand, events.

Moreover, thinking about alternatives, top-down rigid rules and
blunt sanctions are not viable responses to the challenges considered here,
except around the margins. They are not viable responses due to the history
alluded to above, the inevitable constraints on regulatory capacity and
mandate, and the sheer difficulty of the problems being tackled. Even
though monitorships in practice are incomplete and not entirely satisfactory,
viable non-new governance strategies for confronting tenacious problems of
corporate ethical culture do not easily present themselves.\textsuperscript{40} We have a
fairly good idea, by now, of the range of usefulness for blunt, exogenous
sanctioning tools.\textsuperscript{41} Even if financial institutions’ internal proprietary risk

\textsuperscript{40} A complementary article to the Appendix, though independently written, is Jayne
W. Barnard, \textit{Corporate Therapeutics at the Securities and Exchange Commission},
2008 \textit{COLUM. BUS. L. REV.} 793 (2008). Barnard’s article, which is based on
interviews with eight lawyers involved in SEC Enforcement actions, shares similar
conscems about the effectiveness of monitorships, the monitor selection process, and
the capacity of lawyers in general and Enforcement staffers in particular to craft
monitorships aimed at achieving meaningful structural change. Barnard’s final
recommendation is that monitorships and other “therapeutics” should be used
sparingly, because their usefulness has not been demonstrated. She has greater
confidence than I do in mainstream corporate law mechanisms (e.g., the presence of
independent directors) to discipline firms.

\textsuperscript{41} See Chapter 1, \textit{infra} at 54-61 (reviewing the literature on sanctioning); also \textsc{Neil}
modeling software proved to be inadequate and inadequately applied, to ensure appropriate capital reserves, regulators do not have more or better resources for modeling those risks. The industry continues to be extraordinarily fast-moving, complex, and globally interconnected. Its regulation requires financial institutions’ continued participation in the regulatory process itself.

At the same time, it is an incomplete answer, and the universe of examples becomes vanishingly small, if the response to failure is always to distinguish the living example from a “true” new governance model. Elements or (more often) incomplete elements of new governance structures were very much part of the language of recent financial industry regulation. Improving real-life regulation requires engaging with and learning from the half measures, near misses, and failures (especially recurring or similar ones) that hint at the aspects of the model that are hardest to implement in light of any particular context. If new governance is not “modular”\footnote{With apologies to Jody Freeman and Daniel Farber; this variety of modularity is not the same as their positive account of modular environmental regulation, in which regulatory components can be assembled and reassembled in different arrangements depending on circumstance. Jody Freeman & Daniel Farber, Modular Environmental Regulation, 54 DUKE L. REV. 795 (2005).} – that is, if it does not confer benefits when applied partially or imperfectly, and only achieves good regulatory results when all the elements are in place –
then we must be clear about which elements are indispensable and, just as importantly, how to ensure they are in place given the particular conditions in a specific regulatory environment.

The fact that incremental decisions taken at every stage of many monitorships degraded their ability to destabilize the status quo,\textsuperscript{43} or that in practice the devolution of risk analysis to firms was not accompanied by the necessary analytic and comparative capacity among regulators,\textsuperscript{44} sheds light on deeper problems going to power disparities and the popular inaccessibility of securities regulation as a regime. Incrementalism and industry-driven evolution make sense as responses to uncertainty, speed, and heterogeneity. Pragmatic incrementalism may be a powerful tool for change over time, and in fact seems like one of the few logical solutions to very complex problems. However, under the conditions immanent to securities regulation – the absence of a diverse set of voices, the centrality of esoteric technical knowledge, a disproportionately powerful set of industry actors possessing a credible exit threat, a regulator with a limited mandate and resources – incremental movement is more likely than not to reflect status quo priorities and power relations. In this case, that included a preference for deregulation or self-regulation. Moreover, the relative absence of

\textsuperscript{43} See Appendix, infra at 278-79.

\textsuperscript{44} See Chapter 3, infra at 207-12.
alternative, challenging perspectives within the regulatory conversation compromises the quality of decisions and increases the risk that interpersonal pathologies, including groupthink and attitudinal cascades, will hold sway.

Preserving the benefits of incrementalism and endogenous learning-by-doing processes in financial regulation, while not allowing regulatory goals to be defeated by inertia, distraction, and the inevitably human flaws of hubris, irrationality, and greed, requires careful design and attention to context. Taken together, these chapters offer insights about applying a new governance approach to securities regulation, with a view to three components in particular: capacity, dialogue, and regulatory learning processes.

On capacity

Like any regulatory project, new governance regulatory projects will be defeated if plainly inadequate resources are allocated to them. The absence of adequate regulatory staffing at the SEC and the United Kingdom's Financial Services Authority, in the run-up to the recent financial crisis, is an obvious lesson in this regard.\footnote{See Chapter 3, \textit{infra} at 208-09.} More qualitatively, however, new governance methods require a different set of regulatory skills. In the monitorship situation, for example, monitors (in addition to
being independent, accountable, and commanding credibility from subject firms) need to be able to draw upon a more interdisciplinary set of skills than enforcement staffers or even lawyers are necessarily trained to possess.\textsuperscript{46} PBR also requires a new kind of regulator. The regulator must be capable of absorbing large volumes of information, including technical financial information. It must be able and willing to exercise judgment around open-ended concepts and to defend those judgments, where necessary, against forceful industry advocacy. The regulator must be capable of articulating the content of regulatory requirements in collaboration with industry wherever possible, while not being Pollyannaish about the limits of that method. It must be able to operate flexibly, but not without reference to some (contingent, but real) metric for evaluating progress toward regulatory goals. Making new governance processes effective also requires far greater attention to capturing and incorporating learning than real-world examples of either monitorships or PBR attempted on a consistent basis. While new governance may be more hands-off in terms of articulating detailed process-based prescriptions, it is emphatically not less resource-intensive for the regulator.\textsuperscript{47}

\textsuperscript{46} See Chapter 1, \textit{infra} at 98-102; Appendix, \textit{infra} at 260-63, 280-82.

\textsuperscript{47} See also Michael C. Dorf, \textit{After Bureaucracy}, 71 U. CHI. L. REV. 1245, 1270 (2004) (agreeing with Mark Tushnet that in its full realization, “democratic experimentalism is a big new government program”).
The capacity of industry also needs to be taken into account. On one hand, where firm capacity is limited, regulators will need to build in mechanisms to help firms interpret principles for themselves, and to limit the regulatory burden being imposed.\textsuperscript{48} The monitorship example, also, is an attempt to inject an external perspective and a broader set of skills to the problem-solving process. There is also reason to try to build in safeguards against human fallibility and the tendency to satisfice (perhaps through in-built redundancy as well as comparative benchmarking), and to test for emergent attitudinal and informational cascades.

On the other hand, some global industry actors will have far vaster resources and possess far superior knowledge than their national regulators, requiring regulators to develop compensatory strategies. Trying to match industry resources, or independently generate the data necessary to understand events, is neither realistic nor efficient. The problem of complexity in particular is a serious one, which introduces system effects and imposes considerable stress on regulatory capacity and even comprehensibility.\textsuperscript{49} Rather than simply ceding the field and embracing

\textsuperscript{48} See Chapter 2 at 166-72 (considering hybrid rules-principles models and tripartism as responses to the limited compliance resources of SMEs).

\textsuperscript{49} See \textit{generally} Schwarcz, supra note 1. In this context we should consider the possibility that Knightian uncertainty is not necessarily, or not only, a new governance-enhancing background condition. Cristie Ford, \textit{New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation}, 2010 \textit{Wisc. L. Rev.}, notes 102-113 and accompanying text (forthcoming).
self-regulation, however, regulators should be realistic about the resource imbalance and should work strategically to maximize their own effectiveness in scrutinizing industry-generated information at structural and meta levels.\(^{50}\)

**On dialogue**

New governance scholarship puts dialogue at the center of its method. In the monitorship and PBR examples from securities regulation, however, dialogue – though genuflected to – tended to be too narrow, too superficial, or simply lacking. These case studies may be occasional, but we can also draw some generalizable observations with regard to the risks that dialogic approaches face when operationalized by busy, understaffed, legally trained regulators.

First, we should consider the parties whose dialogue will be generating accommodations and contextual applications of the law. In the monitorship context, these are the firms, their monitorships, and (ostensibly, though less so in practice) their regulators or prosecutors. In PBR, the participants in the interpretive community are the firms and their regulators, supported perhaps by industry third parties. The “local level” here should not be a black box. The considerations that attend a broad-based dialogue involving diverse social interests on a subject of intense public concern will

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\(^{50}\) See Chapter 3, *infra* at 206-18 (on regulatory capacity and the potential usefulness, notwithstanding their shortcomings, of prophylactic rules).
not pertain equally here. Traditionally “public” and “private” actors should not be drawn two-dimensionally, but they do operate under different incentive conditions. Private parties will not act in the public interest except insofar as it conforms to their own interest, and there will be important times when it does not. Private parties in the capital adequacy context were driven primarily by an excessively short term understanding of their interests based on profits, market share, and interfirm competition. Potentially, over time and in the right environment, such actors would generate reputation-driven accountability measures to govern their conduct,\(^{51}\) but when charged with regulating themselves they are susceptible to taking shortcuts, satisficing, and to collective action problems.

Second, we should not presume that public-regarding or long term thinking will be generated at the local level in the absence of contestation and diversity, and a public-minded voice. This is obvious, perhaps, but securities regulation is not the only field where regulatory decisions tend not to be subject to broad public scrutiny. The highly technical subject matter of finance, and the historical importance of the relationship between the SEC and the SROs as primary dialogic partners, may have amplified the

situation here. In the monitorship environment, public company
shareholders, employees, and other stakeholders play no role in the structure
or conduct of the monitorships. This eliminates distinct and almost certainly
challenging voices from that dialogic process. The same can be true at the
industry level. In the case of structured financial products, virtual self-
regulation was undertaken by an industry that operated self-referentially,
that became caught up in an attitudinal and competitive cascade, that made
poor decisions even about its own welfare, and that innovated for reasons
that did not advance (that, in fact, undermined) overall social welfare. The
absence of a counterweight in that interpretive community – either in the
form of a well-resourced, active, public-regarding and independent-minded regulator, or some mechanism for public or investor intervention – exacerbated those problems. Diversity in opinion, perspective, allegiances,

52 Appendix, infra at 250-51.
53 See the Turner Review, discussed in Chapter 3, infra at 213-14.
54 We should not dismiss out of hand suggestions that regulators like the SEC can be
too positively disposed toward the industries they regulate. Chapter 3, infra at 219-
22. To say this is not to embrace the current populist anti-Goldman furor as being a
correct understanding of the situation.
55 On pulling a broader set of stakeholders into a principles-based regulatory regime,
see Chapter 3, infra at 222-25. Provocatively, Rosabeth Moss Kanter and Rakesh
Khurana of Harvard Business School have proposed that a Financial Truth and
Reconciliation Commission be established to deal with the causes and consequences
of the recent financial crisis. Rosabeth Moss Kanter & Rakesh Khurana, “President
Obama: Please Create a Financial Truth & Reconciliation Commission” Harvard
Business School Blog (April 17, 2009) at
and priorities is indispensable in order to test assumptions, to ensure that a suitably broad set of factors and interests are taken into account, and to ensure accountability.

Third – and this influences our prospects for forcing meaningful new governance dialogic processes into existing regulatory structures – we must be mindful of the particular incentives of the parties implementing regulation. With respect to PBR, for example, it is not the case that financial institutions’ incentives to innovate around compliance processes are equal to their incentives to innovate around new business products.\(^{56}\) Many monitorships, also, were underambitious in part because none of the players involved in the monitorships ultimately wanted to conduct a “deep dive” into corporate ethical culture, or to force more serious oversight of public companies than necessary.\(^{57}\) Even where the desire exists to engage in a fulsome deliberative process, the sheer challenge and exhaustion associated with the process can cause it to dissipate over time. The problem is not easier for a regulator trying to involve a broader group of stakeholders in its decision-making processes.

We should therefore recognize the importance of a forceful destabilizing mechanism in this context. In contrast to some other situations

\(^{56}\) Chapter 2, infra at 163-66.

\(^{57}\) Appendix, infra at 276-78.
where new governance methods have been applied, monitorships and PBR are not “high reliability” environments, and so cannot rely for their integrity on the discipline provided by low tolerances for error and an immediate and catastrophic feedback loop.\(^{58}\) Moreover, the strategies examined here do not represent collaborations around urgent problems, which none of the parties can solve on their own, but for which the status quo is also not an option.\(^{59}\) More accurately, perhaps, the precise nature of the problems in financial regulation might be very deep indeed, going to the very viability of a disclosure-based system in modern, complex, and interconnected securities markets,\(^{60}\) or the reasonableness of trying to regulate global markets through multiple, uncoordinated, nationally delimited, and often competitive national regulators.\(^{61}\) Yet, they have not been defined in those urgent terms because the parties that might have done so were not at the table.

\(^{58}\) Bill Simon, *Optimization and its discontents in regulatory design: Bank regulation as an example*, 4 REG. & GOV. 3, 6-8 (2010).

\(^{59}\) Edward Rubin, *The Myth of Accountability and the Anti-Administrative Impulse*, 103 MICH. L. REV. 2073, 2131-34 (2005) (arguing for open-ended formulations where the regulator “knows the result it is trying to achieve but does not know the means for achieving it, when circumstances are likely to change in ways that the [regulator] cannot predict, or when the [regulator] does not even know the precise result that she desires”).


Notwithstanding its limitations, the monitorship structure makes a real contribution in establishing a mandatory framework, with deliverables and deadlines. It maintains the investigative momentum and forces continued attention to compliance issues after an acute crisis has passed. Information-forcing mechanisms or guaranteed public participation rights may achieve similar ends, and seem especially important in a regime as prone to technocratic and enmeshed regulation as financial regulation. More work is called for, however, before we can claim to understand precisely how particular destabilizing instruments will function in any given environment.

On comparative analysis, benchmarking, and learning

New governance securities regulation is regulation characterized by, among other things, a move toward more flexible and context-sensitive implementation. In the monitorship example, this means moving beyond one-time, bright line sanctions in favor of a deeper, more open-ended, endogenous process within the firm. With respect to PBR, it means designing regulation around a series of high level regulatory goals, whose content will be filled in on a rolling basis by those with the necessary

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(describing the SEC's scope of concern as having "soft and permeable borders: foreign activity that easily tunnels into your world, as well as creatures from the domestic domains of banking, commodities, and insurance who pop in and out, often as undocumented aliens").

62 Appendix, infra at 275-76.
contextual information. To serve as real governance mechanisms, both examples require considerably more investment in regulatory learning than existed in these cases.

Prescriptive rules and rigid, non-reflexive regulatory processes, for all their flaws, are a form of precommitment strategy. Their costs often outweigh their benefits, not only in securities regulation. However, in the absence of those precommitment strategies, regulators must develop tools to bind themselves to some core set of expectations, and to effectively signal to others that they are so bound. Otherwise, the risk is that regulatory standards will slide, and that industry actors will push harder for compromise than they would if they believed the rules to be unwaivable.

As strategies for maintaining regulatory standards, comprehensive, valid data analysis and comparative benchmarking can serve as a supple and effective alternative to rules and rigid processes. Why these mechanisms were not appropriately developed in the securities regulation examples discussed here is surely multifactorial, but likely includes the fact that systematic learning (such as post-monitorship or comparative cross-monitorship learning, or comparative analysis of firms' internal risk

63 THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT (1960); JON ELSTER, ULYSSES UNBOUND: STUDIES IN RATIONALITY, PRECOMMITMENT, AND CONSTRAINTS (2002). The point is not that rigid rules actually cabin uncertainty or eliminate discretion, but that their facial bright line nature serves a signaling function and prevents regulatory “creep” by requiring parties to give reasons for variations and evolution, always with reference to a pre-existing standard.
analytical processes) is simply harder and less exciting to build in than an acute response to a particular problem. Nor will there necessarily be a champion for it. This may especially be the case in bubble times, when reason-giving generally tends to collapse. The project may be even less appetizing in the face of extraordinary factual complexity and uncertainty, which compromise the human capacity to process and respond to information and which (in this situation at least) seem to have generated almost a form of cognitive fatalism among regulators.

The history of the SEC and analogous regulators may also play a role. As noted above, the SEC was largely immune from the crises of legitimacy and functionality that characterized many New Deal administrative agencies in earlier decades. Its disclosure-based and SRO-engaging regulatory stance did not lead to strangling interest group politics and gridlocked bureaucratization that then demanded creative solutions. Nor did the SEC, in any era, make space for the kind of deep interrogation of its processes and constituents that arose from those crises within other agencies. This may have created its own set of problems. It may be that securities regulators, in step with other regulators, moved to a more flexible, new governance-style orientation in the 1990s and 2000s. However, they did so more or less directly from a simple, basically functional,

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64 Bubbles may also be times when regulators are under-resourced because problems are not at the forefront of peoples' minds.
unidirectional disclosure based system, without having undergone the near-existential and ultimately transforming crisis experienced elsewhere. The results, arguably, were flexible processes overlaid on shallow information-forcing processes, subsequently understood as a first order response to (and embrace of) industry complexity.

Regulatory competition (meaning macro competition between regulators, based on industry actors' ability to choose the regime that will govern them) also played a role. It was not a major concern in the 1930s, when the U.S. federal securities laws were enacted, but it is a concern now. Competition and comparative analysis – comparing monitorships, comparing firms' compliance responses to a PBR directive, and comparing the effectiveness of governance entities – is a central mechanism in new governance theory. Macro regulatory competition can create better results, in terms of making regulation more cost efficient for industry. Certainly, that was part of the position taken by the U.K.'s Financial Services Authority in explaining the drift of capital markets business from New York to London around 2005.\(^{65}\) Regulatory competition will only serve public ends, however, to the extent that the effective provision of public ends is something over which regulators are competing. Where regulators are

\(^{65}\) Proponents of the U.K.'s approach claimed that it was "simply better", meaning not only more cost efficient but also more effective. Chapter 2, *infra* at 117-18, 131-32.
competing for the business of industry, and industry has a clear preference for maximally self- or deregulatory regimes (even if based only on short term interest), this will not be the case. Of course, in this environment, highly prescriptive regulation will also be a nonstarter, practically and politically.\textsuperscript{66}

\textit{Next steps}

This dissertation is an effort to develop insights into the practical implementation of new governance scholarship in the particular context of securities regulation. Its primary takeaway is that, in evaluating the promise of new governance methods in specific contexts, a contextual analysis needs to be undertaken, almost as an independent step after identifying the problem. If regulatory capacity is compromised for some reason – be it complexity, interjurisdictional competition, an absence of adequate resources or an incomplete skill set – then compensatory structures need to be built in as a matter of regulatory design. Excessive homogeneity or other problems with the dialogic process are fundamental, and their rectification must be a priority. Nor should we underestimate the amount of energy that will be required to create serious comparative analytical capacity at the regulator. A wide range of background contextual factors must be considered, including the agency’s history, worldview, competitive

\textsuperscript{66} \textit{Id.}
environment, resources, and ultimately the unavoidable question of whether the policy (and political) will exists for building and locking in the indispensable elements of a new governance structure.

The agenda for future research is rich and includes developing a provisional set of the categories of factors that need to be addressed to make new governance effective, as applied, in varied institutional contexts. Also thought provoking is the apparent paradox that, in trying to employ new governance-style methods to respond to the regulatory problems posed by innovation, complexity, and lack of resources, securities regulators seem actually to have exacerbated those very conditions.

Additionally, it seems clear that reflecting on the most difficult problems of implementation requires a more careful account of power. Power relationships are, obviously, ubiquitous in regulation. They can impose a considerable torque on the most well-considered theoretical approaches. Moreover, the fact that new governance structures are designed to be flexible makes it all the more important that an account of power be generated to shed light on how that power may manifest. Powerful interests may find that fluid environments make it easier to advance their own interests in subtle ways, at the expense of others." Because they are built

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67 See, e.g., Patricia Williams, The Alchemy of Race and Rights (1990) (arguing that formal rights can benefit marginalized groups by providing a backstop against subtle discrimination); Cristie Ford & Carol Liao, Power Without
on multiple interactions and the incremental accretion of shared understandings, new governance strategies also offer multiple insertion points at which powerful interests can bend the arc of regulation in their favor. Specific destabilization rights can and do operate to disentrench power and open processes up in particular contexts. What is called for, then, is a clearer understanding of which destabilizing forms operate vis-à-vis which forms of power, and how.
TOWARD A NEW MODEL FOR SECURITIES
LAW ENFORCEMENT

Cristie L. Ford

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"[A] single enforcement action has the potential to effect change on an enormous scale, causing the development or enhancement of internal controls, supervisory procedures, and compliance functions at hundreds of other companies."1

"The specter of prosecution can motivate corporations to change their long-term behavior . . . ."2

INTRODUCTION

The United States Securities and Exchange Commission (SEC or Commission) expanded its mandate in recent years, in the wake of multiple scandals: its Enforcement Division (Enforcement) was no longer satisfied with punishing wrongdoing. Through the specter of prosecution, Enforcement intended to effect compliance change to internal controls, supervisory procedures, and compliance functions on an enormous scale, as well as to motivate long-term change in corporate behavior. In effect, the quotes from senior SEC officers with which this paper opens suggest that Enforcement has been aspiring to changing corporate culture.3 The SEC has not only emphasized the necessity of having a "culture of compliance" but expressed awareness of and concern for companies' "moral DNA."4 Enforcement’s approach to this goal has been characterized, above all, by increasingly massive monetary penalties levied against firms—that is, against public companies and regulated entities.5 Under Chairman William H. Donaldson, who resigned in June of this year, the SEC initiated enforcement actions against more organizations and imposed more and larger civil penalties than at any time in its seven-decade history.6 These


3. A similar observation could be made about criminal securities law enforcement, but that must be the subject of another paper. Michael Chertoff, the Former Assistant Attorney General of the Department of Justice Criminal Division, has reportedly expressed the view that criminal prosecution can also be "a spur for institutional reform." Michael Chertoff, Speech at the ABA Criminal Justice Section’s 17th Annual National Institute on White Collar Crime (Mar. 2003), as recorded by John Gibeaut, Junior. G-Men: Corporate Lawyers Worry That They're Doing the Government’s Bidding While Doing Internal Investigations, 89 A.B.A. J. 46 (June 2003); see also infra note 9.

4. See infra notes 58-60 and accompanying text.

5. I use the terms "organizations" and "firms" to refer collectively to public companies and other regulated entities subject to the SEC’s enforcement jurisdiction. For clarity, I periodically employ terms such as "corporate governance" or "corporate citizen," but I mean those terms to apply to regulated entities as well.

6. See infra notes 26-38 and accompanying text.
extraordinary fines were combined with a published SEC protocol that allowed firms to bid for leniency in settlements in exchange for cooperating with Enforcement after apparent wrongdoing has been uncovered, and/or for having in place an internal compliance program.

Yet each of the SEC’s recent strategies—massive monetary sanctions and a settlement protocol that permits bargaining for leniency on the terms above—was inadequate if the SEC’s goal was sincerely to motivate long-term change in firm behavior. First, monetary penalties do not address the thornier problems of institutional culture, except in the most accidental way. While optimal penalties, to the extent that optimality can be identified, may deter companies from engaging in open and clearly law-violating conduct, they are unpredictable as a tool for effecting ambitious cultural change. Because deterrence effects are inscrutable, massive deterrence looks like the last resort of the regulator who has given up trying to identify, or address, root causes of social and economic problems in a more systematic way. This is not to say that deterrence-based mechanisms may not be useful in effecting widespread reforms, only that they are insufficient on their own, and potentially unwieldy.

Second, the SEC’s settlement protocol, called the Framework for Cooperation,7 does not advance and may even undermine the stated goal of promoting good corporate governance. Specifically, neither of the Framework’s criteria—having in place a compliance program, and/or cooperating with Enforcement ex post—is a reliable indicator of good corporate citizenship. In fact, for the worst offenders, cooperating with authorities can be a mechanism for scapegoating individuals and avoiding organizational responsibility. Extending leniency to firms that have a compliance program in place can mean in practice that formulaic and facial compliance indicia substitute for evidence that a real culture of compliance exists.

If the SEC is serious about spurring institutional reform, it will need enforcement tools that are better suited to its purpose. Interestingly, during Chairman Donaldson’s era, Enforcement also roughed out the promising beginnings of a new, or resurgent, model in what I call the Reform Undertaking. Under a Reform Undertaking arrangement, SEC Enforcement and the firm enter into a settlement agreement relating to an action that Enforcement has initiated for violation of the securities laws. One term of the settlement agreement is that the firm shall retain, at its own expense, an independent third party monitor (Third Party) to oversee its compliance processes and procedures for a period of time after the

7. See infra Part II.
settlement has been concluded.\textsuperscript{8} The Reform Undertaking model has important advantages over more traditional settlement approaches in that it uncouples the acute enforcement action from the specifics of reform measures, thereby reducing some of the pressure toward strategic action. It goes beyond a pure deterrence model and tries to investigate corporate culture, by making firm actors agents of their own change, in a way that is more transparent and accountable than the existing Framework for Cooperation approach.

Some things are likely to change under new SEC Chairman Christopher Cox.\textsuperscript{9} For example, he is likely to discontinue the substantial monetary penalties levied against organizations that became controversial in the last months of Chairman Donaldson’s tenure.\textsuperscript{10} On the other hand, the published SEC protocol mentioned above, which allows firms to bid for leniency, is likely to persist since the philosophy underlying it—that firms should be rewarded for cooperating with Enforcement and for having internal compliance programs in place—has not been seriously questioned. We should also expect the Reform Undertaking model, as an alternative to heavy monetary fines, to increase in currency under Chairman Cox. Chairman Cox is generally understood to be a strong ally of business

\textsuperscript{8} The Reform Undertaking shares key features with another innovation in federal criminal prosecution: the organizational Deferred Prosecution Agreement. Like the Reform Undertaking, the typical Deferred Prosecution Agreement requires firms to adopt internal controls designed to deter potential violations of firm policies and procedures and to cooperate with an independent Third Party monitor who will report at intervals to the Department of Justice. Failure to abide by the terms satisfactorily over the span of the deferral results in prosecution. See, e.g., Press Release, Department of Justice, America Online Charged with Aiding and Abetting Securities Fraud; Prosecution Deferred for Two Years (Dec. 15, 2004), \textit{available at} http://www.fbi.gov/doi/pressrel/pressreleases/releases121504.htm; Deferred Prosecution Agreement, United States v. Computer Assocs. Int’l, Inc., Cr. No. 04-837 (E.D.N.Y. Sept. 22, 2004), \textit{available at} http://www.usdoj.gov/about/dpa/defprosagreement.pdf; Press Release, Department of Justice, PNC ICLC Corp. Enters Into Deferred Prosecution Agreement with the United States (June 2, 2003), \textit{available at} http://www.usdoj.gov/opa/pr/2003/june/03_crm_329.htm. The Department of Justice also incorporated auditing mechanisms and structural changes to its Enron-related settlements with CIBC and Merrill Lynch. Letter from Leslie R. Caldwell, Director, Enron Task Force, Department of Justice, to Gary Naftalis, Esq. (Dec. 22, 2003), \textit{available at} http://www.usdoj.gov/dag/cftf/chargingdocs/cibcagreement.pdf; Letter from Leslie R. Caldwell, Director, Enron Task Force, Department of Justice, to Robert S. Morvillo, Esq. and Charles Stillman, Esq. (Sept. 17, 2003), \textit{available at} http://www.usdoj.gov/dag/cftf/chargingdocs/merrillyncagreement.pdf; see also \textit{Off the Hook: Deferred Prosecution Agreements on the Rise}, \textit{48 CORP. CRIME REP.} 1 (Dec. 10, 2004), \textit{at} http://www.corporatecrimereporter.com. While Deferred Prosecution Agreements work on a similar model and deserve their own analysis, they are beyond the scope of this paper.


\textsuperscript{10} See Deborah Solomon & John D. McKinnon, \textit{Off the Beat: Donaldson Ends an SEC Tenure Marked by Active Regulation}, \textit{WALL ST. J.}, June 2, 2005, at A1; see also infra note 25 (outlining criticism that the SEC’s implementation of Sarbanes-Oxley Act § 404 imposed extraordinary costs on business without corresponding benefits).
community interests, which have opposed what they perceive as 
overzealous regulation under Chairman Donaldson.\textsuperscript{11} The Reform 
Undertaking model is theoretically consistent with a more decentralized, 
industry-driven regulatory agenda.

Less obvious, but just as important is that, when properly implemented, 
the Reform Undertaking model may contain the power, unanticipated by 
advocates of industry-driven regulation, to effect verifiable positive change 
to a firm’s culture, institutions, and long-term behavior. This paper 
explores and then extrapolates from the Reform Undertaking, informed in 
part by “new governance” or experimentalist theory,\textsuperscript{12} and sketches the 
directions in which the Reform Undertaking must develop in order to have 
a real chance of effecting such change. By relating SEC Enforcement 
practices to New Governance, I connect promising on-the-ground 
developments that may be proceeding ad hoc, without guiding principle, to 
a relevant theoretical conversation. I argue for four things above all: the 
need for the Reform Undertaking to be built around a participatory firm 
process, the need for Third Parties to be accountable for their methodology 
and results within firms’ Reform Undertakings, the need for the SEC to 
develop the information-gathering capacity to credibly evaluate Reform 
Undertakings’ success, and the need to provide consistent incentives to 
Enforcement personnel.

Along the way, this paper identifies the potential for a securities law 
enforcement function that leverages enforcers’ one-case-at-a-time 
approach, as well as their coercive powers, in the service of a more 
effective and more rational regulatory project. As a mechanism for 
affecting corporate culture on a broad scale, the re-imagined Enforcement 
compares favorably not only with existing enforcement structures, but also 
with regulatory rulemaking. In this way, this paper seeks to somewhat 
rehabilitate the enforcement idea among New Governance theorists. The 
coercive enforcement function (as distinct from arm’s length judicial 
action) has been understudied and at times undervalued by New 
Governance theorists. Yet frontline SEC Enforcement staff is developing a 
unique experimentalist structure in the interstices of its practice, 
characterized by endogenous problem-solving embedded within and 
buttressed by an exogenous punitive, adversarial, compliance-oriented 
system. The result is more than just a variant on the existing theoretical 
approach: it represents a fresh interface between a state-sanctioned 
administrative enforcement pyramid and systemic, complex problems like 
corporate cultural dysfunction. This Article explores that interface and

\textsuperscript{11} Solomon & McKinnon, supra note 10.
\textsuperscript{12} See infra notes 62-74 and accompanying text.
finds reason to be optimistic, even in the context of regulatory settlements reached with enforcement staff, with all the real-life constraints of capacity and method that entails.

This Article proceeds in five parts. Part I describes the limitations of the SEC’s deterrence-based strategy in meeting the agency’s stated intention of spurring institutional reform and suggests that a New Governance-style approach may be better suited to the task. It also identifies challenges, relative to other New Governance initiatives, arising from the securities laws’ enforcement-driven and settlement-oriented environment. Part II describes problems with the second component of the SEC’s strategy, the Framework for Cooperation, which permits firms to bid for leniency in exchange for having in place facial indicia of compliance and/or for cooperating with Enforcement ex post. Part III describes and provides examples of the new settlement approach that I call the Reform Undertaking. This Part sets out the Reform Undertaking’s advantages over either pure deterrence-based mechanisms or Framework for Cooperation-based settlements. Part IV identifies the shortcomings of the Reform Undertaking in its current iteration and points to the four additional elements it needs to be a more thoroughgoing and theoretically coherent approach. The final Part imagines a New Governance-inflected approach to enforcement conduct, which leverages its strengths as a hybrid enforcement-oriented experimentalist form.

I. CORPORATE GOVERNANCE AND DETERRENCE-BASED RESPONSE

A. Scope Concerns

This Article starts from a position that should be uncontroversial by now: that industries, companies, and organizations have cultures of their own; that culture affects how those organizations behave; and that certain kinds of cultural attributes can cause organizations to behave in law-violating ways. I do not attempt, nor is it necessary to completely define firm culture, except to note that some organizations can be characterized by an

13. See, e.g., JAMES W. COLEMAN, THE CRIMINAL ELITE (1989) (insisting that a solution to the problem of white collar crime can only be achieved through societal change); KIP SCHLEGEL, JUST DESSERTS FOR CORPORATE CRIMINALS (1990) (distinguishing “corporate” crime from other forms of white collar crime because corporate crime is a product of organizational behavior); see also Lynne L. Dallas, A Preliminary Inquiry into the Responsibility of Corporations and Their Officers and Directors for Corporate Climate: The Psychology of Enron’s Demise, 35 RUTGERS L.J. 1, 10-45 (2003) (canvassing sociological literature on the relationship between social environment and individual ethical conduct). Firms, especially the worst actors, may also be very dysfunctional in the manner described in MAX H. BAZERMAN & MICHAEL D. WATKINS, PREDICTABLE SURPRISES: THE DISASTERS YOU SHOULD HAVE SEEN COMING AND HOW TO PREVENT THEM 95-119 (2004). The recommendations that follow apply equally there.
insiders’ culture, which rewards in-group loyalty at the expense of the best interests of outsiders, such as general shareholders or the public. Loyalty may take the form of keeping confidences or making contributions to in-group members’ income or market share by means that would be criticized were they widely known. For example, in the securities industry, investment advisors may fail to tell mutual fund shareholders about excessive fees or “shelf space” commissions; audit firms may fail to tell an audit client’s shareholders about conflicts of interest that could compromise the independence of an audit; or investment banks may fail to tell the public that the research analysis they produce has a remunerative relationship to banking business, before and after initial public offerings.

Cultures are not monolithic, and they have as much to do with situation and human psychology as with some notion of firm character. But regardless of their provenance, the norms, customs, and rituals that arise in tight-knit communities may create a compelling moral world for those in it. Insiders’ ethical perceptions of conduct are shaped by the actions of those around them, normalizing and even ratcheting up law-violating conduct and marginalizing dissenters. In an extreme form, an insiders’ culture may disdain and try to circumvent inconvenient, externally imposed regulations on issues ranging from employment discrimination, to revenue recognition, to toxic waste disposal. Insiders’ cultures put in place, intentionally or accretively (through situational pressures or escalation of

commitment), structures and relationships that maintain the culture’s opacity. Such public-harming cultures can exist notwithstanding governance processes and compliance mechanisms that look exemplary on paper. A classic example of this phenomenon is Enron, whose Board of Directors voted to waive that company’s state-of-the-art conflict of interest rules to allow CFO Andrew Fastow to make self-dealing transactions. 19 WorldCom also adhered to “checklists” of recommended “best practices.” 20

Although all organizations have cultures, and even some degree of insider culture, let me be clear about the firms that are of primary concern. They are those firms that Ian Ayres and John Braithwaite, in their seminal work Responsive Regulation, would put at or near the top of the “enforcement pyramid”—those firms that attract the greatest enforcement resources because other, lesser attempts at regulation have failed. 21 These are the same firms whose conduct attracts, or should attract, the largest monetary sanctions in settlements based on serious allegations of fraud or something close to fraud, 22 where the degree of harm resulting from the alleged violations is significant. Often, they are recidivists, even if past violations are not identical to the current one. There is reason to believe (regardless of what the firm claims) that the firm suffers from pervasive cultural or ethical problems that are likely to persist beyond the immediate enforcement action, but these are not utterly criminal enterprises. My preoccupation is with what Christopher Stone once described as “that group of firms, impossible to identify in advance, whose behavior in the face of realistically achievable penalty levels will remain inadequately modified.” 23 These are the “worst actors.”

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19. See William C. Powers, Jr. et al., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. 9, 22-23 (2002), available at http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf (last visited June 29, 2005); see also Dallas, supra note 13, at 45-54 (examining Enron’s ethical climate); Ernst & Young, supra note 15 (describing “sham” compliance procedures).


21. Ayres and Braithwaite describe a regulatory structure in which enforcers have an escalating scale of enforcement options at their disposal. The majority of firms at the broad base of the pyramid stay in compliance with little resource expenditure by enforcers. As firm noncompliance escalates, enforcers can escalate deterrence, reserving the most severe sanctions for the small number of very serious cases. See IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION 35-41 (1992). The enforcement pyramid’s effectiveness depends very much on the SEC Enforcement Division’s (Enforcement) ability to collect and interpret valid data on firm cooperation.


23. Christopher Stone, The Place of Enterprise Liability in the Control of Corporate Conduct, 90 YALE L.J. 1, 28 (1980).
I argue below for a remedy that is more interventionist than existing remedies and that will impose additional costs on worst actor firms. The firms are required to engage in a protracted remedial exercise in which they define and apply standards-based (as opposed to narrower rule-based) notions of good governance to their own operations. Readers may reasonably counter that additional regulatory costs should not be imposed on firms without some indication that the project’s benefits would outweigh its costs. A complete response to this challenge is beyond this paper’s scope, but three points are relevant. First, interventionist remedies would not be appropriate all the way down the enforcement pyramid. I am talking about a relatively small subset of firms. Second, and just as crucially, this paper argues for a standards-based approach in the remedial enforcement context. The cost of post-enforcement standards-based remedies should compare favorably to the cost of prophylactic standards-based requirements, such as the controversial provisions in § 404 of the Sarbanes-Oxley Act that require public companies to report on the adequacy of their internal financial controls. Third, any cost/benefit analysis should factor in not only the immediate cost outlay the Reform Undertaking represents, but also the substantial long-term costs the status quo imposes on consumer confidence and firm viability.

Responding to the opposite challenge, this is not a marginal project even if only a few firms are involved. Worst-acting firms should attract scrutiny because they are responsible for disproportionate social costs. Understanding the full range of reasons why certain firm cultures bring forth repeated law-violating conduct also sheds light on firm culture generally. Moreover, the problem of the worst actor sheds light on the effectiveness of the securities law regime as a whole. In evaluating outcomes, regulatory policymakers may be tempted to focus on gold star companies whose success proves the wisdom of the regulators’ approach.

24. The whole purpose of the regulatory pyramid is to allocate scarce enforcement resources toward the worst offenders and to avoid the chilling effect of over-regulating law-abiding firms. See Ayres & Braithwaite, supra note 21, at 35-41; see also Eugene Bardach & Robert Kagan, Going by the Book: The Problem of Regulatory Unreasonableness 112-16 (1982) (arguing that regulatory strategy based mostly on punishment fosters resistance within regulated firms).

A focus on enforcement blunts that tendency. It keeps us realistic—not only with respect to proposals that may be credulous about firms’ bona fides generally, but also with respect to proposals that underscrutinize firm functionality in the name of an ostensibly tough (but actually limited) deterrence approach. Limitations of method in spurring reform among worst actors can be a telltale sign for a more general limitation of method.

B. Relying on Massive Deterrence

One strategy that SEC Enforcement is not likely to pursue under Chairman Cox is the imposition of massive deterrent monetary fines on organizations, as well as individuals. Some advocates of strong corporate accountability mechanisms may see this as a negative development. It is not necessarily so, for the reasons below.

Under Chairman Donaldson, the SEC’s approach to the recent crisis was to step up prosecutions, including prosecutions against organizations, and to impose massive monetary fines on individuals, regulated entities, and public companies. The presumption was that “any serious violation of the federal securities laws should be penalized with a monetary sanction.” The Enforcement Division has filed an unprecedented number of actions, especially against organizations, in the last two years. The quantum of the penalties is also unprecedented: consider the WorldCom settlement.


27. Cutler, supra note 1.

28. Cutler, supra note 26. Taking a different tack, the New York Stock Exchange, under new Executive Vice President and Chief of Enforcement Susan L. Merrill, is engaged in a comprehensive penalty review “designed to change the behavior of firms that run afoul of exchange rules on a recurring basis.” Kip Betz, Comprehensive Penalty Review Underway at NYSE Regulation, Official Says, 36 Sec. Reg. & L. Rep. (BNA) 2116 (Dec. 6, 2004). Among other options, it is considering replacing monetary fines with alternative deterrence strategies including suspending certain business lines for a period of time, suspending a firm’s ability to underwrite an initial public offering of stock or sign new investment banking clients, or restricting the opening of new branch office or brokerage accounts. Id. Like this paper, the NYSE is examining what structural mechanisms, going beyond monetary penalties but falling short of the “penalty default” of firm shutdown, might be available to spur institutional change among worst actors. See infra notes 214-16 and accompanying text. In a similar move, the Federal Reserve recently barred Citigroup from engaging in any major acquisitions until the company had “fix[ed its] regulatory problems.” Mitchell Pacelle et al., Fed Ties the Hands of Citigroup, WALL ST. J., Mar. 18, 2005, at C1.

the global research analyst settlement,\textsuperscript{30} the Enron-related financial services firm settlements,\textsuperscript{31} the market timing and late trading mutual fund company settlements,\textsuperscript{32} or those with public companies such as Quest Communications,\textsuperscript{33} Royal Dutch Shell,\textsuperscript{34} and Bristol-Myers.\textsuperscript{35} The SEC 

\begin{itemize}
\item[\textsuperscript{30}] billion penalty, satisfied post-bankruptcy at $750 million).
\item[\textsuperscript{31}] Not including disgorgement, civil penalties against the ten firms in their settlements with the SEC, NASD, NYSE and several states amounted to $487.5 million, with the lead taken by Citigroup at $150 million. Press Release, SEC et al., Ten of Nation’s Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), available at http://sec.gov/news/press/2003-54.htm.
also supported a still-pending congressional initiative to increase the penalties it may levy, which the SEC has described as “an important step in achieving the desired deterrent effect under the securities laws.”

Former SEC Director of Enforcement Stephen Cutler described the era’s approach as “an evolution, if not a revolution, in thinking.” The nature of the (r)evolution requires some elaboration. In the speech quoted at the beginning of this paper, he explained the shift toward levying massive civil fines against organizations, as well as individuals, in terms that suggest the view that general deterrence can lead to profound, industry-wide change:

\[ \text{[P]enalties against entities should be used for the same reason they are used in part against individuals—to deter misconduct.} \]

\[ \ldots \]

\[ \text{When the Commission obtains a penalty against an entity, it provides a powerful incentive for companies in the same or similar industries to take steps to prevent and address comparable misconduct within their own walls. Thus, a single enforcement action has the potential to effect change on an enormous scale, causing the development or enhancement of internal controls, supervisory procedures, and compliance functions at hundreds of other companies.} \]

Moreover, entities have the ability to influence strongly the compliance orientation of their own employees. . . . Imposing a significant penalty may be the best way for the Commission to cause companies to change their cultures and to make it in their financial interest to take a proactive role in preventing individual misconduct.\[38\]

\[ \text{litreleases/ir18820.htm.} \]


\[ 37 \text{. Cutler, supra note 1.} \]

\[ 38 \text{. Id. (emphasis added). Mr. Cutler’s view on the role of monetary penalties as punishment, when imposed on organizations, comes out less clearly in this speech. He refers to civil fines as “fundamentally a punitive measure intended to enhance deterrence of securities laws violations,” and says that their ratcheting up is “driven by two goals: increased accountability [for past wrongdoing] and enhanced deterrence.” Id. It is unclear whether Mr. Cutler intended to distinguish between organizational and individual liability with respect to the punitive aspect. In any event, he views enterprise liability as operating alongside, not in lieu of, individual liability and “gatekeeper” oversight. Id.} \]
The claim that Enforcement can "effect change on an enormous scale" suggests a larger systemic role than Enforcement historically has claimed.\(^\text{39}\) It also suggests a more nuanced awareness of the role of organizational culture than one associates with the traditional, conduct-preoccupied approach to deterrence. On closer reading, however, the Cutler approach does not stray far from utilitarianism. The reference to culture notwithstanding, the approach is still one that is built on a static understanding of the firm as proverbial bad man, which will only change its culture to the extent that doing so is in its financial interest.\(^\text{40}\) The assumption is that optimally-calibrated punishment increases the cost of violating the law, and thereby changes the firm's calculation of the advantages of doing so.\(^\text{41}\) Indeed, such a response does not signify a cultural change at all, only an acknowledgement that rational firms must learn how to look as though they care about culture, because it is in their pecuniary interest to adopt that public stance. Reform-through-sanctions sets up incentives for firms to do nothing more than avoid more sanctions. Strategies for avoiding regulatory sanctions are not necessarily coterminous with strategies for identifying root causes and problems and working to fix them.\(^\text{42}\)

I do not disagree that the *in terrorem* effect of large but not arbitrary monetary sanctions may directly force important changes in the daily operations of some rational and self-interested firms. As such, this kind of deterrent may be a sensible, if partial, response to firm wrongdoing, and one may hope that it does not fall completely out of favor when dealing with the most egregious cases.\(^\text{43}\) Recent sociological work has suggested new ways in which traditional deterrence mechanisms may reinforce good governance and promote law-abiding behavior in less linear ways as well. This is the case for even the least transformative and most mechanical punitive forms—monetary sanctions, for example—so long as

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39. The charge that the SEC is overreaching its statutory jurisdiction and infringing on traditional state powers in the corporate governance arena is outside the scope of this paper. For a discussion of the SEC's overreach, see generally Deborah Solomon, *SEC Is Sued Over Fund-Board Rule*, WALL ST. J., Sept. 3, 2004, at C17. Worries exist about the appropriateness of potential "backdoor" rulemaking through Enforcement action, but they are beyond the scope of this paper. *But see infra* note 201 and accompanying text.


41. See Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232 (1985) (using a recent version of this approach which considers the use of nonmonetary sanctions in deterring criminal behavior).

42. See *infra* notes 106-18 and accompanying text.

43. See *infra* Part V. I leave to one side the empirical studies suggesting that deterrent mechanisms do not prevent firms, or the individuals operating in them, from violating the law. See, e.g., Sally S. Simpson, *Corporate Crime, Law, and Social Control* 40 (2002); Schlegel, *supra* note 13. My claim is only that some firms may be directly motivated by the fear of sanctions and that sanctions may also have indirect effects as discussed above.
Enforcement’s investigatory procedures and processes are generally believed to be fair, its decisions reasonable and factually supported, and its conduct demonstrably even-handed.\textsuperscript{44} Consider that the enforcement of law, like law itself, serves an expressive purpose.\textsuperscript{45} Firms seek the legitimacy that legal approval confers not only for culturally expressive reasons but also in part because that legitimacy can confer tangible benefits, including currency with other industry actors.\textsuperscript{46} Again, insofar as the conduct of the regulator is perceived to be credible and proportional, enforcement action can stigmatize businesses vis-à-vis the public and other companies with whom they wish to do business.\textsuperscript{47} Enforcement action can also serve an error correction function in that it provides an additional set of standards (redundant in places and/or reflecting different priorities), which helps to reduce wrongdoing arising from simple managerial distraction.\textsuperscript{48}

Enforcement can also resolve collective action problems where new, socially desirable norms are just taking hold.\textsuperscript{49} For example, an industry’s

\textsuperscript{44} Making the same point in the broader criminal context based on psychological studies is Tom R. Tyler, Why People OBEY THE LAW (1990).


\textsuperscript{46} Scholarship on the interaction of law and norms is extensive. E.g., Melvin A. Eisenberg, Corporate Law and Social Norms, 99 COLUM. L. REV. 1253 (1999) (arguing that corporate actors are motivated less by the desire to avoid liability than by the joint effect of social norms and the correlative prospect of financial gain in the market); Mark C. Suchman, Managing Legitimacy: Strategic and Institutional Approaches, 20 ACAD. MGMT. REV. 571 (1995) (arguing that law shapes organizational conduct not only because of law’s cultural weight, but also because organizational legitimacy is pragmatically linked to benefits and penalties); Cass Sunstein, Social Norms and Social Roles, 96 COLUM. L. REV. 903 (1996) (arguing that behavior is less influenced by concepts of free will and choice than by voluntary compliance with social norms; consequently, norm management might be the most effective means for accomplishing law’s objectives).


standard practice may violate the securities laws but be so entrenched, and perhaps competitively advantageous, that no individual industry actor is likely to reject the practice unilaterally. Legal sanctions can influence this type of industry norm. Especially relevant to industries with such entrenched practices is the fact that a well-designed and fairly administered enforcement system can help perpetuate an environment where each actor believes that other actors are complying with rules—a belief that positively correlates with voluntary compliance. Even the worst performers will not want to be the “last ones out of the pool” if they have the impression that norms are changing within their subgroup.

Keeping the “big stick” of massive sanctions in reserve can also buttress other Enforcement demands, including perhaps the demand that a firm engage in additional, explicitly forward-looking remedial steps such as the Reform Undertaking discussed below. There is nothing necessarily inconsistent between forward-looking and retrospective Enforcement sanctions operating together. Whether particular forms or conceptions of deterrence, as implemented, undermine a deeper corporate governance project is part of the subject examined here.

Unfortunately—and this is key—the presence of deterrence-avoiding conduct, as measured externally for regulatory purposes, does not always turn out to be the same thing as the presence of an actual “culture of compliance.” While one may believe that the firm itself is in the best position (in the sense of having access to the greatest amount of information) to allocate compliance costs in ways that most efficiently further its own immediate self-interest, one may not feel confident, for reasons of capacity or trust, about leaving such decisions to the firm. Firms seek the benefits that regulatory approval confers, but simultaneously they may subvert coercive structures that force conflict with other cherished goals. If adherence to externally-defined facial compliance indicators provides the legitimacy-granting rewards they seek, then organizations...
seeking legitimacy may choose to be only facially compliant. This may be so because of conflicting internal commitments, 53 because of internal blindness to causal factors, 54 or because they resist the substantive content of those compliance rules. 55

Without attention to the underlying cultural reasons for the wrongdoing, one risks sending the message that facial compliance alone can avoid sanctions and confer legitimacy on firm conduct. In the process, one reduces the scope for more profound, endogenous cultural change. What a reform-through-sanctions approach signals, more than anything, is the regulator’s inability to imagine remedies that can respond directly to the culture-based problems that the regulator itself has identified. Reform-through-sanctions offloads to the firm, without benefit of regulator support or institutional learning, the task of identifying organizational problems and identifying solutions. The firms this paper is most interested in affecting are those with the most dysfunctional and/or intransigent cultures—precisely the same ones that will not, or are not able to, reorient their own cultures in the hoped-for ways through penalty imposition alone. Deterrence may effect change in some situations, but it is not guaranteed to do so. All of this might be acceptable if it was unavoidable, but it is possible to do better, within existing structures and regulatory resource constraints. In the case of the worst actors, for whom deterrence has proven to be an insufficient driver, regulators and the public need not settle

53. Some empirical work suggests that managers can satisfy external demands for corporate governance reform, while avoiding unwanted compensation risk and loss of autonomy to Board members by adopting but not implementing asked-for governance structures and by bolstering those actions with symbolic language. See James Westphal & Edward Zajac, The Costs and Benefits of Managerial Incentives and Monitoring in Large U.S. Corporations: When Is More Not Better?, 15 STRATEGIC MGMT. J. 121 (1994) (asserting that increased resources devoted to incentive compensation and board monitoring offer diminishing behavioral returns); Edward Zajac & James Westphal, Accounting for the Explanations of CEO Compensation: Substance and Symbolism, 40 ADMIN. SCI. Q. 283 (1995) (arguing that CEO compensation debates are affected by symbolic considerations). Analysis of data from over 400 corporations over a decade-long period suggests that the stock market reacts positively to symbolic corporate governance reforms, even when not implemented, and that the symbolic actions diminish the likelihood of some subsequent governance reforms. James Westphal & Edward Zajac, The Symbolic Management of Shareholders: Corporate Governance Reforms and Shareholder Reactions, 43 ADMIN. SCI. Q. 127 (1998).


for this sort of wishful, black-box\textsuperscript{56} approach to problems of culture.

Strikingly, the other trend in recent SEC rhetoric (only accidentally served by the trend toward massive deterrence) has been a recognition that institutional culture matters because it generates law-abiding and law-violating conduct, meaning that sanctions against only individuals are incomplete as a response to recent corporate and financial sector scandals.\textsuperscript{57} To be sure, the SEC recognizes that good corporate culture is the sine qua non of good corporate citizenship. Former SEC Chairman Donaldson’s ambitions were wider than seeing compliance programs put in place, or even ensuring a law-abiding tone at the top. He stated that his goal was to “enhance and improve corporate governance to help restore the moral DNA of entities throughout the U.S. economy.”\textsuperscript{58} Lori Richards, Director of the SEC Office of Compliance Inspections and Examinations, frequently refers to the notion of a “culture of compliance.”\textsuperscript{59} Mr. Cutler spoke at length about the elements of a law-abiding culture.\textsuperscript{60} There is also a correlation between the new focus on organizations and the new language of cultural reform. This wide-lens approach is new in securities enforcement, although it is reminiscent of the kinds of institutional reform-minded remedies familiar from public law.\textsuperscript{61} It remains to be seen whether it will persist under Chairman Cox, but public perception of the systemic nature of recent scandals certainly suggests a compelling need to continue to speak to those concerns.

\textsuperscript{56} See Christopher Stone, Where the Law Ends 121 (1975); see also Stone, supra note 23, at 28. In Stone’s language, my proposal is “interventionist,” and should be distinguished from the “black box” approach.

\textsuperscript{57} I am not suggesting that the SEC should focus on corporate culture in lieu of making individuals accountable for their wrongdoing, especially at the highest levels of public companies and regulated entities. These are not incompatible approaches. In addition, this culture-oriented approach is not meant to take the place of other structural explanations for recent scandals. See, e.g., John C. Coffee, Jr., Understanding Enron: “It’s About the Gatekeepers, Stupid,” 57 Bus. Law. 1403 (2002); John C. Coffee, Jr., What Caused Enron? A Capsule Social and Economic History of the 1990s, 89 Cornell L. Rev. 269 (2004); Ronald Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias, 28 J. Corp. L. 715, 736-37 (2003). My point is, that given the SEC’s new awareness of the importance of firm culture, it needs a coherent response to problems of that nature.

\textsuperscript{58} Donaldson, supra note 26.


\textsuperscript{61} See infra note 62.
Soft concepts like culture can be hard to pin down, but it is not naïve to talk about them. Nor is it wise to behave as if law enforcement can afford to operate without reference to them. Regulators in a well-functioning system do not have to anticipate every form that wrongdoing can take, or create exhaustive lists of inappropriate conduct, because sanction alone is not what keeps the system going. Because the decentralized securities law model puts so much responsibility in the hands of regulated entities, its regulators drastically hollow out their own system if they profess helplessness—as they effectively do by focusing only on massive deterrence in these hardest cases—in the face of deeper issues of firm culture.

I submit that securities law enforcement mechanisms exist that can respond to in-firm institutional problems in a more considered way, and one that is sensitive to questions of deep organizational culture, without requiring massive resource commitment by Enforcement staff. Moreover, such mechanisms can further a level of collective, industry-wide learning about compliance that is not accomplished through massive monetary fines alone. These new mechanisms are already being used, in a partial way, by the SEC. I call them the Reform Undertakings. In other words, in practice if not in principle, Enforcement has recognized that the deterrence model is not a complete response to problems of firm culture. In this paper, naming the Reform Undertaking phenomenon is partly an attempt to fold the results of the SEC’s own on-the-ground learning into its theoretical conception of itself and its role.

C. Administrative Enforcement and Institutional Reform

Recent work in public law litigation suggests that spurring deep change within complex organizational systems requires a broader range of tools than the traditional prosecution of rights-based claims provides. It is time to introduce this work to the corporate governance field.

Almost three decades ago, Abram Chayes described an emerging dichotomy between traditional conceptions of adjudication and an emerging judicial role in public law litigation.62 In traditional adjudication, the suit involves only the private parties before the court. It is self-contained and party-initiated. A dispassionate judge identifies the private right at issue based on doctrinal analysis and retrospective fact inquiry.

The judge imposes relief, understood as compensation for the past violation of an identifiable existing right. By contrast, in public law litigation, the debate is more about the vindication of broader statutory or constitutional policies. The lawsuit is not self-contained. The judge must manage complex trial situations involving not just the parties to the dispute, but also the many and shifting parties not before the court who may nevertheless be affected by the suit’s outcome. Fact inquiry is predictive. Through a combination of party negotiation and continuing judicial involvement, the judge fashions relief that is ad hoc, ongoing, and prospective. As such, judges can become change agents under whose management specific cases can have far-reaching effects—not just for their deterrent value, but because the relief fashioned focuses squarely on institutional reform.

The public law adjudicatory model pulls away from traditional adversarialism in favor of participatory, forward-looking, non-adversarial methods. Lately, this problem-solving approach has become one theme in an emerging school of thought known as new governance or experimentalism. This approach identifies ongoing deliberation as both the most legitimate and most effective mechanism for making decisions in complex organizational structures. The deliberation is accomplished by decentralized, broadly participatory stakeholder groups that can access local knowledge and context-specific understandings of a situation. Decision-making within the groups is buttressed by explicit reason-giving, based on reference to identified norms rather than pure exchange. A centralized information-gathering body aggregates experience and permits comparative learning. It is a learning-by-doing structure, meaning that groups continually revise both ends and their own process through their participation in it. Transparency and accountability, including accountability for adhering to non-negotiable participatory norms, are

63. I am glossing over noteworthy distinctions in speaking of experimentalism and New Governance together. Other terms for similar approaches include “reflexive law,” “responsive regulation,” and “network governance.” New Governance has emerged as a global term to refer to this set of approaches. Within it, experimentalism (an approach associated with, among others, Charles Sabel, Michael Dorf, Bradley Karkkainen, James Liebman, and William H. Simon) may be distinctive for its Deweyan pragmatist arguments in favor of decentralized decision-making in the service of broader social goals and for the comprehensiveness of its description of the “rolling best practices rulemaking” needed to track progress toward those goals. Susan Sturm shares the emphases on pragmatism, demonstrably reasoned decision-making practices, and centralized comparative learning. But see Susan Sturm, Second Generation Employment Discrimination: A Structural Approach, 101 Colum. L. Rev. 458, 555 (2001) (arguing methods for a more complete implementation of the structural approach by developing a tiered and interactive framework that integrates the decentralized roles of nongovernmental intermediaries with traditional structural regulatory regimes). For a conversation about the current state of play, see generally Orly Lobel, The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought, 89 Minn. L. Rev. 342 (2004), and Bradley C. Karkkainen, “New Governance” in Legal Thought and In the World: Some Splitting as Antidote to Overzealous Lumping, 89 Minn. L. Rev. 471 (2004).
reinforced by the centralized comparative data analysis function.\textsuperscript{64}

In spite of worries about courts' capacity and legitimacy in working larger institutional reform,\textsuperscript{65} the new methods show promise. Civil rights advocates, using public law litigation, have had some significant successes in "destabilizing" failing institutions and reforming practices in areas such as public school administration, mental health institutions, prison management, responses to systemic police abuse, public housing, and health care.\textsuperscript{66} Novel court structures have also emerged as part of the recognition that complex social problems are not always best resolved in a (stereotypically) atomistic and adversarial environment.\textsuperscript{67}

Beyond court action, and operating very much across the traditional public law/private law divide, New Governance theorists are also reorienting conversation about employment discrimination,\textsuperscript{69} environmental regulation,\textsuperscript{70} public school administration,\textsuperscript{71} international labor standards,\textsuperscript{72} and regulation generally.\textsuperscript{73} The most provocative proposals argue for the application of deliberative, pragmatic "democratic experimentalist" methods to constitutional law and jurisprudence.\textsuperscript{74} What


\textsuperscript{65} See Sabel & Simon, supra note 62, at 1017-19 (examining Chayes' analysis of public law litigation).

\textsuperscript{66} See id. at 1022-53. Unlike Chayes, Sabel and Simon do not believe the new public law litigation techniques signal a break with the older adjudicative model. Id. at 1056-62.


\textsuperscript{69} See generally Sturm, supra note 63.

\textsuperscript{70} See Eric W. Orts, Reflexive Environmental Law, 89 NW. U. L. REV. 1227 (1995);


\textsuperscript{72} See ARCHON FUNG ET AL., CAN WE PUT AN END TO SWEATSHOPS? (2001).


\textsuperscript{74} See generally Dorf & Sabel, supra note 64; Brandon L. Garrett & James S. Liebman, Experimentalist Equal Protection, 22 YALE L. & POL'Y REV. 261 (2004); Dorf, Legal Indeterminacy, supra note 68; Crisite L. Ford, In Search of the Qualitative Clear Majority: Democratic Experimentalism and the Quebec Secession Reference, 39 ALBERTA L. REV. 511 (2001); JEAN L. COHEN, REGULATING INTIMACY: A NEW LEGAL PARADIGM.
makes the model attractive in securities law enforcement is not only its willingness to address head-on (albeit through incremental means) the challenge of reforming complex institutions, but also its somewhat unexpected success across a wide range of other, apparently intractable, problems.

D. The Unique Enforcement Environment

I began this section with a reference to courts, rather than regulators, because the idealized traditional adjudication model shares features—and related worries—with the common view of the enforcement function as retrospective and self-contained. Unlike courts or regulators, however, there has been little academic attention focused on the potential of enforcement bodies (i.e., the administrative law analog to the criminal law prosecutor) to force New Governance-style change. 75 First impressions may suggest some conceptual tension between the traditional enforcement role and the New Governance approach, but I argue that reform-oriented solutions can be embedded within the enforcement function, in particular in securities law enforcement. There can be broad overlap between retrospective and prospective approaches, to the benefit of both enforcement and corporate governance reform. 76

To be clear, though, two things make this situation different from the idealized public law litigation context. First, these cases settle. Second, enforcement staff does the settling and brings to the process its own particular culture and orientation. Each of these attributes put significant torque on the New Governance model.

Settlements provide obvious resource conservation benefits, but they impose a cost in terms of lost transparency. Firms settling regulatory actions can keep aspects of their internal wrongdoing out of the public eye by resolving matters before full-blown trial. They can be expected to leverage their greater knowledge of what went wrong, and to try to settle before all the facts emerge, precisely to avoid a more thorough investigation. This reduces public, regulatory, and judicial learning about violation patterns more generally. In fact, firms can resolve matters with prosecutors before even overworked prosecutors have a complete sense of the depth of the problem. Because of their informational advantage, firms can also assess the likely penalty range better than Enforcement.

(2002) (preferring the term "reflexive law" and not necessarily aligning herself explicitly with democratic experimentalism).


76. See infra Part V.
Settlement can even be a way for firms themselves to avoid facing the pervasiveness of their corporate governance problems. Sanctions meted out in settlements may therefore be poorly suited to responding to the most serious problems. At the aggregate level, as well, the opacity can make enforcement’s forceful “culture of compliance” message seem less convincing. Individuals, including those leading organizations, are more likely to abide by rules they perceive as legitimate and procedurally fair. Therefore, enforcement mechanisms that are not transparent may lack demonstrable credibility, which in turn may undermine tendencies toward law-abiding behavior. As discussed below, given Enforcement’s settlement framework, onlookers may be right to be cynical about whether broader corporate governance priorities are being advanced behind the concealing curtain of settlement.

The second key difference here is that Enforcement staff members, not courts, are the primary arbiters of these settlements. As change agents, the enforcement arms of administrative regulators are much understudied. Enforcement in particular has not garnered much attention from New Governance theorists. This may be because the enforcement process has been seen, rightly or wrongly, to have become fossilized into an old-fashioned prosecutorial form based on retrospective and blame-oriented decision-making. Perhaps, because they have been able to offload systemic impact questions to the regulatory arms of their agencies, enforcement divisions have not been pushed toward a more public-minded stance to the degree that courts have.

Having enforcement personnel focus on broader systemic reform has implications. To begin with, relative to regulators, the enforcer’s task is retrospective and blame-oriented, not prospective and reform-oriented. The liability model on which enforcement/prosecution is based serves a legitimate social function in signaling public norms, and those norms affect the conduct of other actors. While blame is only one kind of possible deterrence, its shaming effects can provide a coercive stick, external to the regulatory process, to reinforce law-abiding behavior. At the same time, blame-ascribing models tend to be better suited to individuals than to organizations. Blame-oriented models struggle with how to respond to the corporate form, although the basic intuition—that blame allocation is an

77. See Tyler, supra note 44.
78. Infra Part II.
79. According to Sparrow, this is how proponents of former President Clinton’s customer-oriented National Performance Review regulatory model (an early and incomplete, but still noteworthy, New Governance form) viewed the enforcement function. See Sparrow, supra note 75, at 49-64.
80. See infra notes 218-22 and accompanying text (comparing shaming/blaming punishments to the information-forcing coercive mechanism imagined in experimentalist regulation).

Enforcement action provides a mechanism by which the firm, and the larger market, can digest and move beyond acute instances of wrongdoing. It serves a legitimate purpose in achieving closure, which reduces downward pressure on stock valuation (to the benefit of current shareholders), allows the firm to emerge intact as a productive business entity and employer, and prevents an escalation into a larger industry or market crisis.\footnote{I am not speaking of that exceedingly rare firm that is so "rotten" that the only course must be to shut it down. *See infra* notes 213-16 and accompanying text.} If the goal is to spur institutional reform, however, the downsides to this closure orientation are twofold. First, within the process, the closure-oriented model seems incapable of making space for the kinds of deep and broad, time-intensive, and often difficult self-examinations that a real cultural shift would require.\footnote{See *James Q. Wilson* BUREAUCRACY 61 (1989) (discussing the difference in institutional culture between government lawyers and social scientists, such as economists, in terms of lawyers' preference for circumscribed sets of provable facts over broader systemic analysis).} On the contrary, the focus on closure is likely to stimulate end-game strategic responses from firms. The most one could hope for would be compliance with externally imposed rules, meant to channel firm action within certain bounds. Second, at the institutional level, the fact that enforcement actions are time-limited means there may be no aggregation of institutional knowledge about governance problems. Enforcers as a group may not get better at predicting problems, identifying risk factors, or developing workable remedies over time.\footnote{* See also Herman Goldstein, PROBLEM-ORIENTED POLICING (1990) (arguing in the police context that, rather than merely trying to solve crimes after they are committed, the police should study crime patterns in order to identify underlying conditions that stimulate the commission of crimes and then move proactively to eliminate them).} Similarly, the Enforcement-firm relationship is not geared toward ongoing, trusting collaboration. Like prosecutors, Enforcement's relationship with firms that are being investigated will, by definition, be
adversarial and suspicious. This is not to say that they want to see firms harmed. Individual Enforcement staff may be agnostic on the overall goodwill of market actors, or they may believe that every firm will do anything it can get away with, or they may believe that most firms act responsibly and their job is to weed out the "bad apples." Yet in all cases they are institutionally charged with remaining suspicious of their actual targets and skeptical about unsubstantiated promises. If they were not, we would be concerned about agency capture.

Finally, even if Enforcement culture were less retrospective, blame-oriented, closure-oriented, and suspicious, Enforcement does not have the institutional resources needed to engage in the kind of open-minded, systemically oriented, ongoing process that most experts in change management say are necessary to destabilize entrenched routines and achieve real change. Entire industries are devoted to such tasks. In order to address this kind of problem, Enforcement staff would first have to figure out what cultural problems exist. This would require a sufficiently deep understanding of the complex interplay of reporting lines, personalities, history, and acculturation that create firm culture. Then, the same non-expert staffers would have to develop context-appropriate responses that were as pervasive and elastic as the culture they seek to supplant.

Even without trying to effect large-scale cultural changes, Enforcement resources are stretched to an almost unmanageable degree. Enforcement settles the vast majority of its actions, not only for all the usual settlement reasons but also because it could not effectively prosecute them all. Certainly, it could not prosecute all the cases it is investigating at any one time, but the point goes further: it takes enormous resources to get to the bottom of the kinds of large and complex securities cases that are being brought routinely in recent years. According to one report from mid-

85 Enforcement subpoenas and requests for documents in the post-Enron era tend to be broadly worded and compel vast swaths of data including general business documents, email and instant messaging records, and financial and account systems information. See, e.g., Barry B. Burr, First time: Consultants Under the Gun with SEC Probe: 'Pay-to-Play' Allegations Spur Sweeping, Detailed Investigation, 32 PENSIONS & INV. 1 (Jan. 12, 2004). For one leading East Coast document management firm, the average regulatory document production project involves about 100,000 documents. At the upper end, the firm has processed more than 3 million documents, resulting in about 10 million pages, in a single case. It has produced 250,000 documents—in excess of one million pages—to a law firm in a single day. E-mail from Jay McNally, CEO, Ibis Consulting, Inc., to Cristie Ford (June 13, 2003) (on file with author). Of course, after being individually reviewed by lawyers, those documents are produced to regulators at a distinctly more human pace. Nevertheless, Enforcement is ill-equipped to handle this kind of volume, provided to them at first instance (per their request and in keeping with the firm’s work product privilege) as a largely undifferentiated mass of data. As New York Attorney General Eliot Spitzer’s office has shown, even small teams of enforcers may be able to bring firms to the settlement table. See Richard Thomson, America’s Celebrity Prosecutors, EVENING STANDARD (U.K.), June
2002, SEC Enforcement was so overwhelmed that "evidence rooms on the 8th and 9th floors of the SEC's downtown Washington headquarters [were] so full that boxes of subpoenaed documents [were] stacked in hallways," and Mr. Cutler himself admitted that his staff was "stretched to the limit." The SEC Enforcement model—perhaps like the prosecutorial model generally—was not designed to conduct the kinds of massive document reviews, factual investigations, and informational analysis needed to understand the myriad facets of a particular act of firm wrongdoing, let alone to fashion systemic solutions to cultural problems.

Nor do I think that increasing Enforcement resources to allow staffers to undertake "deep" scrutiny is the solution. Enforcement staff should not be transformed into corporate governance consultants. Recent increases in the SEC's budget allocation from Congress, and a recent push to make the SEC more technically adept at handling the information it does receive, only tinker around the edges of a fundamental mismatch between institutional design and information volume. One can scarcely imagine how an agency facing this kind of information burden could assume additional responsibility for understanding and working to resolve pervasive cultural problems among firms being investigated. If the goal is nothing more than to resolve cases as expeditiously as possible, Enforcement can make significant progress through individual interviews or depositions and a sufficient number of key documents. But one can

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13, 2003, at 42 (noting Spitzer's investigation of stock analysts involved hundreds of thousands of documents and emails and was handled by only four lawyers); Michael Schroeder, Stock Analysis: States' Wall Street Probes Bog Down, WALL ST. J., Sept. 13, 2002, at C5. This does not necessarily imply that those enforcers have a comprehensive picture of the information produced to them.


87. See SEC, 2004-2009 Strategic Plan, 22, 27 (Aug. 5, 2004) [hereinafter SEC Strategic Plan] (showing that over the last several years, the SEC's congressional budget allocation has increased significantly, growing from $514 million in fiscal 2002 to $811.5 in fiscal 2004), available at http://www.sec.gov/about/secstratplan0409.pdf; Anna Wilde Mathews et al., The Bush Budget Proposal: FDA, FCC Get Rare Boosts, While SEC Funding is Stable, WALL ST. J., Feb. 5, 2005, at A14 (reporting that President Bush has requested $863 million for the SEC in fiscal 2006, up only slightly from the fiscal 2005 figure of $857 million).

88. See SEC Strategic Plan, supra note 87, at 32-33, 48-50 (announcing new staff training initiatives and new or expanded automated information management tools).

89. I am speaking primarily of Enforcement, but even in the normal regulatory course, the SEC is expected to manage an enormous information volume. See Schroeder & Ip, supra note 86; see also STAFF TO THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 11 (Oct. 8, 2002), available at http://www.senate.gov/~gov_affairs/100702watchdogsreport.pdf (last visited July 9, 2005).
understand why, aspirational proclamations aside, Enforcement staff might take a deterrence-based approach to trying to further institutional reform. Irrespective of any faith in that approach, staff members are not in a position to do much more.

Because Enforcement does not have the resources, the mandate, the necessary culture, or the appropriate relationship to organizations to effect meaningful organizational change, Enforcement staff members may "satisfice"90 in three ways. First, as discussed above, they revert to a "black box" deterrence approach to the securities laws. In other words, they may impose severe monetary fines, declining to engage in any follow up to determine whether progress is made and depriving themselves of an important learning opportunity in the process. The second and third ways in which Enforcement staff satisfice relate to the ways in which an organization may bid for leniency during settlement negotiations. Specifically, SEC Enforcement will settle with firms on favorable terms, even including taking no sanctioning action at all, in exchange for either of two things: (a) indicia that the firm has an adequate compliance regime in place; or (b) firm cooperation with Enforcement after an investigation has been initiated.

If the presence of compliance programs and cooperation with Enforcement staff were positively and substantially correlated with good corporate governance/citizenship, then it would make sense to extend leniency on these terms. On the other hand, this settlement approach is ill-advised if there is no such correlation, or the correlation is weak. Settlements reached on this basis would not constitute wise husbandry of scarce enforcement resources, but rather arbitrary grants of leniency without regard to the potential that that firm may commit or permit more wrongdoing in the future. It would be even more discouraging if enforcers suspected (as they might) that there is no clear correlation between the bases for leniency and good corporate citizenship, believing they have no choice but to settle on such face-saving terms because impossible volumes of information leave them with a tenuous grasp on their cases or because they are resigned to the system’s imperfections. Especially in the nontransparent settlement context, such a practice could degenerate into a "trading of favors," insincere and unverifiable demonstrations of compliance, and the potential failure of due process for individuals. In the section that follows, I argue that these are precisely the problems presented by the SEC’s settlement guidelines, known as the Framework for Cooperation.

90. The term refers to resolutions that may be good enough in the circumstances (i.e., wherein goals are somewhere between satisfied and sacrificed) but that are not optimal. HERBERT A. SIMON, MODELS OF MAN (1957).
The other alternative, the Reform Undertaking model, recognizes that Enforcement’s purpose is not to get to the root of a systemic corporate governance problem on its own, even if those are the problems that it needs to address. Nevertheless, it constitutes the Enforcement action as an intervention that is far more engaged than the one contemplated by deterrence alone. The Reform Undertaking model involves an independent third party consultant to help the organization address its own governance problems, over a longer period of time, and after the immediate enforcement action has been provisionally resolved. In this way, Reform Undertakings uncouple the catalyst-for-reform of the enforcement action from the specifics of reform measures. This reduces some of the pressure toward strategic action and if properly implemented can create an environment more conducive to fostering meaningful positive culture change.

II. PROBLEMS WITH THE FRAMEWORK FOR COOPERATION

The discussion in Part I, above, describes the limitations of the Donaldson-era SEC’s deterrence-based strategy in meeting the agency’s stated intention of spurring institutional reform and suggests that a New Governance-style approach may be better suited to the task. It identifies some challenges, relative to other New Governance initiatives, arising from the Enforcement-driven and settlement-oriented environment. I return to those below, and make recommendations for incorporating a version of New Governance problem-solving into real-life enforcement. However, deterrence is only half the picture. Enforcement has stated that certain “core” factors influence the decision as to quantum of penalty, or even whether to impose a penalty at all. The factor that often proves decisive in their analysis is the extent of a violator’s cooperation, as measured by the standards set forth in the SEC’s “Framework for Evaluating Cooperation in Exercising Prosecutorial Discretion” (Framework for Cooperation). The Framework for Cooperation effectively sets out the indicia that a firm must

91. See infra Part III (explaining the Reform Undertaking model as one that uses enforcement to further, but not to define or manage, more profound institutional reform).

92. See infra Part V (concluding that a coherent hybridity between experimentalism and securities law enforcement structures can, and should, exist).

93. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969 76, SEC Docket 220 (Oct. 23, 2001) [hereinafter Framework for Cooperation], available at http://www.sec.gov/litigation/ investreport/34-44969.htm. See Cutler, supra note 1 (highlighting that cooperation is the third and often the decisive one of three core factors). The first two factors are the type of violation committed (i.e., fraud or non-fraud, although non-fraud cases can also attract monetary penalties) and the degree of harm resulting from the violations as measured by harm to investors, effect on market capitalization, and/or harm to public trust and confidence. Id. I fold these factors into my definition of the “worst actors” above.
demonstrate to obtain leniency from Enforcement. It is an integral part of
the nontransparent settlement dance described above, and its structure and
rationale should be of concern to those aspiring to foster improved
corporate governance standards through SEC Enforcement action.

A. The SEC Framework for Cooperation

On October 23, 2001, as part of an Exchange Act § 21(a) Report, the
Commission released its Framework for Cooperation.94 Like the United
States Sentencing Commission’s 1991 Organizational Sentencing
Guidelines on which it was loosely modeled, the Framework for
Cooperation settlement approach can be boiled down to two basic
requirements. In order to obtain leniency, the firm must demonstrate
(1) that it has in place compliance mechanisms designed to prevent and
detect violations of law within the firm (credit-for-compliance), and (2) that
it has cooperated with authorities after they uncover apparent wrongdoing
(credit-for-cooperation).95 As a practical matter, the Framework for
Cooperation provides Enforcement with a shortcut that allows it to avoid
sorthing through all the intricacies of the complex and information-heavy
investigations it brings. In the process, though, it has the potential to
undermine efforts toward corporate governance reform.

94. See Framework for Cooperation, supra note 93 (explaining that the word
“prosecution” here refers to SEC Staff attorneys working in the Enforcement Division);
Comm. on Fed. Regulation of Sec., Report of the Task Force on Exchange Act Section 21(a)
Written Statements, 59 Bus. Law. 531 (2003) (outlining the recent history of the use of the
Section 21(a) Report).

(2004). The Organizational Sentencing Guidelines imposed a mandatory sentencing
calculus on federal court judges dealing with corporate and white collar crime. Those
guidelines remain, at a minimum, persuasive in the wake of the Supreme Court’s rulings on
the constitutionality of federal individual sentencing guidelines in United States v. Booker,
125 S. Ct. 738 (2005). See also U.S. SENTENCING COMM’N, REPORT OF THE AD HOC
ADVISORY GROUP ON THE ORGANIZATIONAL SENTENCING GUIDELINES (Oct. 7, 2003),
Organizational Behavior—The Federal Sentencing Guidelines Experiment Begins to Bear
Fruit, in 1 PRACTICING LAW INSTITUTE, CORPORATE COMPLIANCE 113, 115-26 (2002).
Federal criminal prosecutors have also used the Guidelines as an informal roadmap for cases
involving business organizations. See also Memorandum from Deputy Attorney General
Eric H. Holder, Jr., to All Component Heads and United States Attorneys, Bringing
Criminal Charges Against Corporations (June 16, 1999), available at http://www.usdoj.gov/
criminal/fraud/policy/Chargingcorps.html; Memorandum from Larry D. Thompson, Deputy
Attorney General, to Heads of Department Components, United States Attorneys, Principles
of Federal Prosecution of Business Organizations (Jan. 20, 2003) (recognizing that federal
criminal prosecutors have also used the Guidelines as an informal roadmap for cases
guidelines.htm. The Framework for Cooperation, the Organizational Sentencing
Guidelines, and their progeny also ask whether the firm has appropriately compensated
those adversely affected by the alleged wrongdoing. This important criterion is not directly
relevant to this analysis of firm culture and pathologies in regulatory settlements, but
remediation requirements could certainly be a component of a True Reform Undertaking
structure. See infra Part V.
According to the Press Release accompanying the Framework, a firm’s cooperation with SEC Enforcement staff will be measured along four broad measures. They are: (1) self-policing prior to the discovery of the misconduct, including establishing effective compliance procedures and an appropriate tone at the top; (2) self-reporting of misconduct when it is discovered, including conducting a thorough review of the nature, extent, origins, and consequences of the misconduct, as well as promptly, completely, and effectively disclosing the misconduct to the public, to regulators, and to self-regulators; (3) remediation, including dismissing or appropriately disciplining wrongdoers, modifying and improving internal controls and procedures to prevent recurrence of the misconduct, and appropriately compensating those adversely affected; and (4) cooperation with law enforcement authorities, including providing the Commission staff with all information relevant to the underlying violations and the company’s remedial efforts.

The Framework’s structure and language show the influence of SEC Enforcement culture and imperatives. It lists 13 criteria for Enforcement staffers to consider in determining whether, and how much, to credit self-policing, self-reporting, remediation, and cooperation. Relative to the Organizational Sentencing Guidelines, which attempt to articulate general standards against which to measure a firm’s compliance program, the purpose of the Framework for Cooperation is to specify in clear terms how

97. See id.
98. The Organizational Sentencing Guidelines have been compared to the United States Constitution, in that they “contain simple statements of general principles that permit [their] application to varied and changing circumstances.” Judge Diana E. Murphy, The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics, 87 IOWA L. REV. 697, 706-07 (2002). Thus, the Guidelines’ definition of “an effective program to prevent and detect violations of law” is intended to evolve based on best practices and ongoing learning within the firm about its own risk factors and vulnerabilities. U.S. SENTENCING COMM’N, supra note 95, § 8A1.1, cmt. n.3(k) (2004). The Guidelines do not define such an “effective program,” except to say that it is a program that has been “reasonably designed, implemented, and enforced so that it generally will be effective in preventing and detecting criminal conduct.” Id. While the precise actions necessary for an effective program depend upon a number of factors, the likelihood that certain offenses may occur because of the nature of a firm’s business is relevant. The hallmark of such a program is that “the organization exercised due diligence in seeking to prevent and detect criminal conduct by its employees and other agents.” Words such as “effective,” “reasonable,” “due diligence” signal a degree of discretion in deciding what constitutes a good compliance program. The definition of “due diligence” itself is general and contains many open and subjective words. See, e.g., id. Of course, the Guidelines are hardly an improvement over the Framework to the extent that they require judges and/or prosecutors to evaluate firms’ compliance systems, just as the Framework for Cooperation requires Enforcement staff to do it.
firms can obtain leniency. For this reason, the Framework's language is prescriptive—almost forensic—and focused on the acute wrongdoing instance rather than on broader corporate governance indicia.

The only way to convey the Framework's tenor is to quote the relevant criteria in full. The eight criteria relevant to this discussion are divided along the following lines: three evaluate prior conditions and good governance mechanisms in the firm; four evaluate the firm's response to the wrongdoing; and one specifically addresses the firm's cooperation with Staff. The three criteria that evaluate prior conditions and/or good governance ask:

2. How did the misconduct arise? Is it the result of pressure placed on employees to achieve specific results, or a tone of lawlessness set by those in control of the company? What compliance procedures were in place to prevent the misconduct now uncovered? Why did those procedures fail to stop or inhibit the wrongful conduct?

6. How was the misconduct detected and who uncovered it?

12. What assurances are there that the conduct is unlikely to recur? Did the company adopt and ensure enforcement of new and more effective internal controls and procedures designed to prevent a recurrence of the misconduct? Did the company provide our staff with sufficient information for it to evaluate the company's measures to correct the situation and ensure that the conduct does not recur?

The following four criteria that evaluate the firm's response in the period following an allegation of wrongdoing are concerned with compliance, but also with damage control. They ask:

7. How long after discovery of the misconduct did it take to implement an effective response?

99. The other five criteria speak more to the allocation of scarce Enforcement resources. Four criteria assess severity of conduct and magnitude of harm and go to proportionality of punishment-versus-crime, rather than to leniency per se. See Framework for Cooperation, supra note 93, at criteria 1, 3, 4, and 5. The final criterion asks whether the company is "the same company in which the misconduct occurred, or [whether it has] changed through a merger or bankruptcy reorganization." Framework for Cooperation, supra note 93, at criterion 13. While these are all valid considerations, they are concerned with the cost-benefit analysis of pursuing Enforcement action against certain firms, rather than with cooperation, compliance, or culture. See supra notes 24-25 and accompanying text.

100. Recent Commission speeches make it clear that after-the-fact cleanup exercises are no substitute for pre-existing good governance practices. According to Commissioner Cynthia Glassman, "if you are looking for leniency you had better be able to show that you cared about preventing corporate misconduct before you discover that it occurred." Commissioner Cynthia A. Glassman, Speech: Sarbanes-Oxley and the Idea of "Good" Governance (Sept. 27, 2002) (no emphasis), at http://www.sec.gov/news/speech/sphc586.htm.

101. See Framework for Cooperation, supra note 93, at criteria 2, 6, and 12.
8. What steps did the company take upon learning of the misconduct? Did the company immediately stop the misconduct? Are persons responsible for any misconduct still with the company? If so, are they still in the same positions? Did the company promptly, completely and effectively disclose the existence of the misconduct to the public, to regulators and to self-regulators? Did the company cooperate completely with appropriate regulatory and law enforcement bodies? Did the company identify what additional related misconduct is likely to have occurred? Did the company take steps to identify the extent of damage to investors and other corporate constituencies? Did the company appropriately recompense those adversely affected by the conduct?

9. What processes did the company follow to resolve many of these issues and ferret out necessary information? Were the Audit Committee and the Board of Directors fully informed? If so, when?

10. Did the company commit to learn the truth, fully and expeditiously? Did it do a thorough review of the nature, extent, origins and consequences of the conduct and related behavior? Did management, the Board or committees consisting solely of outside directors oversee the review? Did company employees or outside persons perform the review? If outside persons, had they done other work for the company? Where the review was conducted by outside counsel, had management previously engaged such counsel? Were scope limitations placed on the review? If so, what were they?102

The above four criteria have a lot to do with the firm’s ex post cooperation, but there is also one explicit cooperation criterion. It asks:

11. Did the company promptly make available to our staff the results of its review and provide sufficient documentation reflecting its response to the situation? Did the company identify possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law? Did the company produce a thorough and probing written report detailing the findings of its review? Did the company voluntarily disclose information our staff did not directly request and otherwise might not have uncovered? Did the company ask its employees to cooperate with our staff and make all reasonable efforts to secure such cooperation?103

The cooperation criterion is the most immediately alarming for those concerned with safeguarding the attorney client privilege, due process, and an adversarial process that permits a zealous defense of clients. The Framework makes it clear that SEC Enforcement expects value-added firm

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102. See Framework for Cooperation, supra note 93, at criteria 7-10.
103. See Framework for Cooperation, supra note 93, at criterion 11.
participation in its investigation, not just prompt and adequate responses to Enforcement demands. In other words, along with making documents and witnesses available, the firm is expected to identify possible violations and evidence proactively, to produce a thorough and probing written report and make it available to Enforcement, and to bring information that Enforcement might not otherwise have uncovered to its attention. 104

While the credit-for-cooperation requirements raise the most pressing concerns, on further reflection the credit-for-compliance requirements do not fare much better. The problem is that neither ex post cooperation with Enforcement, nor the presence of compliance programs, are necessarily proxies for good firm culture. The Framework model also presumes that firm compliance programs (or, more accurately, firms' representations about them) can readily be evaluated by regulators. This may not be the case. In fact, the Framework criteria relating to compliance may even reflect the SEC's desire to avoid having to evaluate flexible, context-specific standards for compliance programs in the interest of finality. Moreover, the Framework ignores the degree to which cooperation with authorities after wrongdoing has been uncovered can turn into horse-trading and scapegoating. As a result, both credit-for-compliance and credit-for-cooperation create incentive structures that can undermine, rather than support, a theoretically ideal enforcement pyramid.

B. "Cynical Happy-Talk": The Problem with Credit-for-Compliance

Good corporate governance is a hard thing to measure. Enforcement staff is not equipped to identify or wrestle with the attendant issues at any depth. Thoroughly understanding a firm's compliance structure and culture would require going through vast quantities of documents and information during an investigation, and then applying relatively specialized knowledge about compliance—two functions that Enforcement staff has neither the time nor the expertise to perform. Moreover, even among experts the notion of an "effective program to prevent and detect violations of law" is constantly changing, vague at the margins, and subject to dispute. Enforcement staff faced with the prospect of plumbing the depths of a compliance program for purposes of extending leniency may avoid the problem in a couple of ways. They may choose to define "compliance" in a flattened way, or they may avoid defining it entirely.

The temptation for those familiar with the history of command-and-control regulation in the United States is to define the essential "effective compliance program" to a high gloss of certainty, even at the cost of being

104. In the criminal context, a similar provision has caused anxiety for at least one observer, who notes that some practitioners think the government is "laz[y]" and "hitch[ing] a free ride" on defense counsel's work. Gibeaut, supra note 3, at 49.
optimally effective from a long-term risk management or good governance perspective. Enforcement staff could try to evaluate firm compliance according to a checklist, rather than in a flexible or empirically-based way. Checklists are simpler to use and provide a degree of clarity for both firms and overworked Enforcement staff members. However, rigid, anticipatory rules have limited range for compelling systemic scrutiny or good behavior. For example, contemporary compliance scholarship considers having an independent board of directors to be a crucial step in safeguarding shareholders and the public against managerial self-interest. The presence of a code of ethics is also an important component. Yet, in an empirical study of 221 large- and medium-sized U.S. corporations, James Westphal found that changes in board structure that increase the board’s independence from management are associated with higher levels of CEO ingratiation and persuasion behavior toward board members, and that such influences offset the effect of increased structural board independence. Corporate codes of ethics have also been criticized as

105. The similarity with discredited command-and-control administrative mechanisms, the stereotypical example of which requires regulated entities to meet detailed and rigid, learning-resistant process criteria, is striking. It brings to mind the literature on bounded rationality suggesting that, when confronted with overwhelming complexity, people tend to rely on cognitive shortcuts such as heuristics and schema as a way of managing the universe of possibilities. See, e.g., Amos Tversky & Daniel Kahneman, Judgment Under Uncertainty: Heuristics and Biases in Judgment Under Uncertainty 3 (Daniel Kahneman, Paul Slovic & Amos Tversky et al. eds., 1982); Jeffrey J. Rachlinski & Cynthia R. Farina, Cognitive Psychology and Optimal Government Design, 87 CORNELL L. REV. 549 (2002) (applying a cognitive model to regulatory design). People make bad decisions when the volume of information increases, and they are forced to apply simpler analytical tools. See Troy A. Paredes, Blinded by the Light: Information Overload and its Consequences for Securities Regulation, 81 WASH. L.Q. 417, 434-43 (2003) (discussing investors’ “information overload” and mandatory disclosure system in securities laws).

106. The Sarbanes-Oxley Act of 2002 and related new self regulatory organization rules emphasize the importance of a strong and independent board of directors, with certain committees of the board either a majority or completely comprised of independent directors. The Act creates extensive protections for Audit Committees in particular, including the requirement that Audit Committee members be independent of the company, and that at least one member of the Audit Committee be a “financial expert.” See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 407, 116 Stat. 779, 790 (codified as amended in 15 U.S.C. § 7201-7256 and scattered sections of 18 U.S.C. (Supp. II 2002)). The Act gives the Audit Committee sole responsibility for appointing, compensating, and supervising auditors and requires the Audit Committee to set up internal procedures for receiving and reacting to complaints concerning accounting, internal control, or auditing matters, including establishing a mechanism for handling confidential, anonymous concerns of employees. See id. § 301; see also Self Regulatory Organizations, Exchange Act Release No. 48745, 81 SEC Docket 1586 (Nov. 4, 2003), 68 Fed. Reg. 64,154, 64,157-59, 64,161-64 (Nov. 12, 2003) [hereinafter Self Regulatory Organizations], available at http://www.sec.gov/rules/sro/34-48745.htm.

107. See Sarbanes-Oxley Act of 2002 § 406(c) (defining the code of ethics as, among other things, honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships); see also Self Regulatory Organizations, supra note 106, at 64,164 (explaining the code of business conduct and ethics).

108. See James D. Westphal, Board Games: How CEOs Adapt to Increases in...
being ineffective. Relying on shallow tests for board independence, then, fails to account for the undoubtedly nuanced relationship between board independence and good corporate citizenship. Part of the problem is that procedural outputs—e.g., internal reports generated, the number of compliance officers on staff, and/or the installation of a 24-hour anonymous whistleblower hotline—are easier to measure than high level compliance outcomes. In fact, relatively easy-to-measure outputs are even likely to receive more attention than hard-to-measure outputs. One can understand how observers might be cynical as to whether prototypical compliance programs do more than provide lip service to governance norms.

Interestingly enough, this is not what the Framework for Cooperation does. It avoids over-specification—historically, a regulator’s tic—in favor of no specification, the largely unfettered discretion of the criminal prosecutor. The Framework asks only what compliance measures were in place at the firm and why they failed. But recall the impossible information volume that Enforcement must handle, the inscrutability to Enforcement of effective compliance, and the Framework’s emphasis on proactive firm cooperation. In real life, the Framework’s credit-for-compliance provision only opens the door for the firm to convince staffers that its compliance structures were meaningful and that the reasons for failure were specific and unlikely to be repeated at the firm. The typical medium for making this kind of pitch is the Wells Submission, a carefully crafted written brief the firm submits in support of its position as

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Structural Board Independence from Management, 43 ADMIN. SCI. Q. 511, 529-32 (1998) (explaining, for instance, that increases in structural board independence lead to larger subsequent increases in CEO compensation by increasing the level of CEO interpersonal influence behavior).


110. This says nothing of more unorthodox approaches to compliance, the merits of which cannot even be considered under a checklist-style understanding of compliance. For example, it may be that not all legitimate compliance mechanisms will be based on increasing scrutiny. Some research suggests that over-monitoring can decrease employees’ independent motivation to comply with law. See Robert B. Cialdini, Social Influence and the Triple Tumor Structure of Organizational Dishonesty, in CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS 44 (David M. Messick & Ann E. Tenbrunsel eds., 1996).

111. WILSON, supra note 83, at 161-62. The problem is most severe in dysfunctional firms, where the absence of easy-to-read signals from inside—e.g., calls to the whistleblower hotline—may mask a more pervasive problem.
Enforcement's initial investigation draws to a close.\textsuperscript{112} A firm will virtually never say that deep cultural problems caused its law violations and that those conditions persist. Enforcement will rarely have the informational arsenal to counter that claim in specific terms.

The absence of meaningful evaluation standards, combined with the desire to avoid liability, can also create a moral hazard for firms. The notion that "there simply does not exist an accepted metric used to assess program design, operation, and outcome" underlies William Laufer's pessimistic view of corporate compliance programs as risk-shifting devices.\textsuperscript{113} In his view, firms purchase compliance programs modeled on the Organizational Settlement Guidelines and their progeny, regardless of their efficacy, because those programs are designed to result in grants of corporate amnesty or immunity should wrongdoing be uncovered. Institutional inertia means that most compliance and ethics programs do not result in significant change.\textsuperscript{114} Yet, by pointing to a costly and elaborate compliance structure, a firm can plausibly shield itself from vicarious liability for an employee's alleged wrongdoing.

Thus, according to Laufer, many large firms come to think of compliance and even corporate ethics as matters of risk management—what Citigroup CEO Charles Prince calls "cynical happy-talk."\textsuperscript{115} Compliance serves an insurance function against zealous prosecutorial action, and firms purchase only the amount of compliance required to shift liability away from the firm.\textsuperscript{116} It would not be in a firm's interest to


\textsuperscript{113} See William S. Laufer, Corporate Liability, Risk Shifting, and the Paradox of Compliance, 52 VAND. L. REV. 1343, 1390 (1999) (arguing that, given equivocal evidence of compliance effectiveness, the rise of the "good corporate citizenship" movement risks undermining the objectives and spirit of the corporate criminal law); see also Marie McKendall et al., Ethical Compliance Programs and Corporate Illegality: Testing the Assumptions of the Corporate Sentencing Guidelines, 37 J. BUS. ETHICS 367, 379 (2002) (alluding to studies which indicate that ethical compliance programs do not lessen legal violations).

\textsuperscript{114} See Laufer, supra note 113, at 1407-11 (citing commentators who note that ethics codes are poorly integrated into firm culture).

\textsuperscript{115} See Mitchell Pacelle, Citigroup Works on Its Reputation, WALL ST. J., Feb. 17, 2005, at C3. To be clear, Mr. Prince was speaking of the need to avoid cynical happy-talk in designing compliance programs.

\textsuperscript{116} See Laufer, supra note 113, at 1382-1402 (explaining that prescriptive steps for due diligence afford firms protections from criminal investigations, indictments, conviction, and fines); Reinier H. Kraakman, Corporate Liability Strategies and the Costs of Legal
purchase too-effective compliance structures that could uncover wrongdoing that would otherwise remain undiscovered. Firms may be tempted to follow compliance requirements in a minimal, even cynical, way. 117 Because the Framework does not explicitly require that compliance programs continually improve, they become a ceiling instead of a floor. Ironically, then, Laufer suggests that the “good corporate citizenship” movement may actually generate moral hazards that undermine corporate governance objectives. 118

Rewards for having a compliance program in place only go to the existence of that program—not to the existence of a thoughtful presence behind them that can work to make them effective and self-reflexive. Strategies for avoiding regulatory sanctions are not necessarily coterminous with strategies for identifying root causes and problems and working to fix them. The problem, then, is not only overdefinition or underdefinition of the term compliance. Rather the problem is the institutional situation that forces Enforcement to extend leniency to firms in exchange for having an effective compliance program. Enforcement can have no way of knowing what an effective compliance program entails or whether it exists at the firm in question. What is needed instead is a problem-solving approach that focuses on endogenous learning and norm generation.

C. The Problem with Credit-for-Cooperation

Self-policing and self-regulating are integral components of the modern administrative regime. The complexity of modern business means that neither regulators nor Enforcement staff could do their job without leveraging the firm in its own regulation. Presumably this makes Enforcement staff feel justified in meting out increasingly severe punishments to firms that do not cooperate with their investigators. 119

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117. See Laufer, supra note 23, at 47-56 (arguing that employee indemnification can be a “ruse a firm can devise to take care of its good soldiers”). The SEC takes the position that indemnification for securities law violations is void as a matter of public policy. See Regulation S-K, 17 C.F.R. § 229.512(h)(3) (2005).

118. See Laufer, supra note 113, at 1405-19. Laufer does not see a way out of the moral hazard and the problem of “cosmetic compliance” until prosecutors/enforcers and firms share a consistent understanding of what an “effective” compliance system entails as well as a workable metric for evaluating compliance systems. Laufer, supra note 113, at 1419-20; see also Kimberly D. Krawiec, Cosmetic Compliance and the Failure of Negotiated Governance, 80 Wash. U. L.Q. 487, 491-92, 519-16 (2003) (arguing that placing excessive importance on compliance structures raises dangers of underenforcement and social waste).

119. Lucent Technologies, Inc. was fined $25 million recently for failing to cooperate in an investigation. According to Associate Director of Enforcement Paul Berger, the case “sends a message about cooperation during an investigation.” Press Release, SEC, Lucent settles SEC Enforcement Action Charging the Company with $1.1 Billion Accounting
According to Mr. Cutler, "the Commission is placing a greater emphasis than ever before on assessing and weighing cooperation when making charging and sanctioning decisions." 120

But there is cooperation, and then there is cooperation. 121 In its benign presentation, the cooperation condition is an expression of regulators’ desire to avoid corrosive adversarialism. It aspires to a genuine partnership between the enforcer and the good corporate citizen, which after all should want to cooperate to root out wrongdoing. In this sense, firm cooperation after wrongdoing is discovered can be an important indicator of a firm’s bona fides. The cooperation condition seeks to eliminate the hide-the-ball culture among both defense counsel and regulators, in favor of mutually beneficial disclosure and problem-solving. 122


122. Cooperation between investigator and subject was not the norm, at least in the criminal context, before the Organizational Sentencing Guidelines were implemented. As one observer noted in 1985, because white collar criminal investigations often went on for substantial periods of time, “information control”—i.e., “keeping documents away from and preventing clients and witnesses from talking to government investigators, prosecutors, and judges”—was central to at least some counsel’s defense strategy. See KENNETH MANN, DEFENDING WHITE COLLAR CRIME: A PORTRAIT OF ATTORNEYS AT WORK 6-8 (1985).
Credit-for-cooperation schemes of any sort can be problematic, but my concern is primarily the "flipping" kind of cooperation. Seen through a darker lens, the cooperation condition can imply a quiet agreement between a firm and its regulator, in which the firm acquires leniency in exchange for assisting Enforcement staff to make a case against another Enforcement target. Enforcement staff members must make retrospective sense of the document universe and face theoretical and practical problems involved in attaching blame to a complex corporate form. As a result, enforcers might be expected to welcome cooperation where it furthers the enforcement action in question. This is especially true if the action includes sanctions against a high-profile individual. Ever-increasing standards of cooperation can become a substitute for good corporate citizenship.

The information that emerges from such a process may be suspect, like all information coming from a self-interested informant. Cooperation is an effective enforcement tool because it cuts through volumes of information through which Enforcement staff themselves do not have the resources to wade. The problem is that cooperation cuts through volumes of documents in unverifiable ways. Moreover, the cut is generally performed by a party that has a stake in the investigation's outcome and that normally has greater financial, human, and information-management case one is left with the impression that only defendants were perceived to be "hiding the ball," see for example United States v. Liquid Sugars, Inc., 158 F.R.D. 466, 471 n.4 (E.D.Cal. 1994) and United States v. Houlihan, 937 F. Supp. 65, 69 (D. Mass. 1996). These cases state that criminal discovery is not, nor should it be, a game of hide the ball, as the stakes are too high for both sides. The dates of these cases demonstrate, of course, that "hide the ball" behavior did not end with the Organizational Sentencing Guidelines' promulgation in 1991.

123. Even in its benign form, the cooperation requirement can cause problems for defense counsel. Cooperating with the SEC does not guarantee leniency with other regulators or prosecutors. Privilege waivers in exchange for credit-for-cooperation are rightly controversial. See, e.g., Am. Coll. of Trial Law., The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations, 41 DUQ. L. REV. 307 (2003) (asserting that, by waiving attorney-client privileges, the government demands change the very nature of the adversarial process of the criminal justice system). Cooperation can also be detrimental to a firm where information and even counsel work product produced to a regulator becomes discoverable in parallel civil litigation proceedings.


125. See supra note 81.

126. Criminal prosecutors have known this for a long time. See, e.g., Graham Hughes, Agreements for Cooperation in Criminal Cases, 45 VAND. L. REV. 1 (1992); Ellen Yaroshfsky, Cooperation with Federal Prosecutors: Experiences of Truth Telling and Embellishment, 68 FORDHAM L. REV. 917 (1999) (arguing that there are no studies that examine the manner in which cooperators work with prosecutors and the extent to which prosecutors can determine whether cooperators are truthful).
resources than any other party. Recall the value-added cooperation the SEC demands under the Framework for Cooperation. Because cooperation means not only producing documents and making witnesses available but also assisting the SEC’s understanding of the case, the firm has the ability to shape and frame the evidence, potentially even before the SEC develops its own impressions of the evidence.\textsuperscript{127}

In this distorted environment, the parties’ incentives may be aligned, and this compounds the problem. Where both Enforcement and the firm have a common interest in seeing problems resolved quickly and both understand that allocating blame is a central part of the exercise, expeditious and mutually satisfactory resolution may become a higher priority than deep corporate governance reform or due process for individuals. The firm has an incentive to emphasize those facts that suggest that a rogue employee— not senior management and not a general culture of disregard for law—is the cause of its woes.\textsuperscript{128} The incentive toward what William Laufer calls “reverse whistleblowing” would theoretically be strongest in those companies with the most to hide.\textsuperscript{129} Presumably, an entrenched insiders’ culture is also more likely to scapegoat where necessary to protect itself. Frontline Enforcement staff are under a great deal of pressure (from the public, the media, other regulators, and likely superiors) to achieve results and exhibit toughness toward corporate wrongdoing.\textsuperscript{130} High profile enforcement actions can significantly enhance Enforcement prestige. The goals of an enforcement action always must include allocating responsibility—blame—and resolving the case. Behavioral psychologists maintain that the risk of bias will exist even when both sides, here the Enforcement staff and defense counsel, act with integrity and goodwill.\textsuperscript{131} Whether or not individual Enforcement staff and counsel are fair and capable—as no doubt they are—as a structural matter, no enforcement

\textsuperscript{127} In addition to producing reports and bringing potential violations to Enforcement’s attention, other forms of cooperation might include developing chronologies or producing selective bundles of “hot” documents.

\textsuperscript{128} A disagreement between employee and firm along these lines is recorded in Randall Smith & Susan Pulliam, IPO ‘Rogue’ Battles to Clear His Name, WALL ST. J., Sept. 17, 2002, at C1.

\textsuperscript{129} See Laufer, Corporate Prosecution, supra note 124, at 648-50, 659-60.

\textsuperscript{130} The powerful effect of prestige-related incentives on prosecutors to bring and resolve cases is one of the points made by James S. Liebman, The Overproduction of Death, 100 COLUM. L. REV. 2030, 2078-81 (2000). According to Liebman, the pressure on law enforcement and prosecutors to “solve the crime and punish the perpetrator, harshly,” combined with the fact that capital murder cases can often be hard to solve because of the absence of certain kinds of key evidence, can lead to cutting corners in investigations. Id.

system should rest so heavily on embedded individuals’ perfection of judgment.

Moreover, Enforcement conduct that is not transparent, credible, and characterized by due process undermines efforts to promote good governance within regulated companies. SEC Administrative Releases shed little light on the nuts and bolts of how firm cooperation contributed to any particular enforcement outcome. Settlement releases are pre-negotiated between firm and Enforcement and generally provide only boilerplate language to the effect that the Staff had considered the firm’s cooperation in its settlement decision.\textsuperscript{132} Worse yet, Enforcement staff themselves may not be in a position to verify that the firm’s cooperation provided anything more than potentially shotgun information implicating individuals.

The cooperation condition skews the enforcement pyramid in the service of conduct that bears only an oblique relationship to compliance with law. Even the perception that firms can reduce their liability and avoid meaningful reform efforts by making backroom deals is costly. An employee’s sense that she could be a scapegoat can result in self-protective and often counterproductive behavior. When a firm blows the whistle on one or more individuals, it also obscures the ways in which corporate wrongdoing is so often an organizational problem.\textsuperscript{133} Perhaps more importantly, by offering an easier route to leniency, the cooperation option can help firms avoid necessary but difficult, resource-intensive, and ongoing self-analysis, carried out in the shadow of a demonstrated compliance failure. Searching self-reflection is a challenging project that requires discipline and stamina. Firms might be entitled not to undertake such a project—in fact their shareholders might expect them not to—where an officially endorsed shortcut is available.


\textsuperscript{133} See Lauf, \textit{Corporate Prosecution}, supra note 124, at 653, 657. There is some evidence to indicate that the most harmful white collar crimes are those which are most “organizationally complex.” See, e.g., DAVID WEISBRUD, STANTON WHEELER & NANCY BODE, \textit{CRIMES OF THE MIDDLE CLASSES: WHITE-COLLAR OFFENDERS IN THE FEDERAL COURTS} 183-85 (1991).
III. Reform Undertakings as Enforcement Innovation

Whether or not by conscious design, recent SEC actions are showing the first indications of a new, or newly rediscovered,134 approach to enforcement settlements. This approach responds to worries about facial compliance, scapegoating, institutional capacity, and the limitations of deterrence in effecting thoroughgoing reform to corporate governance. This is the Reform Undertaking previously referred to in this paper.

Reform Undertakings may be court-ordered,135 administratively ordered,136 or incorporated into settlement agreements between

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134. The SEC has employed "creative" relief, including requiring firms to make an undertaking to retain an independent consultant or committee to conduct some kind of review, at least since the 1970s. Comm. on Fed. Regulation of Sec., Report of the Task Force on SEC Settlements, 47 BUS. LAW. 1083, 1128-31 (1992); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 463-64, 541, 616-19 (3d ed. 2003); STONE, supra note 56, at 185-86. According to Mr. Cutler, they were used especially pre-1984, when the SEC's statutory power to impose substantial civil penalties was more limited. Cutler, supra note 1. Other precedents for interventionist enforcement remedies, outside the public law litigation context, include New York City's response to organized crime in the late 1980s. See RONALD GOLDSTOCK ET AL., CORRUPTION AND RACKETEERING IN THE NEW YORK CITY CONSTRUCTION INDUSTRY: FINAL REPORT TO GOVERNOR MARIO M. CUOMO FROM THE NEW YORK STATE ORGANIZED CRIME TASK FORCE 157-74 (1990).

135. In the WorldCom case, for example, the SEC filed suit in June 2002, following the company's announcement that its earnings had been massively misstated. SEC Charges WorldCom with $3.8 Billion Fraud, Litigation Release No. 17588, 77 SEC Docket 3013 (June 27, 2002), available at http://www.sec.gov/litigation/litreleases/lr17588.htm. Following a court-ordered expert's recommendations, the Commission sought and was granted injunctive relief under Exchange Act §§ 21(d) and 27, requiring WorldCom to undertake extensive reviews of its corporate governance and internal controls as well as establish a training and education program for its officers and employees to minimize the possibility of future violations of the federal securities laws. The Commission took the innovative step of requesting of sitting Judge Jed S. Rakoff that a "Corporate Monitor" (in my terms, a Third Party) be appointed by the Court, initially only to oversee management's conduct and ensure that no inappropriate conduct occurred. As part of a subsequent settlement, the SEC sought, in addition to a monetary penalty, to have the Corporate Monitor, former SEC head Richard C. Breeden, conduct a governance overhaul as part of an agreed-upon Permanent Injunction. SEC v. WorldCom, Inc., Litigation Release No. 17866 (Nov. 26, 2002), available at http://www.sec.gov/litigation/litreleases/lr17866.htm. According to Mr. Breeden's Report, the permanent injunction provides that the Corporate Monitor ... shall ... review the adequacy and effectiveness of WorldCom's corporate governance systems, policies, plans, and practices. This review will include but is not limited to inquiries into (1) whether WorldCom is complying with recognized standards of "best practices" with respect to corporate governance; (2) whether WorldCom has sufficient policies and safeguards in place (a) to ensure that WorldCom's Board of Directors and all committees of WorldCom's Board of Directors ... have appropriate powers, structure, composition, and resources, and (b) to prevent self-dealing by management; (3) whether WorldCom has an adequate and appropriate code of ethics and business conduct, and related compliance mechanisms; and (4) whether WorldCom has appropriate safeguards in place to prevent further violations of the federal securities laws. Breeden, supra note 20, at 9 n.4.

136. See, e.g., Ernst & Young, supra note 15. Chief Administrative Law Judge Murray concluded, inter alia, that Ernst & Young's stated reliance on a "culture of consulting" to avoid violating auditor independence rules was a "sham," and that its business relationships with PeopleSoft LLP were "outrageous," "improper," and "blatant" in their violation of those rules. She noted that the Commission had tried on two previous occasions to bring Ernst & Young into compliance through litigation and held that absent an explicit directive
Enforcement and a firm. When part of a settlement agreement, the Reform Undertaking tends to be accompanied by a cease-and-desist order and by additional relief against either the firm or individuals including disgorgement, restitution, a bar against an individual serving as a director or officer, the requirement that the firm develop or enhance existing compliance processes, and civil penalties. The Reform Undertaking appears as a settlement term to the general effect that the firm shall retain, at its own expense, an independent third party consultant (Third Party). The Third Party's role is to intervene in the firm, identify compliance failures and reasons for the alleged law violation, and report back to the SEC. While there is substantial variation in Undertakings' specific terms, and especially in the language describing the scope and depth of the Third Party's investigation, the Undertakings share certain core features. They include (1) a focus on the firm, not individuals, with particular view to its compliance and corporate governance policies, practices, and procedures; (2) prospective, standards-based language, giving the Third Parties substantial discretion to interpret what constitutes a reasonable or appropriate remedial recommendation; (3) a presumptively final settlement with Enforcement, combined with provision for a relatively extended time period during which the Third Party conducts its review, sometimes further reinforced by subsequent periodic review; (4) a provision for a written

to cease and desist, the firm would likely commit future violations. Along with other penalties, Judge Murray ordered:

Ernst & Young LLP shall retain an independent consultant acceptable to the Commission, to work with Ernst & Young LLP to assure the Commission that Ernst & Young LLP's leadership is committed to, and has implemented policies and procedures that reasonably can be expected to remedy the violations found in this Initial Decision and result in compliance with the Commission's rules on auditor independence related to business relationships with clients and with GAAS. Ernst & Young LLP shall cooperate with the independent consultant in all respects, including staff support, and shall compensate the independent consultant, and staff, if one is necessary, at reasonable and customary rates. Once retained, Ernst & Young LLP shall not terminate the relationship with the independent consultant without Commission approval. The independent consultant shall report to the Commission in writing six months from the date work has begun as to the findings of its review and Ernst & Young LLP's efforts at correcting the violations.

Ernst & Young, supra note 15.

137. The Commission has the statutory authority to supplement a cease-and-desist order with a requirement that its subject:

comply, or... take steps to effect compliance, with such provision, rule, or regulation, upon such terms and conditions and within such time as the Commission may specify in such order. Any such order may, as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with such provision, rule, or regulation with respect to any security, any issuer, or any other person.

Third Party report; and (5) provisions to safeguard the Third Party’s independence.

In every case I am aware of in which a Reform Undertaking has been put into action, it has fallen short of being a textbook New Governance remedy in both drafting and execution. Part Four, below, sets out a model of a more complete True Reform Undertaking, as a remedial alternative that incorporates New Governance learning into the distinct Enforcement environment. However, even in its present form the Reform Undertaking represents a profound shift in enforcement philosophy. The first step, I suspect, must have been Enforcement staff’s willingness to address their own institutional limitations in an innovative way. Unlike the credit-for-compliance and credit-for-cooperation models, the Reform Undertaking model accepts that Enforcement itself is ill-suited to promote institutional reform because it has neither the resources nor the appropriate culture. At the same time, in its best form the Reform Undertaking model provides a mechanism for identifying concrete steps the firm must take to reform its corporate governance as a condition of getting out from under Enforcement scrutiny. In other words, the Reform Undertaking parses the liability and remedial phases in dealing with a regulated firm. In its ideal form it uses the enforcement stick to spur, but not to define or manage, more profound institutional reform. It employs the concept of best practices, which is a Trojan horse for more thoroughgoing reform. Having committed to that standard, the firm is charged with ratcheting up its governance practices above mere industry standards to match the best practices available on an ongoing basis. This process, in turns, ratchets up general corporate governance standards.  

During his tenure as Northeast Region Associate Director, Barry Rashkover observed that the SEC now frequently defers to independent consultants to tailor specific reforms in the context of court-ordered undertakings. Reform Undertakings also appear in settlement documents, sometimes jointly reached with other government bodies, such as the United States Attorney’s Office. Perhaps unsurprisingly, the

138. As one set of commentators has stated, “the relationship between law and organizations is a highly reciprocal one: Each realm interpenetrates, transforms, and reconstitutes the other, with neither being fully exogenous nor causally prior.” Mark C. Suchman & Lauren B. Edelman, Legal Rational Myths: The New Institutionalism and the Law and Society Tradition, 21 LAW & SOC. INQUIRY 903, 905 (1996).

139. See Rashkover, supra note 2, at 544.

scope of an Undertaking reached through settlement (rather than adjudication) seems to be more broadly worded, and undertakings are becoming more detailed and sophisticated over time. Undertakings appear in settlements with private companies,\textsuperscript{141} investment advisors,\textsuperscript{142} specialist firms,\textsuperscript{143} and self-regulatory organizations\textsuperscript{144} (whose own governance has been a large player in recent securities law enforcement actions, to my knowledge, his office has not played a role in fashioning the Reform Undertakings I describe here.


142. See, e.g., In re Nevis Capital Management, Investment Advisers Act Release No. 2214, 82 SEC Docket 523 (Feb. 9, 2004), available at http://www.sec.gov/litigation/admin/ia-2214.htm; In re H.D. Vest Investment Securities Inc., Securities Act Release No. 8383, 82 SEC Docket 424 (Feb. 12, 2004), available at http://www.sec.gov/litigation/admin/33-8383.htm; In re Massachusetts Financial Services, supra note 32; In re Alliance Capital Management, supra note 32; In re Putnam Investment Management, LLC, Investment Advisers Act Release No. 2192, 81 SEC Docket 1913 (Nov. 13, 2003), available at http://www.sec.gov/litigation/admin/ia-2192.htm. Banc of America Capital Management voluntarily undertook to retain an independent compliance consultant in a recent settlement. In re Banc of America Capital Management LLC, Securities Act Release No. 8538 (Feb. 9, 2005) at http://www.sec.gov/litigation/admin/33-8538.htm. As part of each of these settlements, the SEC obtained (in addition to a cease-and-desist order, monetary fines, and in some cases, other consideration) firm undertakings to appoint a Third Party, at the firm’s expense, to conduct an in-depth review of the firm’s policies, practices, and procedures related to the firm’s area of alleged wrongdoing, for purposes of determining compliance with the federal securities laws and recommending policies and practices designed to ensure such compliance. The firms undertook to require the Third Parties to produce a report to the firm and the Commission, describing the review performed and providing recommendations, and to implement substantially all the Third Parties’ recommendations or reach an alternative good faith agreement. Additional terms seek to ensure the firm’s cooperation and the Third Party’s independence, including a stipulation that the firm shall not have the ability to fire the Third Party, a prohibition on an attorney-client relationship between firm and Third Party, and a prohibition on “repeat business” between Third Party and firm. The Massachusetts Financial Services, Putnam, and Alliance Capital settlements also provide for periodic compliance review after the Undertaking period, although not subject to Commission oversight. The Banc of America settlement requires the family of companies’ CEOs to certify that the firms have adopted and complied in all material respects with their undertakings.

practices have been under scrutiny lately).  

The Reform Undertaking should be distinguished from centralized, one-off structural reorganization, such as the 2003 Global Research Analyst Settlement. However, as structural remedies and especially in terms of the loss of control the firm experiences, they are similar to what one might see in bankruptcy reorganization. We should expect them to be unpopular with firms not only for their indeterminacy and cost but because to some degree, the Reform Undertaking moves the loss of control further up in a dismal chronology of events. On the other hand, behavioral


144. The SEC is empowered to impose sanctions and cease-and-desist orders on self-regulatory organizations (SROs) under Exchange Act §§ 19(b) and 21C respectively. Significantly, in the first regulatory action following her appointment as Director of SEC Enforcement, Linda Chatman Thomsen announced an especially comprehensive Reform Undertaking scheme in connection with a settlement agreement with the National Stock Exchange and its President and CEO. In re National Stock Exchange, Exchange Act Release No. 51714 (May 19, 2005), at http://www.sec.gov/litigation/admin/34-51714.pdf. The independent Third Party monitor in that case is responsible for conducting a comprehensive review of the National Stock Exchange's policies and procedures relating to, inter alia, rulemaking, surveillance, member firm compliance examination, virtually the full range of enforcement functions, and document retention. The Chicago Stock Exchange (CHX) also recently agreed to a cease-and-desist order in settlement of an administrative action relating to its failure to supervise and correct trading rules violations by specialists and co-specialists on its trading floor. See In re Chicago Stock Exchange, Exchange Act Release No. 48566, 81 SEC Docket 490 (Sept. 30, 2003), available at http://www.sec.gov/litigation/admin/34-48566.htm. Its Undertaking terms are substantially similar to those contained in the Investment Company Act and specialist firm settlements above, but additionally stipulate that either the Board of Governors or the Regulatory Oversight Committee must certify that it has read the Third Party's report, made "reasonable inquiry about the issues raised," and observed the Exchange's Undertakings. Further, the CEO must certify that "he or she reasonably believes that CHX's trading floor surveillance and enforcement programs are adequate to meet CHX's obligations under Section 19(g) of the Exchange Act."


146. While the Global Research Analyst Settlements call for the settling firms to retain independent monitors at their own expense, those monitors' responsibilities are limited to "conduct[ing] a review to provide reasonable assurance that the firm is complying with the [agreed to] structural reforms." SEC, SEC Fact Sheet on Global Research Analyst Settlements, at http://sec.gov/news/speech/factsheet.htm. See also In re KPMG LLP, Exchange Act Release No. 51574 (Apr. 19, 2005) (relying that KPMG undertook to retain a consultant for the "limited purpose" of certifying to the SEC that a series of agreed-upon corporate governance undertakings "continue to be in effect, are being complied with and appear to be effective in achieving their overall goals" after two years), at http://www.sec.gov/litigation/admin/34-51574.pdf.


148. In Ernst & Young, supra note 15, the defendant firm argued that the requirement
psychology has taught us that people tend to overly discount the future in their calculations. Thus, when one recalls that a large number of the firms publicly accused of massive frauds over the last few years have ended up in bankruptcy proceedings, the Reform Undertaking looks like a sensible intervention before the costs to all involved get even higher.

A. Comparative Advantages

Relative to the mechanisms discussed above, the Reform Undertaking does a better job of leveraging Enforcement’s strengths and compensating for its limitations.

To begin with, the Reform Undertaking handles the resource problem facing Enforcement. It is the thoughtful result of squarely facing the misfit between Enforcement’s processes and its aspirations of spurring institutional reform. As discussed above, Enforcement will never be as well equipped to analyze detailed information on compliance structures as the settling firm itself would be. The Reform Undertaking does not require Enforcement staff to act as long-term regulators or compliance specialists. It allows Enforcement teams to remain temporary, flexible, and non-bureaucratic. It matches tools to problems, rather than trying to shoehorn problems into existing tools.

Secondly, as a function of distinguishing the liability phase from the remedial phase, the Reform Undertaking substantially neutralizes the counterproductive elements of the adversarial stance. There will be little trust between Enforcement and firms that are being investigated. Firms often behave in a strategic end-game manner in that environment. Investigations are a high stakes situation that promotes evasive, not collaborative, action. The Reform Undertaking relieves some of the immediate pressure by taking the full articulation of a remedy out of the hands of Enforcement staff and putting it in the hands of an independent Third Party. Removing the Enforcement stick from direct view can create a space where the firm is free, at least in relative terms, to think about compliance creatively and autonomously, based on voluntary problem-solving instead of rule-based enforcement. Because it comes from the

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149. Bazerman & Watkins, supra note 13, at 84-87.
150. This is not to say that there will not still be work for Enforcement to do in, e.g., choosing the criteria firms should be subject to through Reform Undertakings. See Sparrow, supra note 75, at 155-70. Nevertheless, these are not the same issues that arise from being confronted with impossible information volumes in an Enforcement division entirely structurally unsuited to handling it.
151. Sabel & Simon, supra note 62, at 1051-57.
152. See Sturm, supra note 63, at 555 (making the same point in a different context); Susan P. Sturm, New Governance and the Architecture of Learning, Mobilization, and
firm itself, in conjunction with Third Party action, and is not imposed from above, this method has a better chance of producing a sustainable and meaningful response. Relatedly, the Reform Undertaking reduces the pathologies associated with the short term orientation. A resolution that is substantially satisfactory to the market is achieved when settlement occurs, relieving pressure on Enforcement to resolve the matter through whatever means necessary, but the parties have a longer remedial timeframe within which to work out the details based on better information and contextual analysis.\textsuperscript{153}

The Reform Undertaking avoids the over- and under-definition problems from which credit-for-compliance regimes may suffer, while still achieving an adequate level of closure. The Reform Undertaking structure permits Enforcement staff to jettison rigid compliance checklists in favor of broad outcome measures. At the same time, they are not left, as they are now, to exercise their discretion in extending credit-for-compliance based on an inevitably incomplete analysis of what an adequate program would entail. Enforcers’ worries about the manageability or enforceability of vague rules are deflated since standards-based approaches in the remedial enforcement context do not face the problems of overbreadth they do in the predictive context. What remains are general standards, the specific implementation of which is worked out through the remedial process. One can track the shift in the language of the Reform Undertaking terms, which reintroduce open, discretion-granting words. There is talk of “policies and procedures that reasonably can be expected to remedy violations,” or the need to consider broader or structural issues as well as immediate ones.\textsuperscript{154} The Reform Undertaking’s investigatory nature addresses the firm’s incentive to treat a compliance checklist as insurance or to avoid implementing too-effective mechanisms that might uncover wrongdoing.

Properly implemented, the Reform Undertaking settlement also has a more explicit, transparent, and therefore reinforcing relationship to the enforcement pyramid than do credit-for-cooperation or credit-for-compliance settlements. Firms with deep compliance problems are directed to respond to those problems rather than extricating themselves

\textit{Accountability: Lessons from Gender Equity Regimes, in New Governance and Constitutionalism in Europe and the United States, supra note 81} (manuscript at 14-15, on file with author) (identifying that “public interventions justified by institutional failure may thwart the necessary openness, engagement, and institutional embeddedness for collaborative problem solving to work”).

\textsuperscript{153} Reform Undertaking terms generally require Third Parties to produce a first report within 60 days of being retained, but their involvement with the firm tends to be longer: for example, in \textit{In re Monsanto Co.}, supra note 141, the firm retains the Third Party for three years.

\textsuperscript{154} See Ernst & Young, supra note 15; Chicago Stock Exchange, supra note 144 (discussing the existence of policies and procedures that can reasonably remedy violations).
from the Enforcement ambit through inscrutable means. The True Reform Undertaking, described in greater detail below, does not raise the sorts of obvious due process concerns that credit-for-cooperation raises. It avoids both agency capture and backroom horse-trading, as Ayres and Braithwaite suggest the injection of a Third Party is likely to do.\textsuperscript{155} This is important at the broader level as well. If other firms understand that they cannot buy their way out of Enforcement action through cooperation and that Enforcement actions are credible, proportional, and factually justified, this shortcut to resolution-without-reform will be closed off. By removing from Enforcement's hands the ability to reward companies, it neutralizes the fact that the firm's and Enforcement's short term interests in closure and even scapegoating may be aligned. Transparency produces accountability, and transparent Enforcement processes are more likely to create market structures more demonstrably worthy of investors' confidence.

The Reform Undertaking also maintains the power of the coercive stick and stays focused on the worst actors. The coercive background situation remains. Firms that, according to their Third Parties, do not succeed in the Reform Undertaking environment remain answerable to the SEC.\textsuperscript{156} Intuition supports regulatory responses that target the worst offenders.\textsuperscript{157} The entire enforcement pyramid presupposes that the worst offenders are singled out for sanctioning, and that the example of worst firms reinforces

\textsuperscript{155} See Ayres & Braithwaite, supra note 21, at 56-58 (discussing "regulatory tripartism").

\textsuperscript{156} Under the language of all the settlements above, firms are required to accept the Third Parties' recommendations if they cannot reach a good faith agreement about an alternative solution. Faced with an unsatisfactory result, the SEC could choose to extend the term of the Reform Undertaking or to impose additional sanctions, up to and including license revocation.

\textsuperscript{157} An important predecessor—successful on its merits, though short-lived for separate legal reasons—was the Occupational Safety and Health Administration's (OSHA) "Cooperative Compliance Program," (CCP) created in 1997 and directed specifically at workplaces with the highest injury rates. The program was modeled on the award-winning "Maine 200" program, begun in 1993, which targeted the 200 companies in that state with the highest workers' compensation rates (i.e., Maine's worst actors). Companies opting into the program would establish a health and safety program in cooperation with OSHA and in exchange would be dropped from OSHA's regular inspection program. High-injury workplaces not opting into the program would be the subject of heightened inspections. In Maine, 65% of participating employers saw reductions in overall injury and illness rates, and over the first two years participating employers experienced a 47.3% decrease in compensable claims for worker's compensation (as compared to 27% for all Maine employers). U.S. Food & Drug Admin., Mini Case Study: "Maine Top 200"—OSHA Shifts Its Focus From Regulations To Outcomes (2000), at http://www.fda.gov/edtd/leneveraging/030.html. The CCP's underlying directive was vacated by the U.S. Court of Appeals for the District of Columbia Circuit on the basis that OSHA's issuance of its directive failed to comply with the notice and comment requirements of the Administrative Procedure Act. Chamber of Commerce v. Dept of Labor, 174 F.3d 206, 213 (D.C. Cir. 1999). Since then, OSHA has reverted to rewarding good firms rather than educating/reforming the worst performers: information on its Voluntary Protection Program (VPP) is available at http://www.osha.gov/dcs/vpp/index.html. As a case-specific remedial enforcement mechanism, the Reform Undertaking is not vulnerable to the same charge.
the system's credibility down the line. The marginal effect of change is also greater when dealing with the worst actors, which cause disproportionate damage. A focus on the worst actors provides a necessary counterweight to regulators' tendency to focus on the best performers, which may be celebrated because they reinforce the wisdom of the agency's policies.

Further, the Reform Undertaking model is better suited than a model oriented toward individual liability to problems of organizational behavior. It accepts that there can be systemic institutional problems at a firm (something that individual blame models cannot accommodate) but its focus is not on the senseless exercise of punishing the bad firm. The focus is on reform and preventing similar occurrences in the future. This is a situation where forward-looking remedial standards, relying on technical, contextual forms of thought rather than blame allocation, are better suited to the corporate form and to the goal pursued.\footnote{158}

Finally, the Reform Undertaking is, if anything, even more of a wake up call to firms than normal enforcement. SEC Enforcement action is, of course, always destabilizing. It is even more destabilizing when the prescribed remedy is to engage in an open-ended process, the goal of which is to reject the status quo ante in favor of as-yet-unspecified results, reached through hard-to-control processes in the presence of an independent Third Party.\footnote{159}

\footnote{158. Simon, \textit{supra} note 81, at 25-28; Sabel & Simon, \textit{supra} note 62, at 1054. \textit{But see} Dallas, \textit{supra} note 13, at 2-8 (arguing in favor of individual director and officer liability for failure to address the existence of a "corporate climate that encourages and supports unethical and illegal behavior" in a firm).

159. Sabel & Simon, \textit{supra} note 62, at 1020; see also Bradley C. Karkkainen, \textit{Information-Forcing Environmental Regulation: Penalty Defaults, Destabilization Rights, and Environmental Governance, in NEW GOVERNANCE AND CONSTITUTIONALISM IN EUROPE AND THE U.S.,} \textit{supra} note 81 (manuscript at 6-7, 29-32, on file with author). According to Sabel and Simon, writing in the public interest litigation context, the principal effects of destabilization rights are (1) the Veil Effect: parties "cannot count on their prior positions, and it may be hard for them to anticipate what their positions will be like in the alternative future regimes under consideration," so the "struggle for selfish advantage is impeded at the outset of remedial negotiations;" (2) the Status Quo Effect: "The condemnation of the status quo has a distinct cognitive effect: it releases the mental grip of conventional structures on the capacity to consider alternatives;" (3) the Deliberation Effect: "justifying one's position by giving reasons and responding to reasoned arguments for competing views can alter a person's understanding of her factual circumstances and her interests, disclosing previously unseen opportunities;" (4) the Publicity Effect: contingent on transparency, public scrutiny may generate pressure toward responsible behavior; (5) the Stakeholder Effects: the balance of power between plaintiff and defendant shifts, and subordinate players get more autonomy; internal pressures are generated within the plaintiff class and the defendant institution; new stakeholders are motivated or empowered to participate; and (6) the Web Effect. Action ramifies to other institutions and practices and creates a new best practices standard that other institutions will have to consider. Sabel & Simon, \textit{supra} note 62, at 1073-82.}
IV. NEXT STEPS AND MISSING PIECES

The attributes described above may make one dare to hope that the Reform Undertaking will be more effective at spurring institutional reform than any other tool in the Enforcement staffer’s kit. Yet this is not to say that a poorly designed Undertaking cannot be gamed or manipulated or that more traditional sanctions are now anachronistic. On the contrary, one of the important points this paper tries to make is that New Governance mechanisms may operate most effectively in tandem with other forms of compliance-oriented action. No single remedial approach will be an all-purpose magic bullet. Yet, New Governance concepts can make a more-than-theoretical contribution to the complex and messy world of real-life enforcement action and settlements.

If it is to be as effective as it can be within its bandwidth, however, the Reform Undertaking structure will need to gain more traction with respect to four main issues: the firm’s participation in the process, the role and accountability of the independent Third Party, the SEC’s ability to aggregate data on best practices, and Enforcement’s ability to synchronize staff incentives with mechanisms that further meaningful governance reform. The sections that follow describe the attributes of a True Reform Undertaking model that incorporates these important elements and that establishes the connection between New Governance theory and real-life enforcement.\footnote{160}

A. The Intervention: Attributes of the Process

Unlike the rest of the enforcement process, the Reform Undertaking is forward-looking. One of the main purposes of separating the enforcement and remedial phases is to create a relatively brief temporal space within which the firm can begin to make sense of its history, define objectives, and identify solutions to cultural problems on an ongoing, iterative basis.\footnote{161}

\footnote{160. For now this project is limited to investigations of large firms. The calculation will be different when dealing with small and medium-sized enterprises (SMEs), where ownership may be less dispersed and both financial resources (to retain a Third Party) and pre-existing institutional capacity (in the form of a well-staffed compliance department) may be more limited. Document volumes in the investigation will be more limited as well. Small firms are too varied in their operations and market niches to generalize about the problem. The SEC is working through similar problems with respect to the Sarbanes-Oxley Act’s requirements. Press Release, SEC, SEC Establishes Advisory Committee to Examine Impact of Sarbanes-Oxley Act on Smaller Public Companies (Dec. 16, 2004), \textit{available at http://www.sec.gov/news/press/2004-174.htm}. For a thoughtful discussion of New Governance environmental regulation and SMEs, see \textit{NEIL GUNNINGHAM & DARREN SINCLAIR, LEADERS & LAGGARDS: NEXT-GENERATION ENVIRONMENTAL REGULATION} 13-40 (2002).}

\footnote{161. Susan Sturm’s work on addressing subtle cultural problems in complex social environments, such as workplaces, develops fine-grained insights into the specific challenges of such projects and substantially informs the discussion that follows. \textit{See, e.g., Sturm, supra note 62; Sturm, supra note 63; Sturm, supra note 152}.}
The point should be to leverage the organization's own internal vocabulary and norms to reorient the firm's perspectives on governance. No one said this would be easy in practice. On the contrary, there is no lack of empirical evidence suggesting that the reasons that organizations so often behave in myopic, rigid ways are deep-seated and not amenable to easy change.¹⁶²

The magnitude of the challenge notwithstanding, the Reform Undertaking process can take advantage of the substantial learning that has occurred in the last few decades, in both private and public sectors, on problem-solving and participatory corporate governance strategies.¹⁶³ Some elements of the True Reform Undertaking will be unremarkable to those familiar with basic governance principles. Most would agree, for example, that the process should be transparent, thorough, and credible. The Third Party should produce a written report for the Commission, based on demonstrably reasoned decision-making.¹⁶⁴ This means that decisions are supported by a clear factual record which is the product of a credible investigatory process; that discussions and decisions about proposed solutions are justified with explicit reasoning, making reference to available information and identified governance priorities; and that the investigatory process as a whole canvasses the range of perspectives and concerns that are likely to affect the practicality and wisdom of a particular solution.¹⁶⁵ Transparent reasoning helps preclude decision-making based on pure exchange, bias, or scapegoating. Decision-making is disciplined by its openness to outsiders' scrutiny.¹⁶⁶

Just as importantly, the process should be explicitly participatory. One might contrast a True Reform Undertaking with the WorldCom model, in which a central expert—albeit a very capable one—acted essentially alone


¹⁶⁴ All the Reform Undertakings identified supra, in Part III, require the Third Party to produce a written report and require that it be provided to the Commission.

¹⁶⁵ See Sturm, supra note 62, at 1399-03, 1411, 1434-36. There is more than one sort of reasoned decision-making. See, e.g., Simon, supra note 81, at 19-22 (describing "root cause analysis").

¹⁶⁶ Which outsiders should have access to the report is a difficult question. Limiting participation does limit debate and collective learning, and the results of the Undertaking would be of quite general interest. Nevertheless, I say that only the SEC and other Third Parties (either directly or through the SEC) should have access to the full reports because of the extraordinary cost and chilling effect of making the specifics discoverable in shareholder or other litigation. Similar concerns have been raised with regard to the Organizational Sentencing Guidelines. See U.S. SENTENCING COMM'N, supra note 95, at 116-25. Existing Reform Undertakings make no provision for public dissemination of Third Party reports.
to produce a series of guidelines to be implemented by the firm. Corporate Monitor Breeden's report is a sophisticated and thoughtful blueprint for revising corporate governance structures at WorldCom and beyond, but it was written with that high level purpose in mind—not with a view to creating a reflexive process within the firm. If the purpose is to spur thoroughgoing institutional reform, then a Third Party's top-down solutions will not be a substitute for the firm's own involvement. Imposed solutions are less likely to embed themselves, and a failure to come to terms with the organization's collective history can create pathologies around information sharing and problem-solving. As Mr. Cutler has said, law-abiding behavior is a product not only of structural governance mechanisms, but of the three Ps: people, process, and place (meaning external variables and causative factors).

Broad participation serves several purposes in this context. Its advantages over nonparticipatory processes are considerable. First, it increases the pool of information and contextual knowledge, thereby improving the discovery process. By contrast, the WorldCom model reflects a closed system, where a snapshot of information yields a one-time report, written by an outsider. Second, participation creates buy-in. It gives key players a basis for investing in the process and committing to its results. Third, participatory exercises are exercises in governance. They serve an educative function and actively demonstrate new ways of doing business, ideally while learning to speak realistically about those areas where firm culture or collective action played a role in permitting past wrongdoing. By contrast, the expert-centric WorldCom model leaves little room for the firm to do its own learning during the Undertaking time.

167. Corporate Monitor Breeden's final report makes 78 specific recommendations, many of which are geared toward increasing transparency and shifting the balance of power toward shareholders. See Breeden, supra note 20. The experimentalist approach to the same problem would have involved extensive empirical analysis, extensive consultation with WorldCom stakeholders (including service providers and contractors, shareholders, employees, and others with a stake in the company's ongoing success), and the creation of a prospective process for fashioning flexible, effective, self-reflexive governance regimes that answered to unknown future problems as well as clear past ones. Id.

168. Cutler Speech, supra note 60; see also Diane Vaughan, Rational Choice, Situated Action, and the Social Control of Organizations, 32 Law & Soc'y Rev. 23 (using a case study to illustrate that "a fully elaborated explanation of decision-making necessarily would merge structure, culture, and agency").

169. Cognitive psychological insights into experts' tendencies toward overconfidence and "expert myopia" are also relevant here. See Rachlinski & Farina, supra note 105, at 558-61; see also Sturm, supra note 62, at 1419-21 (discussing the limitations of the "expert remedial formulation model").

170. In a similar vein, see Sturm, supra note 62, at 1290-96. Sturm also argues that at the remedial stage, the conceptual restrictions imposed by legal doctrine during the liability phase are more limited. Thus, what keeps the process rational and legitimate is a different discipline imposed by participation. Participation also realigns party interests, making possible agreements along unexpected lines. See Susan P. Sturm, The Promise of Participation, 78 Iowa L. Rev. 981, 1006 (1992).
frame, and the guidelines are not revisable through ongoing learning thereafter. Finally, in view of the insiders' culture that underlies many securities law violations, broad top-to-bottom participation makes the process credible to enforcers and to lower and mid-level firm employees.

The Third Party's operational methodology should focus on problem-solving, not just compliance. Relative to compliance, problem-solving requires that a broader and more diverse set of actors be involved, across a longer timeline, using a different set of information-gathering and decision-making mechanisms. Success is measured not by adherence to a rigid checklist, but by whether the firm's institutional capacity to identify, prevent, and redress wrongdoing is improved in a sustainable way. This is not to say that facially compliant or otherwise unsatisfactory accommodations will never be reached. However, they stand a better chance of being identified, scrutinized by reference to important governance values, and addressed through the True Reform Undertaking process.

Correlatively, the process should be flexible. It should be capable of learning from its carefully documented successes and failures, as well as adjusting accordingly. The Third Party should be willing to be creative about the means used to address firm pathologies, avoiding a priori preferences for particular approaches. The Third Party should take an incremental approach, breaking the problem into manageable pieces and tackling each one based on its specific attributes.

The firm's general governance standards, then, are realized and reinforced by the firm's own careful, unique experience with the True Reform Undertaking process itself. This is no small point. Through this sort of participatory work, the True Reform Undertaking grows

171. See Sturm, The Promise of Participation, supra note 170. The Reform Undertaking process should require ongoing periodic review after the Undertaking period itself is complete. Only a few existing Reform Undertakings do so. See, e.g., In re Banc of America, supra note 142; In re Putnam Investment Management, LLC, supra note 142; In re Massachusetts Financial Services, supra note 32; In re Alliance Capital Management, supra note 32. They do not require that either the Third Party or the Commission play any role in the review.

172. Sparrow argues that specificity, incrementalism, and flexible methods characterize many innovative civil and criminal enforcement techniques. SPARROW, supra note 75, at 81-97. Similarly, Sturm argues that effective workplace problem-solving regimes share four main characteristics: they are (1) problem-oriented, (2) functionally integrated, (3) data-driven, and (4) accountable. See Sturm, supra note 63, at 519-20.

173. Sturm, supra note 63, at 475 ("General rules, unless linked to local structures for their elaboration in context, provide inadequate direction to shape behavior."). The nexus between broad compliance standards and specific governance and accountability mechanisms, combined with the presence of a centralized clearinghouse to evaluate individual firms' success, provide the missing components to Krawiec's description of "network governance." See Krawiec, supra note 118 (arguing that open standards-based regulations create incomplete contracts within which parties can engage in strategic gap-filling).
connections between the firm’s own operations and problem-solving practices, and broad and vague governance and compliance standards, in a way that has nothing to do with facial adherence to externally-imposed, rigid rules.\textsuperscript{174} Overly-defined rules are never more than a proxy for more general standards; but overly-vague standards are only made real through their situational learning and careful testing in practice. Unlike traditional settlement arrangements, the True Reform Undertaking can make situational learning an integral part of Enforcement action.

B. Profile of the Third Party

Third Parties will have substantial discretion. What do we know, then, about their ability to effect change? How do we know they will not be captured, as agencies sometimes are captured by the entities they regulate? How will the Third Party manage resistance from inside the firm, and on what resources will it rely in the event of non-cooperation? What rewards will the Third Party seek in return for taking on this potentially thankless task? The Reform Undertaking substantially transfers the ability to reward and forgive from Enforcement to a Third Party. What, then, of the possibility that the firm’s and the Third Party’s mutual interests in closure and proclaimed success will also be aligned and that gaming conduct, present in relations with Enforcement, will simply be transferred to the post-settlement time frame?\textsuperscript{175} Given that the Enforcement context deals with worst actors, we cannot simply assume that firms will engage genuinely in the Undertaking process without credible oversight and without the certainty that other possible shortcuts have been blocked.

My purpose here is only to sketch out the broad outlines of the Third Party’s profile and to demonstrate the idea’s applicability to securities law enforcement.\textsuperscript{176} The problem is not a simple one, and the next step must be to identify the attributes that prove to be most important in actual securities law enforcement practice. But to be effective, the Third Party will surely

\textsuperscript{174} This also responds to Scholz’ worries about vague prophylactic compliance standards in the Enforcement context. Scholz suggests that firms are tempted to cheat on vague directives, and prosecutors have the power to insist on Herculean efforts at reform after wrongdoing has occurred (even if a firm took reasonable and effective self-regulatory steps before the fact). This produces a prisoner’s dilemma, where both firms and the SEC would be better off with vague rules, but both sides could gain an even more favorable outcome by cheating on the other. John T. Scholz, Enforcement Policy and Corporate Misconduct: The Changing Perspective of Deterrence Theory, 60 Law & Contemp. Probs. 253, 259 (1997). Making remedially-developed standards, instead of prophylactic ones, the driver dissipates some of this tension.

\textsuperscript{175} The worry brings to mind recent suggestions that so-called “independent” research analysts, whose industry was given an enormous boost by the terms of the 2003 Global Research Analyst Settlement, may also have conflicts of interest. See Ann Davis & Susanne Craig, Analyze This: Research is Fuzzier than Ever, WALL ST. J., Apr. 26, 2004, at CI.

\textsuperscript{176} For a compatible and more comprehensive description of the roles of various problem solvers in addressing systemic problems, see Sturm, supra note 63, at 522-37.
need four key attributes: credibility, independence, the right skill set, and accountability.

The Third Party will need credibility with the SEC, but more importantly, it will need credibility with the firm. It should be able to speak the firm’s language, including the language of value-for-money that will be relevant to the firm’s perception of the Reform Undertaking process itself. The Third Party should be aware of, and be prepared to dispel, the perception that the True Reform Undertaking is a cynical process or a rent-seeking opportunity for compliance professionals.177 The Third Party should probably be someone with previous experience in the industry writ large and with sufficient gravitas to signal that the Undertaking has the attention of management and the SEC.178 This is one reason that it may make sense to appoint top-flight law firms or high profile individuals as Third Parties. However, the most important element of credibility is likely the Third Party’s ability to continually generate trust. Doing so requires transparency and good faith in dealing with the firm, in what will no doubt be trying circumstances. Because we are dealing with worst-performing actors, it is appropriate to ensure that the Third Party has some considerable heft. Nevertheless, the Third Party can only facilitate, challenge, and oversee a process that must have the firm’s own agency at its core. Creating a communicative environment within which parties are willing to participate, and where they can imagine the possibility of a new way of doing business, is a crucial part of the role.

Second, the Third Party will have to be independent from the firm. This comprises both structural and psychological elements. Structural independence means that the Third Party should not be operating with a view to obtaining future business by curry the firm’s favor.179 The Third Party should also be able to rely on outside support from the

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177. See, e.g., Erica Beecher-Monas, Corporate Governance in the Wake of Enron: An Examination of the Audit Committee Solution to Corporate Fraud, 55 ADMIN. L. REV. 357, 368 (2003); Krawiec, supra note 118, 511-12, 528-32; Donald C. Langevoort & Robert K. Rasmussen, Skewing the Results: The Role of Lawyers in Transmitting Legal Rules, 5 S. CAL. INTERDISC. L. J. 375 (1997) (describing compliance personnel and lawyers as rent-seekers).


179. Most Reform Undertaking provisions restrict the Third Party’s ability to do business with the firm for a period of time after the Undertaking period is concluded. See, e.g., GE InVision, supra note 141 (requiring the Third Party to agree that, for the duration of its retainer and for two years thereafter, neither it nor any firm with which it is affiliated shall, subject to the Commission’s consent, “enter into any employment, consultant, attorney-client, auditing or other professional relationship with InVision, its successor-in-interest . . . or any . . . present or former affiliates, directors, officers, employees, or agents acting in their capacity”); In re Monsanto Co., supra note 141. Existing Reform Undertakings also stipulate that the firm shall not have the ability to terminate the Third Party and must cooperate with the Third Party’s investigation.
Commission in the event of non-compliance. The firm itself must recognize that it cannot exit. It must know that facial compliance, "freezing out" the Third Party, or other dysfunctional behavior has a good chance of being spotted and will result in the direct reappearance of the SEC's enforcement stick. 180 At the psychological level, the Third Party must have the courage to publicly repudiate the process or report to the Commission, if the Third Party concludes that it is failing irredeemably. 181 Here, Judge Rakoff's approach in the WorldCom settlement was to engage an individual whose own considerable reputation served as a buttress against the firm pressures. 182

Third, the Third Party will have to have a considerable range of skills and a level of acceptability to all parties without being beholden to any. The Third Party can and perhaps should be a team, not one individual. The Third Party must have the ability to connect and facilitate dialogue across the firm hierarchy, and to manage large volumes of viva voce and paper or electronic information. The Third Party will need a strong knowledge base in compliance and corporate governance principles, including issues of organizational structure and experience with culture. The ideal Third Party

180. An outstanding question is whether the firm has a right to contest the Third Party's findings. One independent Third Party monitor with experience in anti-corruption initiatives in New York City believes that the risk is too great that an appeal mechanism relating either to the Third Party's recommendations or to any centralized best practices standards would be hijacked by a firm that was disinclined to engage in the process in a meaningful way. Telephone Interview with Carl Bornstein, Attorney and Independent Third Party Consultant (Dec. 27, 2004). Existing Reform Undertakings, supra notes 136 and 140-55, make no provision for appeal by the firm. Although the firm can take issue with the Third Party's recommendations, those recommendations must be followed if an alternative good faith agreement cannot be reached between firm and Third Party.

181. In re Monsanto Co., supra note 141, requires the Third Party to affirmatively report violations of law to the company's compliance officer, who "shall then be obligated to promptly report the same" to SEC staff. Recently, Independent Monitor Edwin H. Stier publicly resigned his leadership of the International Brotherhood of Teamsters' internal anticorruption program. The program was established in 1999 as part of continuing federal oversight of the union following the 1989 settlement of a federal racketeering lawsuit. Mr. Stier resigned on the basis that union President James P. Hoffa, Jr. had "backed away from the Teamsters' anticorruption plan in the face of pressure from self-interested individuals." Steven Greenhouse, Citing Pullback, Antigraft Team Quits Teamsters, N.Y. TIMES, Apr. 30, 2004, at A1. There is considerable tension between the Third Party's "snitching" function and its ability to win the firm's trust. See Note, Mastering Intervention in Prisons, 88 YALE L.J. 1062, 1063 (1979) (arguing that conflicts between the multiple roles of Special Masters appointed in the prison reform context hampers their effectiveness). I do not believe this problem is insurmountable in this context. These parties are likely to have had more experience than prison administrators and inmates would with contingent or nuanced professional relationships. As sophisticated parties, they would likely respond positively to a clear statement of "ground rules" at the beginning of the engagement. Relative to the prison situation, this situation is less focused on working through powerful intergroup and interpersonal tensions than it is on working through a process that will save the firm from shutdown. Equally important is the background presence of the enforcement stick here, which operates on actors' direct interests and forces them to the table in a particularly urgent way.

182. See Breeden, supra note 20.
may or may not be a lawyer. At the same time, the Third Party will have to be judicial and able to take into account the power imbalances between, for example, management and the individuals that “followed orders” during the era of the law violations. The Third Party must be alive to the possibility that the firm’s directing minds may be tempted to scapegoat individuals. A “justice audit” should be part of the process. The Third Party, like the firm, is a potential abuser of individual due process rights.

Faced with the hurdles of trying to create change, the parties, Third Party included, could be tempted to satisfice for superficial compliance or less thorough reforms. The Third Party may also be tempted by over-rigid resolutions in situations where any progress, however superficial, seems better than deadlock.

For all these reasons, the Third Party must be accountable to the SEC. Her ultimate report should speak not only to recommendations for firm change, but also to the Third Party’s own methodology and independence. The Third Party cannot be the final arbiter of the success of her own recommendations. There must be a mechanism to ensure that the same satisfying that characterizes the pre-settlement Enforcement process does not characterize the True Reform Undertaking process. There should be no attorney-client privilege between the firm and Third Party since this promotes information hoarding and prevents comparative learning. The Third Party’s report should speak not only to areas where there was

183. In other areas of reform-minded remedies, the most innovative New Governance changes seem to take place when lawyers are not at the table. Linda Treviño has argued that the presence of lawyers signals mistrust and suggests that the reforms are the product of external compulsion. Linda Klebe Treviño et al., Managing Ethics and Legal Compliance: What Works and What Hurts, 41 CAL. MGMT. REV. 131 (1999). Legal training also results in a focus on narrow, legalistic, compliance approach as opposed to a “values approach.” Id. Contra Sturm, supra note 63, at 527-30 (applauding, through example, lawyers’ ability to develop “flexible, accountable” remedies aimed at reform).

184. Serious resource inequalities between the firm, the individual, and the Third Party exist in the Reform Undertaking process, but this is a topic for another paper. Richard Stewart has suggested that in the 21st century:

- New forms of administrative law will be developed to address the distinctive issues presented by the new network and economic incentive methods of regulation . . .
- Formal legal procedures, backed by judicial review, will be targeted toward protecting private rights from particularized applications of regulatory power, although there may be renewed scope for tort law as well.

Stewart, supra note 73, at 454. See Gillian E. Metzger, Privatization as Delegation, 103 COLUM. L. REV. 1367, 1371 (2003) (arguing that current state action doctrine is inadequate to address the constitutional challenge presented by privatization).

185. Cf. Sturm, supra note 62, at 1413 (arguing that, in the context of courts, such a dual role creates an appearance of unfairness and prevents a full articulation of the normative reasons underlying the adoption of a particular remedy). In this respect, the fact that little public information has emerged on the SEC’s response to Third Parties’ final reports is worrying.

186. Appropriately, the more recent Reform Undertakings stipulate that there shall be no attorney-client relationship between firm and Third Party. See, e.g., supra notes 142, 143 and accompanying text.
considerable success, but also to those inevitable areas where compromises were reached or roadblocks were encountered. The information should be capable of being aggregated—it should be set out in a sufficiently organized form that others can learn from it, and the Commission can compare one result to another. At the same time, conscious attention should go to ensuring that there does not emerge a reporting "orthodoxy" that causes different firms to reach the same conclusions, not independently because they are good ideas, but rather through mimicry with a view to satisfying the Commission in the least intensive way. Third Parties are not expected to reinvent the wheel—quite the contrary—but they should be prepared to demonstrate that they have given independent thought to the particular people, process, and place before them.

Obviously this is challenging work, but real success is far from impossible. Enforcement action, buttressed as needed by additional enforcement sticks, is virtually the only way to put such a challenging yet promising investigative process in motion at a worst-acting firm.

C. The Need for a Center

Even if the Third Party succeeds in creating a Reform Undertaking process that can negotiate the pitfalls of collective self-reflection in this charged situation, progress will remain ad hoc and accidental without coordinating insights from other successful Reform Undertaking processes. On the aggregate level, as well, the SEC needs a mechanism that can compare one firm’s response to another’s, both to make the process credible and to augment Enforcement learning. Information capture represents one of the real benefits of using Reform Undertakings over less transparent settlement mechanisms. Conversely, a failure of good information processes significantly undermines the structure’s promise.

Thus, the True Reform Undertaking approach should be reinforced by the active presence of a centralized data clearinghouse: i.e., an information-gathering and learning structure that aggregates information on the progress being made in these worst cases. Progress should be measured by reference to high-level impacts and outcomes, not just outputs. The clearinghouse function also serves a social signaling

187. Several New Governance scholars agree on the need for a centralized data management clearinghouse. See, e.g., Dorf & Šabel, supra note 64, at 345-56 (calling for agencies to engage in benchmarking, or “comparative evaluations” of one another, in order to ultimately achieve best practices); Bradley C. Karkkainen, Collaborative Ecosystem Governance: Scale, Complexity, and Dynamism, 21 VA. ENVTL. L.J. 189, 222-25 (2002) (advocating that different levels of government “pool” their information in order to “build a richer collective understanding . . . of [a] problem”); Sturm, supra note 152, at 9. See also Sparrow, supra note 75, at 167-68 (expressing a desire for agencies to “organize the lessons they learn and to make the accumulated knowledge readily available”).

188. See Wilson, supra note 83, at 161-62 (noting that focusing on output creates an
purpose. Deterrence, on its own, sends a message of seriousness about corporate wrongdoing. However, having a clearinghouse that can evaluate success in changing corporate culture sends a much deeper message of seriousness and makes it clear that facial compliance or other mechanisms for short-circuiting the change process will not be tolerated.

The clearinghouse must focus on best practices among Reform Undertakers, rather than industry standards or rigid rules. This gives Enforcement the ability to define the ends to be achieved by comparison to other examples, to challenge failing firms and their Third Parties to investigate the methods, and to meet the achievements of their peers. In addition to providing Enforcement with standards by which to measure progress, valid centralized data gives both firms and their Third Parties more information, helping them to learn simultaneously from their own experience and the experience of others. The clearinghouse would be in a position to mandate that firms and Third Parties maintain careful records and record data in a way that permits aggregation with other data (from other firms and elsewhere), which helps predict potential problems and identify systemic weaknesses. It should develop comparison matrices, and settling firms could be required to develop and make data available in that form as an additional settlement condition. Measured performance improvement would have to be a presumptive condition for lifting True Reform Undertaking conditions.189

Crucially, a best practices regime or “rolling best practices rulemaking” forces better learning by firms. Without conscious, outcome-based analysis, institutional responses to the coercive Undertaking mechanism may produce imitative isomorphism between firms, based not on that firm’s internal investigation and considered response but rather on mimicry of other previously approved compliance programs.190 Because the

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189. Because of its situation within the enforcement context, there will never be as much room in my model for parties’ own articulation of novel governance standards as there is in the most wide-ranging versions of experimentalism. See, e.g. Dorf & Sabel, supra note 64, at 404-07 (noting that gains in efficiency are often made when those who have traditionally been denied a voice are given one). Settling firms must be able to revise what constitutes “good governance” and to make a case for trying out novel compliance mechanisms, but their proposals would have to meet the approval of the SEC so long as they were operating within the Reform Undertaking timeline. Given their limited credibility in Enforcement’s eyes, they would have to make their case quite compellingly.

relationship between rule and response is reciprocal, industry practices in Reform Undertakings can become the basis of enforced legal norms for subsequent firms for no better reason than that others have used them.\textsuperscript{191} The risk of missing the mark with any particular firm, and consequently, the risk of recidivism, increases to the extent that the received wisdom on how to navigate through the Reform Undertaking process, perhaps based on replicated industry standards and imperfect information about how a specific firm operates, misaligns the Undertaking response with root causes of wrongdoing. Institutional learning by regulators is curtailed, and regulatory thinking is constrained. By contrast, best practices standards are continually evolving, which limits the parties' ability to satisfy for facial compliance.\textsuperscript{192}

The SEC's new Office of Risk Assessment, established in 2004, is the place for the clearinghouse function. Its staff is tasked with gathering and maintaining data on new trends and risks from a variety of sources, such as external experts, domestic and foreign agencies, surveys, focus groups, and other market data, including both buy-side and sell-side research. The Office of Risk Assessment also analyzes data to identify and assess new areas of concern across professions, companies, industries, and markets, as well as prepares assessments and forecasts on the agency's risk environment.\textsuperscript{193} The Office is an overarching body, not situated within Enforcement.\textsuperscript{194} The Office has internal risk teams which work according

\textsuperscript{191} See, e.g., Lauren Edelman, \textit{Legal Environments and Organizational Governance: The Expansion of Due Process in the Workplace}, 95 Am. J. Soc. 1401 (1990) (arguing that industry elaborations on broad equal protection requirements become the basis for court-defined "industry standards," constituting the statutory mandate for subsequent industry actors).

\textsuperscript{192} See Dorf & Sabel, \textit{supra} note 64, at 354-56 (describing "rolling best practices rulemaking"); Sabel & Simon, \textit{supra} note 62, at 1074-75 (describing the "Veil Effect"). Obviously the presence of the words "best practices" in a firm's compliance manual does not mean that best practices are observed. See, e.g., Breeden, \textit{supra} note 20. This observation only reinforces the need for a meaningful clearinghouse function.

\textsuperscript{193} See William H. Donaldson, Testimony Concerning Regulatory Reforms To Protect Our Nation's Mutual Fund Investors Before the Senate Committee on Banking, Housing and Urban Affairs (Nov. 18, 2003) ( canvassing the components of the new "risk management initiative"), at http://www.sec.gov/news/testimony/ts111803whd.htm. This discussion is also compatible with the SEC's latest Strategic Plan, which focuses more explicitly on risk assessment, data analysis, and the quality of internal agency functioning than any plan to date. According to the Plan, the information coming from the risk assessment process will also be used to make the SEC's enforcement pyramid more informed and rational in its resource allocation:

\begin{itemize}
\item Such risk assessment techniques also will help the SEC focus its examination and disclosure review programs. In identifying firms and filings to examine, the Commission is shifting away from a "one size fits all" review cycle to new risk-based approaches that direct resources toward those firms, issuers, filings, or industries that most warrant review.
\end{itemize}

\begin{itemize}
\item SEC Strategic Plan, \textit{supra} note 87, at 25.
\end{itemize}

\textsuperscript{194} The clearinghouse should not be too closely tied to Enforcement. The SEC must be in a position to pronounce the success or failure of each Reform Undertaking, but involving
to a bottom-up approach for major program divisions. The Office will coordinate those teams with a view to anticipation and early identification of potential problem areas or illegal or questionable activities, across the securities industry.\textsuperscript{195} The work of the Office of Risk Assessment is complemented by a Risk Management Committee, whose primary responsibility is to review the implications of identified risks and recommend an appropriate course of action.\textsuperscript{196} The key challenge, as the risk management function defines itself, will be for it to actively develop rolling best practices rules as a basis for forcing accountability within the True Reform Undertaking process.

\textbf{D. Ramifying Back to the Enforcer}

As Jim Liebman observed in a different context, no one chose to create a prosecutorial system that seemingly rewards horse-trading and scapegoating, facial but meaningless compliance structures, and insensitivity to prosecutors’ inability to handle the massive volume of information they face.\textsuperscript{197} In identifying the prospect of spurring institutional reform of firm culture, and in recognizing its own institutional limitations in achieving that goal, SEC Enforcement may have succeeded above all in charting a path toward its own reform. Recent scandals across financial sectors, followed by Enforcement scrambling to demonstrate its own continued relevance to problems of culture, have brought the clear incapacity of Enforcement’s processes into sharp relief and suggested new reformative possibilities. Seen this way, the SEC may only now be catching up with innovations in enforcement at other administrative agencies, where the utter failure of the command-and-control administrative model (not an issue in the disclosure-based securities

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\textsuperscript{196} See Donaldson, supra note 193.

\textsuperscript{197} See Liebman, supra note 130, at 2155-56; see also William J. Stuntz, The Pathological Politics of Criminal Law, 100 Mich. L. Rev. 505, 523 (2001) (arguing that criminal law as written differs substantially from criminal law as enforced as a result of incentives for and politics between legislators, prosecutors, and judges and warning that “the law’s messages are likely to be buried, swamped by local variation and hard-to-discriminate arrest patterns, by low-visibility guilty pleas, and even lower-visibility decisions to decline prosecution”). MICHAEL LEVI, REGULATING FRAUD: WHITE-COLLAR CRIME AND THE CRIMINAL PROCESS (1987) (arguing that white collar criminal law and law enforcement in the United Kingdom is more the product of sporadic and irrational political forces than rational planning).
regulation context) began to force change more than a decade ago.\footnote{198} Enforcement behavior, like prosecutorial behavior more generally, is a product of its own structure and processes, and that structure will create its own context-specific effects.\footnote{199} What an employer measures and rewards will have an effect on outcomes and employee behavior. Thus, Enforcement staff should be trained to identify key elements of a forward-looking, transparent, and accountable remedial scheme, to be distinguished from resolutions that achieve case closure at the expense of other values, including due process to individuals or broader corporate citizenship norms. Individual Enforcement staff should be rewarded to the extent that their own decisions are demonstrably as information-based and systemically justified as the good governance requirements they impose on firms.\footnote{200} The same standards of credibility and transparency that characterize the True Reform Undertaking process should characterize problem-solving at Enforcement.

\footnote{198} During the 1990s, enforcement functions in agencies such as the IRS, OSHA, and Customs began to develop their own vocabulary focused on risk reduction that incorporated the problem-solving, results-oriented, data-intensive, and industry-collaborative characteristics of New Governance regulation. \textit{See generally Sparrow, supra note 75} (recounting the history of non-SEC administrative enforcement reform in the 1990s). Sparrow’s empirical research across regulatory bodies found that three common elements characterized the best new enforcement structures as of the year 2000: (1) a clear focus on results—not in terms of process or quotas, but based on an expanded and more specific set of indicators including “big picture” Mission Statement-level impacts, behavioral outcomes such as compliance rates, agency activities, outputs, and resource efficiency; (2) adoption of a disciplined problem-solving approach based on systematic identification and prioritization of important risks or patterns of noncompliance, a flexible and functional project-based approach, and periodic outcome evaluation with flexible resource allocation based on outcomes; and (3) selective investment in collaborative partnerships. Sparrow suggests (as I do here) that partnership with bad actors may be more important in achieving results. \textit{Sparrow, supra note 75}, at 103-08.


\footnote{200} The SEC’s latest Strategic Plan emphasizes the need to “sustain and improve organizational excellence.” The Plan announces a new continuing education program, new performance measurement systems, and a new pay-for-performance system for individual employees. \textit{SEC Strategic Plan, supra note 87}, at 26-27. The SEC should include credit for innovative solutions that circumvent organizational limitations in performance metrics. \textit{See also Sparrow, supra note 75}, at 168 (recommending rewards for employees’ successful problem-solving efforts).
Actually, reworking Enforcement staff incentives to reward transparency and demonstrably reasoned decision-making is the easy part. The larger challenge for Enforcement will be to imagine a global approach to securities law enforcement that remains healthily skeptical, liability-conscious, and closure-permitting. This approach must show greater responsiveness to the strictures under which real-world enforcement operates and acknowledge the magnitude of the challenge of spurring widespread institutional reform. New Governance theory offers a theoretical structure for making sense of the Reform Undertaking in both normative and efficiency-based terms. In return, the creative action of enforcement personnel in practice is a reminder to New Governance theorists not to underestimate either the necessity or the creative potential of the enforcement role.

Enforcement has its own purpose. It is not a court, a corporate governance consultant, or a rulemaking administrative body. This is not to say that, to the extent that Enforcement action can spur long-term changes in firm behavior, we should fetishize the distinction between regulation and enforcement. The challenge in regulation is to identify how each actor can leverage its unique qualities of place and purpose to permit learning and wise, context-specific, impact-aware problem-solving. It requires the actor in question to understand the purposes it is trying to achieve and to learn from its own experience.

V. TOWARD A NEW ENFORCEMENT MODEL

Forward-looking, reform-oriented regulatory structures can and do function within traditional Enforcement structures. Understanding this hybrid requires some elaboration. Three points seem especially relevant.

First, one would not want to lose, through a novel enforcement approach,

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201. Consider Mr. Cutler's recent comments:

As an enforcement lawyer, I am quite familiar with the complaint, often raised by defendants or respondents, and even by an occasional SEC Commissioner, that a proposed settlement amounts to rulemaking by enforcement. While I'm confident that we hear that argument far more often than warranted, it points up that an enforcement proceeding can, in fact, realign an industry standard. That is, when faced with the risks and costs of litigating an enforcement action, some parties may agree in settlement to change or restrict their future conduct in significant and far-reaching ways.


202. My focus is on the Reform Undertaking as a straddling device between New Governance and traditional enforcement models. Many other important elements of building a new enforcement model are beyond this paper's scope—how Enforcement ought to nominate and select firms for Reform Undertakings and how Enforcement should allocate resources to individual projects. See generally SPARROW, supra note 75, at 155-70 (describing components of a "problem solving infrastructure").
Enforcement's unique structural advantages. Certain elements of the enforcement model—primarily the reliance on temporary, task-specific teams and context-specific remedies—give enforcers an edge over other regulators in devising good responses to problems among public companies and regulated entities. Second, one must be prepared to imagine that a flexible, learning-by-doing structure can exist embedded within a more traditional adversarial one. Finally, the advantages of nesting New Governance experimentation within coercion can be significant because it allows Enforcement staff to rely on the full range of behavior-modifying mechanisms, from shaming to information-forcing remedies.

A. Structural Advantages

Perhaps surprisingly, certain aspects of the Enforcement function seem to mesh more naturally with New Governance mechanisms than do those mainstream regulatory functions that adapted the new methods first.

To begin, Enforcement mechanisms naturally work from the specific to the general, rather than the other way around. Enforcement staff is tasked with responding to the empirical evidence from a particular case, and this spares them some of the clumsy overreaching of the under-informed rulemaker. Indeed, as the history of New Governance initiatives has shown, command-and-control regulators have struggled to develop mechanisms to absorb and learn from the kind of information that flows continually and easily to Enforcement (a fact that causes one to wonder why enforcement divisions have not been central information-gathering tools for modern regulators across the board).

Second, compared to mainstream regulators, enforcement teams are flexible and temporary. Law and practice have allowed them to operate relatively free of bureaucratic process obligations, and they are more likely to be immune to bureaucratic sclerosis: i.e., the accretive process and personnel commitments that make quick response capability difficult to maintain over time. Enforcement managers can choose the right people, internal and external, for the job at hand. They can disband the teams when the job is complete, and they can have a new team coalesce for the next round without fear of flouting internal agency protocols. To some degree, shifting team composition can prevent ingrained distrust from building up between parties, even where the temporary team members continue to come from a pool of Enforcement staff. Because of their one-case-at-a-time orientation, the remedies that temporary teams develop (staffers and firms in drafting Reform Undertaking terms, and Third Parties and firms in

203. See Stewart, supra note 73, at 440-42, 446-48 (describing events resulting in regulatory process "fatigue" in recent decades).
effectuating them) can be tailored to the facts at hand. Enforcement can experiment with multiple possible solutions at once, across short timelines, and try to force very discrete kinds of action in the hope of catalyzing a broader compliance cascade.

Third, largely due to resource constraints, Enforcement practice is accustomed to decentralizing the investigatory and learning processes to the firm being investigated. We have discussed the attendant risks above, but the practice also has the advantage of leaving some degree of agency with the industry actors themselves. From this position, it is an extrapolation, rather than a complete change of direction, to work on achieving endogenous firm learning and norm generation.

Finally, and importantly, enforcers have no choice but to be outcome-oriented in that they are tasked with finding solutions to specific problems. Enforcement concentrates on taking action and doing so with respect to the worst actors in the system. Regulators may be tempted to focus on the most enlightened members of the regulated community or to highlight gold star companies to demonstrate the wisdom of their policies. We should not forget that regulatory regimes operate within a larger political system and that regulators can be responsive to political pressures. In contrast, frontline Enforcement staff members have no choice but to try to do something about intransigent actors and intractable problems. In this respect, so long as they are not allowed to take shortcuts in the form of credit-for-facial-compliance or credit-for-cooperation, Enforcement staff’s on-the-ground actions can have as much impact, though in a different way, as the broadest legislative responses. For all of these reasons, as well as for the special constraints under which enforcers operate, the particular nature of enforcement action deserves closer study than it has received from New Governance scholars thus far.

B. Embedding New Governance

The conflict between firm welfare and investor protection is a mixed-motive situation.\(^{204}\) That is, over the long term, SEC Enforcement’s interests and the firm’s interests are neither purely cooperative nor purely competitive. By pulling the reformatory project away from the liability-oriented one, the Reform Undertaking creates a space within which the parties can transcend adversarial win/lose dichotomies and concentrate on specific, achievable steps that can serve both long term investor protection and long term firm flourishing. The Reform Undertaking, as introduced by SEC Enforcement, represents a significant new approach to securities law

enforcement. It contradicts the stereotype of enforcement personnel as stuck in an outmoded, adversarial, almost actively anti-reformative posture.\footnote{205}

Bifurcating the problem-solving remedy from the liability stage also allows Enforcement's reform aspirations and its non-delegable mandate to coexist. It embeds the reformatory project within a still-viable prosecutorial function. There are costs at the margins, in that the firm's problem-solving process will probably not be completely free of a coercive taint. However, the comparison should be to other existing alternatives, not to an idealized problem-solving technique. At a minimum, the Reform Undertaking process holds out the possibility of catalyzing an endogenous reformatory process within a firm—a possibility that is largely precluded by credit-for-compliance and credit-for-cooperation settlement arrangements and that may never be more than an accidental byproduct of massive deterrence. Perhaps one of the most exciting questions is how far back one can push the reformatory project: i.e., whether the presence of an open and iterative remedy at the back end can give the SEC the comfort to rejig its modus operandi at the front end—moving away from both overly rigid-but-enforceable rules in Enforcement, and underspecified-thus-costly prophylactic standards in regulation.\footnote{206} One might hope for a new form of governance, emanating from Enforcement's Reform Undertakings, that marries a high-level, standards-based understanding of compliance with the flexible and evolving yet specific architecture necessary to make those standards meaningful. Further, one might hope for it under what is likely to be the outcome-oriented, industry-focused, and decentralized leadership of Chairman Cox.\footnote{207}

The Reform Undertaking also serves as an optimistic counterexample to those who worry that adversarialism and entrenched interests inevitably consume or undermine fragile experimentalist processes.\footnote{208} Relative to

\footnote{205. See supra note 79. Criminal prosecutors have made similar advances. See supra notes 6, 11.}
\footnote{206. It is a harder project to ramify the learning all the way back to Congress, which also promulgates broad prophylactic requirements.}
\footnote{207. One set of observers has commented on the striking way in which the current presidential administration, through its emphasis on decentralization and accountability in government programs, may have unexpectedly put into motion a vast reevaluation of public responses to systemic problems, far beyond those programs' intended mandate. They argue that, despite its many deficiencies, this may be the case with the No Child Left Behind Act in education. James S. Liebman & Charles F. Sabel, The Federal No Child Left Behind Act and the Post-Desegregation Civil Rights Agenda, 81 N.C. L. Rev. 1703 (2003).}
\footnote{208. See Mark Tushnet, The New Constitutional Order 168-72 (2003) (urging caution against, but nonetheless advocating, "democratic experimentalism" because of its nascent status, its unknown outcomes, and its questionable effectiveness); Mark Tushnet, New Institutional Structures of Governance and American Political Development, in New Governance and Constitutionalism in Europe and the U.S., supra note 81 (manuscript at 18-20, on file with author) (observing that traditional national interest groups, such as...}
situations lower on the enforcement pyramid, enforcement is the least hospitable environment for New Governance solutions. Mutual trust between the parties is substantially lacking. Past efforts at voluntary compliance with the law have demonstrably failed. The primary actors in this scenario—Enforcement staff on one hand, and firm on the other—are operating in a high-stakes, adversarial, potentially punitive environment. This is not a benign “laboratory for democracy,” and one party is in a position to impose sanctions on the other.\textsuperscript{209} Costs are clear, and high. Nevertheless, Enforcement staff, on its own initiative and operating in its adversarial stance, has sketched out a structure that gives the worst actors in its regulated universe an opportunity to transcend that acute adversarial situation through a reformist experiment.

\section*{C. Remedial Agnosticism}

Experimentalism in its pure theoretical form might eschew the blaming/punitive component of enforcement in favor of prospective steps directed at future reform,\textsuperscript{210} but I argue for the continued utility of, and theoretical justification for, a full range of legal responses. When dealing with the worst actors, the central concern must be what seems to work most consistently and demonstrably in effecting the sought-after change.

I share the conviction that New Governance-style participatory problem-solving processes are a most promising mechanism for spurring institutional reform. This does not mean that one should hope for a deeply effective process to emerge spontaneously. While New Governance puts actor agency at the core of its program, it is not a voluntary compliance model. Most New Governance theorists would agree that, in the regulatory context, a coercive stick is essential to making an enforcement pyramid function.\textsuperscript{211} Significantly, this is a stick of a different kind than that

\footnotesize{\textsuperscript{209} See New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (“It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.”)).


\textsuperscript{211} Karkkainen, \textit{supra} note 159; see \textit{Ayres & Braithwaite}, \textit{supra} note 21, at 35-41; John Braithwaite, \textit{Institutionalizing Distrust, Enculturating Trust, in Trust and Governance} 343, 356 (Valerie A. Braithwaite & Margaret Levi eds., 1998) (arguing “that without a strong state capable of credible deterrence and incapacitation, you cannot channel regulatory activity down to the base of the pyramid, where trust is nurtured”); Karkkainen, \textit{supra} note 63, at 485-89 (rejecting a model of New Governance that obviates any need for “hardness” in the law); Sabel & Simon, \textit{supra} note 62, at 1067 n.154 (recognizing that the threat of sanctions is a “key function ... [in] forc[ing] to the table a party who otherwise might not be willing to negotiate at all”); Archon Fung et al., \textit{Inst. for Government Innovation, The Political Economy of Transparency: What Makes Disclosure Policies Sustainable?} 41-42 (2002) (asserting that enforcement is a central component of New Governance), at http://www.ashinstitute.harvard.edu/ Ash/FGW.pdf (last visited Aug.
presented by the fear of massive one-time monetary sanctions. It is information-forcing and participation-forcing over a longer period of time relative to a traditional enforcement action and is directed at stimulating the kind of bottom-up change that is more likely to be sustained and self-reinforcing. When dealing with actors that require a nudge in the right direction, New Governance regulation via the Third Party steps up inspections and sets comparative benchmarks to challenge the firm to face and respond to its own deficiencies in processes and outcomes.212 Firms can be expected to want less regulatory interference in their daily operations. Thus, in situations where something like an experimentalist system is up and running, one can theoretically give firms incentives to improve by stipulating that good behavior—in the form of demonstrated good practices and internal learning—leads to greater autonomy, and bad behavior leads to greater scrutiny.213 One may anticipate a cascade effect as a critical mass of firms in a particular industry begin to observe good practices, to share information, and to put in place mechanisms that allow them to self-reflect.

This paper’s concern is for what happens when the necessary mindset has not emerged and shows no signs of emerging among certain industry actors. In other words, the question is what happens when, even if the need to do something seems clear and urgent to outsiders or to some of the parties involved, other key parties are resistant and even hostile to reform efforts.214 Some firms and even some industries may be too pathological or dysfunctional, and their own stories about themselves too entrenched to be pulled in through experimentalist incentives. A system that presumes a certain base level of capacity and bona fides among industry actors will find no initial purchase among the worst actors. New Governance theory would respond by shutting the intransigent firm down. The top end of the New Governance enforcement pyramid is the penalty default. It is a harsh result, suboptimal for all parties, including shareholders and employees, and operates as a default outcome in the event that Enforcement and the

12, 2005).
212. See Dorf & Sabel, supra note 64, at 336-39 (recognizing that “firms often turn to third parties to organize benchmarking”).
213. It makes sense to speak specifically of experimentalism in this section. Among New Governance approaches, experimentalism provides the most completely imagined description of incentive systems for ratcheting up best-practices learning among decentralized groups.
214. It is thought that new forms of experimentalist governance are most likely to emerge in circumstances where both ends and means are disputed. Nevertheless, there is a collective sense of urgency that something must be done. Without knowing how frequently those conditions prevail, or if close to ideal conditions are necessary before experimentalism will gain momentum, we can agree that those conditions are not obviously present in every situation that calls for institutional reform.
firm fail to reach a satisfactory accommodation.215 In practical terms, this means that SEC Enforcement retains the right and the means to destroy or shut down the noncompliant firm.216 To function as intended, however, the default option must be credible. Enforcers must be willing, in extreme cases, to allow the default option to play itself out.217

The penalty default is a necessary part of any enforcement scheme, but it should operate as a last resort. Except when dealing with utterly criminal organizations, public interest considerations argue against destroying publicly held, wealth-creating, and job-providing organizations, even where they may be quite flawed in governance terms. Nevertheless, there may be considerable space between the penalty default option and the point at which experimentalist learning necessarily will take hold. For this reason, other options, including the use of traditional enforcement sanctions, should be considered before enforcement’s worst-case-scenario is allowed to play itself out.218

215. See Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 YALE L.J. 87 (1989) (coining the term “penalty default” in the context of contract theory); Bradley C. Karkkainen, Adaptive Ecosystem Management and Regulatory Penalty Defaults: Toward a Bounded Pragmatism, 87 MINN. L. REV. 943, 965-83 (2003) (introducing the “regulatory penalty default” in the environmental context). Penalty defaults are likely to prove especially useful in contexts where, due to a high degree of local variability, the best results are highly fact and context specific. Id. at 977. This applies to institutional corporate governance reform as well. Karkkainen worries about rent-seeking agencies and whether the need for an objective third party to impose the penalty default are also apropos. Id. at 938-90.

216. For example, punitive fines from the SEC can force a noncompliant firm into bankruptcy. The SEC cooperates with criminal prosecutors on the most serious cases. By bringing a successful civil fraud conviction against a firm in federal court, the SEC triggers other federal statutes that may make it difficult for the corporation to continue as a going concern. See, e.g., Federal Acquisition Regulation, 48 C.F.R. §§ 9.406–407 (2005) (barring or suspending a firm from obtaining federal government procurement contracts). Private securities litigation and less commonly, state business charter revocation may also follow on the heels of an SEC investigation and force a company into bankruptcy. SEC actions also affect a firm’s reputation.

217. I am not suggesting that giving regulators the power to shut down noncompliant actors is unique to New Governance theory, far from it. I mean that the penalty default is an integral component of the enforcement pyramid structure that informs the New Governance approach to enforcement. In fact, even the idea of an enforcement pyramid has deep roots in securities regulation. As William Orville Douglas stated decades ago, government’s role in regulating finance was to “keep the shotgun... behind the door, loaded, well oiled, cleaned, ready for use but with the hope that it would never be used.” WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 82 (James Allen ed. 1970).

218. Some experimentalist work does envision spurring reform through graduated traditional sanctions. E.g., Dorf & Sabel, supra note 68. Thus far, this avenue is underdeveloped. This project moves beyond the drug treatment court model in note 68 in the following ways: it is concerned with the actions of enforcement personnel, not a specialized but still arm’s length court. As such, it must address the complicated strategic environment of settlement, rather than picking up the narrative after the subject individual has already pled guilty. Problems of responsibility, causation, and remedy are substantially more complex for the regulator when addressing institutional culture rather than individual drug-related law violations. While the drug treatment court model focuses on the court as experimentalist organ, this project is preoccupied with spurring a decentralized experimentalist process within settling firms, producing a subsequent feedback effect on
In fact, prosecution in all its forms can focus the mind. A True Reform Undertaking, embedded within and buttressed by deterrent sanctions, shaming, selective business line shutdown, individual liability, disgorgement or restitution, and any number of other enforcement options can be the bridge between the worst actor and the abyss. Shaming and blaming can serve a forward-looking purpose as well as a retrospective one. Public liability determinations, too, affect a firm’s reputational capital. Network effects in business relations flow from and often reinforce the shaming effect of public sanction. If firms believe that the adverse consequences for failing at the Reform Undertaking stage will be swift, significant, and certain, then even unreconstructed old school Enforcement action may get people moving. Some of these options may be necessary, if insufficient, components of a comprehensive coercive reform-spurring process.

In this way the line between deterrence and reform generation blurs, reminding us of the danger of overdrawing that distinction. None of this undermines the promise of the New Governance approach: it does not say that sanctions work and New Governance is epiphenomenal. What it does

SEC Enforcement. The absence of a court structure at the center of this project makes it more challenging, contingent, and complex but also more reflective of actual securities law enforcement practice.

219. This is one of the options being considered by the New York Stock Exchange. See Betz, supra note 28.

220. Two scholars making this point, essentially on expressive grounds, are Schlegel and Braithwaite. See John Braithwaite, Crime, Shame and Reintegration (1989) (arguing that public condemnation and shaming can have a reintegrative and community-affirming effect on law violators and those affected by them); Schlegel, supra note 13 (arguing that punishing corporations sends an important message of social condemnation distinct from any subsequent general deterrent effects). New Governance scholars have pointed out important differences between the profile of a retrospective, liability-allocating model and the imperatives inherent in a remedial, or otherwise more prospective and problem-solving, model. There may be a tendency to overdraw the distinction in the interest of making it visible. See, e.g., Simon, supra note 81 ( contrasting "mainstream jurisprudence" with "Toyota Production System as jurisprudential phenomenon"). In any remedial process arising out of a finding that the organization’s previous practices are unacceptable, allocations of liability will leave an impression on subsequent events. Forward-looking remedial problem-solving mechanisms are, of course, different from retrospective liability determinations, but those involved in the problem-solving will not (and should not be expected to) operate as though history and liability were irrelevant. On the contrary, one of the key functions of the problem-solving process will be to make sense of the organization’s collective history.

221. See supra notes 46-50 and accompanying text.

222. Commissioner Glassman has said:

[There is no question that fear is a potent motivator. Therefore, if fear of an investigation or enforcement action motivates board directors and executives to make sure that their companies are complying with the spirit and the letter of the securities laws, that’s OK with me—just as long as the result is that people are encouraged to, and in fact, do the right thing.]

say is that New Governance-inflected approaches to reforming firm culture can work, especially when reinforced by consequences for failure. While alternate sanctioning effects will impose some costs on the problem-solving process, the only way to determine whether the costs are worth running is to set up a mechanism by which the SEC can monitor and evaluate the Reform Undertaking structure in practice. This brings us full circle. In focusing on reforming firm culture and in taking the first steps toward incorporating New Governance style remedies into its approach, SEC Enforcement may have charted a path toward its own institutional reform.

POSTSCRIPT: A DIFFERENT KIND OF GOVERNANCE

This paper identifies some dangers of over-abstraction in discussing governance. Securities law enforcement is a system that attempts to protect investors and allocate responsibility for past wrongdoing, veined through with other values such as efficiency, retributivism, the search for political capital, and market pressure toward closure. Moreover, who enforces the principles—be it courts, the actors themselves, or some third party—is at least as integral to how and whether it will work as is the theoretical distinction between New Governance and other methods. It is only likely to work where all parties believe that they will be accountable, through transparent processes, to a larger audience than they can control.

The securities law enforcement example is a lesson in the value of contextual analysis and open-minded examination, not only as a theoretical matter relevant to regulators, but also as an imperative for those of us that write about them. Innovations are taking place, perhaps unexpectedly for New Governance scholars, in the interstices of securities law enforcement practice. They risk going unnoticed by those most pessimistic about the enforcement model's limitations, or most committed to the bright line between retrospective, liability-oriented mechanisms and prospective, remedial-stage problem-solving ones.

This paper does not propose final solutions, and it leaves some questions unanswered. Yet, it argues that a coherent hybridity between experimentalism and securities law enforcement structures can, and should, exist. In presenting the differences between existing settlement approaches and the new Reform Undertaking model, the right questions, from the perspectives of justice, accountability, market health, and investor protection, have been raised.

223. See also Tom R. Tyler & Yuen J. Huo, Trust in the Law: Encouraging Public Cooperation with the Police and Courts 95 (2002) (arguing that even while police compel obedience through the threat or use of force, they can also gain the cooperation of people with whom they deal if they behave in procedurally fair ways).
Even more significantly, in trying on the Reform Undertaking approach, SEC Enforcement has opened the door to further developing its own unique expression of New Governance-style learning in the particular enforcement universe within which it operates. In its best form, the powerful combination of enforcement and New Governance contains the potential to transform not only the way the SEC deals with the worst actors, but also the way it structures itself. These are exciting developments that will bear watching.
New Governance, Compliance, and Principles-Based Securities Regulation

Cristie L. Ford

I. INTRODUCTION

The significance and wisdom of “principles-based” securities regulation may be among the most pressing questions facing securities regulators internationally today. The Financial Services Authority (FSA) in the United Kingdom moved to a comprehensive principles-based regime in 2003. The shift attracted a great deal of interest as it came to light that in 2005, for the first time in recent history, the overwhelming majority of the largest international Initial Public Offerings took place in London rather than in New York.\(^2\) A report by consultants McKinsey & Co., commissioned by

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\(^1\)Assistant Professor, University of British Columbia Faculty of Law. I am grateful to Alex Burton, Michael Dorf, Brandon Garrett, Harvey Goldschmid, Troy Paredes, Chuck Sahel, Bill Simon, Peter Strauss, Susan Sturm, and participants at Brooklyn Law School’s International Economic Law Forum, the Georgetown University Law Center Governance Series, and the UBC Faculty Colloquium Series for comments on earlier versions of this article. I also appreciate the factual assistance provided by several individuals at the British Columbia Securities Commission (BCSC), including Commissioner Robin Ford and staff members Brenda Benham, Langley Evans, Sandy Jakab, and Michael Sorbo. Ronke Odunmosu and Sarah Vander Veen provided excellent research assistance. Errors and omissions remain my own.


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New York City Mayor Michael Bloomberg and New York Senator Charles Schumer, primarily blamed American overregulation for the city’s continuing financial sector woes. Hank Paulson, United States Treasury Secretary, has suggested that, to preserve its global competitiveness, the United States should move toward a more flexible, U.K.-style approach to regulating capital markets. For its part the London Stock Exchange has argued that its superior principles-based approach—not lax standards and not simple distaste for Sarbanes-Oxley Act requirements in the United States—was the reason behind the historic shift.

While the shift is surely complex and multifactorial, the role of principles-based regulation is an important part of the puzzle. In fact, principles-based regulation, described more fully below, is not unknown in North America. The U.S. Commodity Futures Trading Commission now uses principles-based regulation with respect to the clearinghouses and exchanges it regulates. Even the U.S. Securities and Exchange Commission (SEC), often characterized internationally as a particularly rule-oriented and prescriptive securities regulator, has made recent moves toward a more principles-based approach. In Canada, where securities

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5The chief executive officer of the London Stock Exchange, Clara Furse, argued that “London’s principles-based regime, rather than a more prescriptive rules-based approach, continues to prove itself as a model that facilitates pro-competitive innovation in a tough but sensible regulatory environment. All the important independent corporate governance surveys confirm that the U.K. is number one for corporate governance standards.” Clara Furse, Comment: Sax is Not to Blame London is Just Better as a Market, FINANCIAl TIMES (U.K.), Sept. 18, 2006, at 19.

6See infra Parts II.A and II.B.


regulation is a provincial matter, the province of British Columbia is an ambitious champion of principles-based securities regulation and outcome-oriented regulatory practice. In fact, through its advocacy the entire Canadian securities system may be making a momentous shift away from its historic template, the American approach, and toward U.K.-style principles-based regulation.

In 2004, after a series of regulatory impact analyses and public consultations, the B.C. legislature introduced a bill to create an innovative new principles-based Securities Act for the province (Bill 38). Bill 38 and its associated proposed rules and regulations (together, the “B.C. Model”) would have established the most comprehensively principles-based regime in securities regulation in North America. The companion piece to the statutory reforms was so-called “outcome-oriented” regulation at the level of practice. Bill 38 received Royal Assent on May 13, 2004, and was set to come into force by regulation. It has not done so. Continued evolution in Canadian securities regulation—and especially the growing momentum behind a so-called “passport system” between provincial regulators—means that Bill 38 is now unlikely to come into force in its current form. Nevertheless, the province has not resiled from its advocacy of principles-based and outcome-oriented regulation. The B.C. Securities Commission (BCSC) now takes the position that, in any event, “the most important aspect of regulatory reform is a change in how [regulators] administer securities legislation.” It has stated that, “although the 2004 act is not

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10See infra text accompanying notes 67–78.

11See infra text accompanying notes 79–84.


13British Columbia passed a more circumscribed Securities Amendment Act in 2006. Bill 20-2006, Securities Amendment Act, 2nd Sess., 38th Parl., British Columbia, 2006. Depending on external political factors and the results of harmonization negotiations with other Canadian jurisdictions, the Securities Amendment Act may be more circumscribed only in the near term. It contains several provisions that mirror those of Bill 38. However, those provisions will only come into force if enacted by separate regulation, at an as yet unspecified date.

14BCSC, MOVING AHEAD WITH REGULATORY REFORM IN BRITISH COLUMBIA (Mar. 2005), http://www.bcsc.bc.ca/uploadedFiles/Moving_Ahead.pdf (emphasis added).
in force, the BCSC has moved ahead with changing [its] regulatory processes and approach in much the same way [it] would have done under the 2004 act."\textsuperscript{15}

Moreover, British Columbia's principles-based and outcome-oriented approach is now having a clear effect across Canada through British Columbia's agency and advocacy within the Canadian Securities Administrators (CSA), the Canadian securities regulatory umbrella group. British Columbia's coherent vision of its principles-based regulatory regime makes it a significant presence at the negotiating table. As a result, important prospectus-related components of the B.C. Model are now in effect across Canada by way of CSA National Instruments.\textsuperscript{16} Also, the CSA has issued for comment sweeping new proposed rules designed to put in place a revised, nationally harmonized and streamlined registration regime for firms and individuals.\textsuperscript{17} With respect to firm compliance processes in particular, the CSA has indicated that it intends to make principles-based rules.\textsuperscript{18} In the last twelve months, two major reports have come out


\textsuperscript{16}See infra note 68 (discussing the Continuous Market Access approach under Bill 38). Depending on the province, National Instruments are typically incorporated into provincial law through the provincial securities regulators' rulemaking powers, by regulation, or by blanket ruling or order. British Columbia's most striking success so far in pushing Canadian regulators in the direction of its vision occurred in late December 2006 with the adoption of National Instrument 44-101 concerning short-form prospectuses. (Concurrent National Instruments made parallel changes to the requirements governing shelf distribution prospectuses and PREP prospectuses.) Section 2.2 of NI 44-101 provides that an issuer with equity securities listed and posted for trading on an eligible exchange, which is up to date in its periodic and timely disclosure filings in all jurisdictions in which it is a reporting issuer, may file a much-streamlined short-form prospectus. NATIONAL INSTRUMENT 44-101 SHORT FORM PROSPECTUS DISTRIBUTIONS (Dec. 29, 2006), http://www.bcsc.bc.ca/uploadedFiles/NI44-101(1).pdf. The new qualification criteria greatly expand the number of Canadian listed issuers that can participate in expedited short-form offerings. As such, NI 44-101 is a step toward the Continuous Market Access model championed in Bill 38, which would have done away with prospectuses entirely for issuers that were already in the public markets and that were keeping their disclosures up to date.

\textsuperscript{17}CAN. SEC. ADM'RS., PROPOSED NATIONAL INSTRUMENT 31-103, REGISTRATION REQUIREMENTS AND PROPOSED COMPANION POLICY 31-103CP (Feb. 21, 2007), http://www.bcsc.bc.ca/uploadedFiles/N131-103_11Proposed.pdf.

\textsuperscript{18}Prema K.R. Thiele et al., Canadian Securities Regulators Release Comprehensive Registration Rule For Comment (Feb. 21, 2007), http://www.mondaq.com/I_article.asp_Q_articleid_E_46392.
supporting principles-based regulation,\textsuperscript{19} and the Chair of the nation’s largest provincial securities regulator, the Ontario Securities Commission, is now of the view that “the arguments in favor of principles-based regulation are very compelling.”\textsuperscript{20}

This article looks at principles-based securities regulation as a New Governance regime—one that uses innovative, pragmatic, information-based, iterative, and dialogic mechanisms to gather, distill, and leverage industry learning in the service of a still-robust but better designed, that is, more effective and less burdensome, public regulatory mandate.\textsuperscript{21} Using British Columbia’s approach as an example, this article argues that the B.C. Model’s outcome-oriented, open-ended, and collaborative features locate it within the ambit of that emerging analytical perspective. As such, the B.C. Model shares the beneficial characteristics of other New Governance regimes, especially relative to the more prescriptive and inflexible mechanisms associated with classical regulation. The New Governance perspective also brings to light some fresh questions about the B.C. Model, going in particular to the kinds of incentives that industry and regulators have and the relationship between them.

This article draws connections between principles-based regulation and New Governance in a way that transcends specific administrative law topics and should be of interest to scholars of regulation generally. In addition, the article seeks to engage with New Governance scholarship itself, by providing a contextual example of a New Governance experiment operating in the particular environment of securities regulation. While one can be confident overall about the value of putting principles-based and New Governance-inflected regulatory strategies to work in this area, securities regulation also presents its own particular challenges.

\textsuperscript{19}Crawford Panel on a Single Canadian Securities Regulator, Blueprint for a Canadian Securities Commission (2006), http://www.crawfordpanel.ca/Crawford_Panel_final_paper.pdf, at 7 (“to provide Canadian capital markets with a competitive advantage globally it is desirable to have as much principles-based regulation as is feasible”). Task Force to Modernize Securities Legislation in Canada, Canada Steps Up (2006), http://www.tfsml.ca/index.htm (see, for example, Volume 1, Executive Summary, at 2, recommending “that Canadian securities regulation be based on clearly enunciated regulatory principles which do not need a detailed set of interventionist rules for sound implementation”).

\textsuperscript{20}David Wilson, Chair Ontario Sec. Comm’n, Address at Dialogue with the OSC: Momentum for Change: Providing the Regulation Canada Needs (Nov. 10, 2006), http://www.osc.gov.on.ca/MediaSpeeches/sp_20061110_dw_dwo-momentum.jsp.

\textsuperscript{21}See discussion infra Part III.A.
Understanding the contextual implications of decentralized, principles-based, outcome-oriented New Governance approaches to securities regulation in particular helps to deepen the conversation about those approaches more generally.

The article proceeds in four parts. Part II defines “principles-based” and “outcome-oriented” regulation, by reference to classical theoretical debates, the debate around the B.C. Model, and recent trends in public administration. It provides an example of how regulation of a particular compliance requirement, broker firm supervision of client accounts, might be different under principles-based and outcome-oriented regulation. Part III sets out the relationship between principles-based securities regulation and New Governance theory, with specific attention to implications for firm compliance processes and the relationship between “rolling best practices rulemaking” and “light touch regulation.” It examines the relationship between regulator and industry especially in terms of the defensibility of potentially imposing on industry actors the costs of articulating, ex post, the specific content of principles-based regulatory requirements in the compliance context. Part IV identifies two particular challenges presented by the securities regulatory context, from the perspective of New Governance: firms’ uneven incentives to innovate in new product development versus compliance and problems of small firm capacity to operationalize principles. The article considers hybrid rules-and-principles regulatory structures, arguing for incorporating relevant third parties into the regulatory structure. Tripartism can be an effective mechanism for responding to regulatory failure, and it may be especially useful in responding to the particular challenges posed by the many small enterprises and “junior cap” issuers operating in the province of British Columbia. Part V offers some concluding thoughts.

II. WHAT IS PRINCIPLES-BASED SECURITIES REGULATION?

A. The Theoretical Debate

The classic example of the difference between rules and principles or “standards” (to use another term) involves speed limits: a rule will say, “Do not drive faster than 55 mph,” whereas a principle will say, “Do not drive faster than is reasonable and prudent in all circumstances.” Put another way, a rule generally entails an advance determination of what conduct is
permissible, leaving only factual issues to be determined by the frontline regulator or decision maker. A principle may entail leaving both specification of what conduct is permissible and factual issues to the frontline regulator.

A number of scholars have used the relatively straightforward rules–principles dichotomy as a vehicle for evaluating the structural and analytical choices that go into lawmaking. Many of the major arguments relate to the relative certainty of rules and flexibility of principles and the costs of these regulatory choices for regulation promulgators, enforcers, and followers. These broad themes echo in the debate in British Columbia respecting Bill 38, discussed below; its proponents argued that a

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22See Louis Kaplow, Rules versus Standards: An Economic Analysis, 42 Duke L.J. 557, 559-60 (1992). Ronald Dworkin’s rules–principles distinction, in which principles are reasons that a judge takes into consideration in deciding which all-or-nothing rule should apply, uses the terms in a different fashion than is intended here. Ronald Dworkin, Taking Rights Seriously 22-28, 71-80 (1977).


24For example, on the one hand, scholars usually argue that rules promote precision, formal equality, predictability, certainty, uniformity, and judicial restraint; produce greater net social welfare gains than principles; foster democracy and consistency; facilitate efficient allocation of goods; provide fixed consequences for action; minimize the costs of reaching decisions in particular cases; discourage rent-seeking behavior; and reduce the likelihood of bias, arbitrariness, and abuse of power by decision makers. Rules are, however, not without their disadvantages. Rules can be inflexible, reactive, and costly to promulgate; they require constant amendment to meet changing circumstances; they may be simultaneously over- and underinclusive. Rules permit different treatment of cases that are substantially alike, mask bias, allow people to engage in socially unproductive behavior to the extent of prohibition (to the “limits of the law”), restrict communication and may thwart understanding, restrict the exercise of discretion, and can be procedurally unfair.

Principles provide advantages that are the flip side of rules’ disadvantages. They provide decision makers with the ability to make their own choices, promote substantive equality and justice, reduce arbitrariness, are flexible and can adapt to changing circumstances over time, favor distributive motives, promote accountability on the part of decision makers, are less costly to promulgate, and allow decision makers to tailor their treatment to the facts of particular cases. Principles can also be disadvantageous in that they can be unpredictable, uncertain, costly for individuals to interpret and for decision makers to enforce, may prevent risk-averse people from engaging in lawful conduct, and they can be manipulated.
principles-based and outcome-oriented approach would discourage “loophole” behavior and “checklist” style approaches to law and would promote a more effective and flexible regulatory approach. Opponents of the B.C. Model worried about the uncertainty it could produce and the cost of that uncertainty to market actors. Of course, the conversation is much enriched by the predictable fact that there is no unanimity regarding the basis for analyzing the advantages and disadvantages of each: scholars have evaluated rules and principles in economic terms, abstract normative ones, in terms of regulatory design and behavioral analysis, and on the basis of particular values such as freedom/autonomy, democracy, community, or perceived legitimacy.

Scholars expressing a near-unequivocal preference for either rules or principles are relatively rare, although most lean one way or the other. Many note that rules and principles are more points on a continuum than discrete concepts and that there is a good deal of overlap and convergence between them. Others have resisted the stark dichotomy between rules

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23 See, e.g., Kaplow, supra note 22.


28 Scalia, supra note 23.

29 Rose, supra note 23 (arguing that both rules and principles are metaphors for lapses of community).


31 But see Scalia, supra note 23.

and principles and have pointed out that, historically, the decision-making pendulum has swung between them. Some warn that the rules-versus-principles debate should avoid setting up an artificial separation between law promulgators and law followers that fails to reflect the true iterative quality of the legislative process. More fundamentally challenging arguments also have been made to the effect that it has become an "arrested dialectic" or that the rules-versus-principles debate is really a stand-in for other, deeper disagreements about the proper ordering of society and the proper substantive content of legal rules.

There can be no question that a stark, bipolar understanding of the rules–principles dichotomy risks overdrawing the distinction, making it less useful in practical terms. No statutory scheme is a pure type—as, in fact, the FSA's description of its groundbreaking principles-based approach as simply "more principles-based regulation" acknowledges. Rules still admit of considerable discretion and interpretation. Principles, in the fullness of context, may congeal around a particular meaning. Moreover, calling the B.C. and FSA Models principles-based implies that the main run of securities regulation is comparatively rule based. This is not entirely the case, either constraining securities laws in objective terms, to the extent possible, or certainly by reference to other administrative law schemes. The U.S. Securities Act of 1933 and Securities and Exchange Act of 1934, for example, display real economy in conception and drafting and exhibit nothing like the detailed, rule-bound, command-and-control approach so often now associated with bureaucratic sclerosis and ineffectiveness in other regulatory arenas.

35Ian Ayres, Preliminary Thoughts on Optimal Tailoring of Contractual Rules, 3 S. Cal. Intersci. L. J. 1, 18 (1993) (arguing that "in many circumstances the dichotomous choice between rules or standards may be a false one, because lawmakers may prefer to enact a complementary set of rules and principles"); MacCormick, supra note 34 (arguing that there is no necessary opposition between rules and principles).
36Atiyeh, supra note 29; Rose, supra note 23.
38Schlag, supra note 23, at 383.
39Kennedy, supra note 23. But see Sullivan, supra note 23 (denying that superficial liberal/conservative political allegiances adequately explain judicial preferences for either rules or principles).
40See infra text accompanying notes 55–66.
Canadian securities law statutes are not appreciably more rule based than U.S. ones. Even if we assume that it is possible to distinguish meaningfully on a large scale between rules and principles, rules as implemented may look more like principles if decision makers use their discretion to temper the harsh effect of a rule that is imperfectly tailored to a specific situation. At the same time, principles may slide into rules over time because people and systems may desire more certainty than they find principles provide.

Nonetheless, taken as a whole, securities regulatory regimes can be comparatively principles or rules based. A regime can choose to regulate

\footnote{Canadian provincial securities statutes are generally very similar to the American 1933 Act and 1934 Acts. See also Lawrence A. Cunningham, Principles and Rules in Public and Professional Securities Law Enforcement: A Comparative U.S.-Canada Inquiry (2006), http://www.law.dal.ca/docs/V655A%20Cunningham.pdf (arguing that the U.S. SEC and the Canadian CSA show strong similarities in enforcement approach, that the SEC/CSA approach is principles based relative to the rule-based models at the U.S. National Association of Securities Dealers and the Canadian Investment Dealers Association (see infra note 72), and arguing against broadly principles-based securities regulation).}

\footnote{Schauer, supra note 23 (arguing that individuals "resist excess choice as much as they resist excessively constrained choice," so law implementers and enforcers tend to "round[ ] off the crisp corners of rules" as well as systematically "sharpen the soft edges of principles"). See also Barry Schwartz, The Paradox of Choice: Why More Is Less (2004) (arguing that from a psychological perspective there is a cost to having an overload of choice). The pressure toward certainty is even more pronounced when the possibility of sanctions exists, and this makes sense for due process reasons. However, this is not to say that principles-based regimes inherently violate the rule of law. The trick is that the regime must not be arbitrary in its exercise of power, and it should be transparent. That it is capable of handling inevitable vagueness in human relations should not invalidate it. Timothy Endicott, Vagueness in Law (2000); Keith C. Culver, Varieties of Vagueness, 54 Univ. Toronto L.J. 109 (2004).}

\footnote{Although our analyses are compatible in many respects, at this conclusory level this article parts ways with Lawrence A. Cunningham's thought-provoking recent article, A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation and Accounting (Mar. 13, 2007), (Boston College Law School Research Paper No. 127), available at http://ssrn.com/abstract=970646. Cunningham exposes the various ways in which the labels of "principles-based" or "rules-based" systems can be misleading. He argues that, while individual provisions may be classifiable as either rule or principle when stated as a legal norm, this does not account for how those provisions are interpreted, enforced, and applied. Moreover, he argues that "vague concepts such as materiality and fairness unaccompanied by some specific content create risks of both managerial decision-making and arbitrary enforcement." Id. at 19. Professor Cunningham and I agree on these points, and we agree that rules and principles exist on a spectrum rather than as pure types. Where this article parts ways with Professor Cunningham is with regard to the implications. Cunningham says that problems of classification and implementation are foundational and make the rules-principles dichotomy deeply suspect when used to describe systems. In his view, the most likely explanation for the "favouring" rhetoric extolling principles-based systems is political: regulatory jurisdictions
internal compliance processes, for example, by way of detailed checklists or by way of sweeping administrative guidelines. Each kind of regime will necessarily include both rule-based and principles-based elements. And, when applied to particular contexts by human regulators, there may be even more bleed-over than drafters intend. Still, one can make meaningful conceptual distinctions between regimes functioning primarily around principles and those operating mainly by way of rules. Moreover, the language of principles is useful for understanding the regulator’s necessarily modified role under a New Governance regime, within which the regulator establishes broad goals and outcome requirements but leaves it up to the regulated industry itself to develop effective means for achieving those requirements.

B. The Securities Regulatory Context

In describing the B.C. Model as principles based, drafters and proponents also were participating in a larger transnational debate, which took place following the many scandals of this millennium’s early years, about the proper structure of securities regulation and accounting rules. The initial concern was national accounting rules. The primary U.S. accounting standard setter, the Financial Accounting Standards Board (FASB), was criticized in the wake of the Enron debacle for relying too much on detailed rules to determine appropriate accounting treatment with respect to accounting standards.\textsuperscript{44} Thereafter, considerable work went into drafting more principles-based Generally Accepted Accounting Principles

operating in a competitive market for regulatory services use the term, misleadingly, for product differentiation purposes. \textit{Id.} at 54–62. This article is comparatively less gloomy about the scalability of rules and principles to the systems level and, while it recognizes the (positive and negative) impacts of transnational regulatory competition, it is less cynical about regulators’ motives in advocating principles-based regulation. This article’s response to the problems of classification and implementation recognized here is rather that, in order to be meaningful and effective, principles-based regulation requires a correlative shift in approach among the frontline regulators who interpret, enforce, and apply those principles. Part II of this article, supra, argues for a New Governance-style approach as a means of developing a systematic, coherent, conceptually compatible approach to the crucial implementation aspect of principles-based regulation.

(GAAP). In Canada and the United Kingdom, the most common view has been that those countries’ respective national GAAP are (and are appropriately) more principles based than U.S. GAAP. Europe, generally speaking, has come out broadly in favor of a more principles-based approach to accounting guidelines. Naturally, in practice as in theory, the site of the distinction between rules-based and principles-based approaches is contested ground.

In short order, the rules-versus-principles terminology moved beyond accounting and into securities regulation and corporate governance...


46In Canada, Daniel Thornton and Erin Webster have argued that Canadian GAAP principles are more principles-based than American GAAP. Their analysis is based, inter alia, on an examination of the CICA Assurance Handbook and the CICA Accounting Handbook, which they claim are much less prescriptive than American Institute of Certified Public Accountants assurance guidance and FASB accounting guidance. Daniel B. Thornton & Erin Webster, Earnings Quality Under Rules- vs. Principles-Based Accounting Standards: A Test of the Skinner Hypothesis (June 2004), available at http://ssrn.com/abstract=557983. According to Robert Ker- shaw, the common—though mistaken—view in the United Kingdom is that it avoided Enron-style scandal in the early years of this millennium because its approach to accounting regulation is principles based rather than rules based. I dispute the claim that U.K. GAAP really are more principles based than American GAAP however, and argue that the lack of an Enron-style scandal in the United Kingdom may be attributed to good fortune, a more robust professional culture, and/or plain ignorance of the extent of professional failure in the absence of a high-profile scandal. David Kershaw, Exposing Enron: Taking Principles Too Seriously in Accounting Regulation, 68 Mod. L. Rev. 594 (2005). The fight has gone out of this conversation somewhat, given recent transnational convergence of accounting principles around International Financial Reporting Standards. See, e.g., News Release, FASB, FASB and IASB Reaffirm Commitment to Enhance Consistency, Comparability and Efficiency in Global Capital Markets (Feb. 27, 2006), http://www.fasb.org/news/news022706.shtml.


48See, e.g., Gill, supra note 44 (disputing the common wisdom that American GAAP principles are more rule based than British ones); Kershaw, supra note 46 (same).
generally. In the United States, there has been a good deal of discussion about the distinction between rules and principles, although legislative outcomes have been more mixed. To take the most obvious example, observers have identified principles-based tendencies in some Sarbanes-Oxley provisions, although the statute also imposed numerous new, detailed rules. Among the Commonwealth countries as well, the scandals at Enron, WorldCom, Canada’s Nortel, Australia’s HIH, and elsewhere stimulated considerable soul searching about securities regulation and a renewed debate about the virtues and vices of principles-based as opposed to rules-based regulation and the significance of the distinction.

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50See, e.g., John C. Coffee Jr., Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, 84 B.U. L. REV. 301, 342-44 (2004) (arguing that Sections 302 and 906 of the Sarbanes-Oxley Act, which require CEOs and CFOs to certify that information contained in periodic reports "fairly presents" the financial condition and results of operations of the issuer, represent a shift to a principles-based system for financial disclosure).


52Championing principles-based securities regulation in Canada, see, for example, Michael Kane, Investor Protection at Top of Agenda for Chairman, SUBURY STAR, July 30, 2005, at E2 (see infra note 72, discussing Ross Sherwood, new chair of the Investment Dealers Association, and his preference for principles-based regulation); Ben Maiden, Canadian Lawyers Take New Look At Due Diligence, 24 IN'T'l. FIN. L. REV. 37 (2005) (discussing Canadian regulators' initiatives post-Sarbanes-Oxley and the desire to remain more principles based than rule based). In Australia: Gerry Gallery & Natalie Gallery, Inadequacies and Inconsistencies in Superannuation Fund Financial Disclosure: The Need for a Principles-Based Approach, 36 AUST. ECON. REV. 89 (2003) (arguing that Australia’s Superannuation Fund structure should move from a rules-based structure to the structure with corporate reporting, which the authors contend show that a principles-based approach applied to corporate reporting).


54Neil Baker, Global Debate Over Controls, INTERNAL AUDITOR, June 2005, at 50 (discussing the impact of the Sarbanes-Oxley Act in Europe and Britain's attempts to defend their principles-based approach from incursion by post-Sarbanes European regulations); Press Release, Price WaterHouseCoopers, Financial Firms Face High Reputational Costs from Poor Compliance Risk Management (June 27, 2005), available at http://www.pwc.com/Extweb/nccompressrelease.nsf/
From an early stage, the U.K. FSA has been a thoughtful leader on principles-based financial services regulation. Its approach warrants a brief sketch. What the FSA has in mind, in speaking of principles-based securities regulation, is a comprehensive philosophy about regulation that affects not only its approach to regulating industry, but also its own processes. The FSA’s move toward principles-based regulation in the securities area crystallized in 2001, not long after its own creation, with the promulgation of eleven overarching Principles of Business within its Handbook.\textsuperscript{55} In the intervening years the FSA has replaced huge swaths of its detailed Handbook rules with short, high-level requirements, often accompanied by regulatory guidance.\textsuperscript{56} Between 2002 and 2005, for example, the FSA simplified and restructured its rules relating to listed companies, reducing the length of the rules by 40% and adding six listing principles plus guidance.\textsuperscript{57} In 2006, the FSA began consulting on simplifying its rules relating to dealings with retail customers, and it began to replace the detailed obligations established by its existing money-laundering requirements with more streamlined provisions focusing on ensuring that firms have effective risk management and systems and


\textsuperscript{56}General guidance is contained in the FSA Handbook. For example, guidance on appropriate responses to whistleblowing appears in FSA, Handbook Module SYSC (Senior Management Arrangements, Systems and Controls) 18.2: Practical Measures, http://fsahandbook.info/FSA/html/handbook/SYSC/18/2 (last visited Sept. 4, 2007). From time to time, where a matter is urgent or likely to be temporary, the FSA will publish a “Guidance Note.” See, e.g., FSA, Guidance Note No. 8 (2003), http://www.fsa.gov.uk/pubs/guidance/guidance8.pdf (covering Credit Union Common Bonds).

controls and that firms' senior management take responsibility for managing money-laundering risk.\textsuperscript{58}

In some circumstances, relevant FSA guidance has been formulated in concert with industry itself. For example, in 2004 a group of four trade associations published industry guidance on their understanding of the FSA's rules with respect to trading ahead of investment research. The FSA publicly confirmed that the guidance was consistent with the regulator's intent.\textsuperscript{59} The FSA has even moved away from prescribing the specific examinations that individuals engaged in particular financial-sector activities must pass. Now, firms choose from a list of examinations based on what they believe is appropriate to their circumstances.\textsuperscript{60} In terms of its own processes, the FSA has moved to a risk-based regulatory approach (assisted by the "Arrow" methodology),\textsuperscript{61} and it emphasizes consultation with the public and industry. The FSA consults on many aspects of its operations, and it even began consulting on streamlining its own Enforcement and Decision-Making manuals in early 2007.\textsuperscript{62} Also, it has shifted some of the innovative burden from itself to industry—for example, in challenging industry to propose a credible solution to conflict-of-interest issues arising from soft commission and bundled brokerage arrangements.\textsuperscript{63} The FSA considers its work unfinished; its Business Plan for 2007/8, which sets out its priorities for the coming year, focuses on the organization's ongoing drive toward "more principles-based regulation."\textsuperscript{64}

Significantly, the FSA's move toward a principles-based approach is something other than deregulation, outsourcing, or reduced regulation. John Tiner, the FSA's Chief Executive, recently described his organization's principles-based approach to include "[t]he heightened significance of

\textsuperscript{59}FSA, supra note 57, at 8.
\textsuperscript{60}Id. at 10.
\textsuperscript{63}FSA, supra note 57, at 7.
communication in a principle-based system. Our efforts to rationalise and focus the FSA Handbook. Our enhanced Risk-Based approach. And, managing down regulatory costs. He argued that principles-based regulation produced simply “better” regulation, meaning simultaneously “(1) a stronger probability that statutory outcomes are secured; (2) lower cost; and (3) more stimulus to competition and innovation.” Like proponents of the FSA approach, proponents of the B.C. Model argued that its principles-based regime could produce both more effective and less costly regulation.

C. The B.C. Model as Principles Based and Outcome Oriented

Bill 38 is principles based relative to other North American securities law regimes. In terms of requirements for regulated issuers, for example, the most striking proposal in Bill 38 would have replaced existing prospectus-disclosure rules, short-form prospectus provisions, the entire exempt-market transaction structure, and existing continuous disclosure obligations with an overarching “Continuing Market Access” structure. Continuous Market Access simply would require all companies accessing


66) Tiner, supra note 65.

67) Relative to other securities law statutes, the language of Bill 38, supra note 9, is also considerably streamlined. The statute is drafted in plain language and the statutory architecture is comparatively stripped down. Compare, for example, §§ 57 and 57.1 of the existing British Columbia Securities Act, [RSBC 1996] c. 418, with § 27 of Bill 38. Both deal with the prohibition on fraud and market manipulation. The two sections in the old Act run to 222 words, and separately address “direct or indirect” engagement or participation in prohibited transactions relating to trading in British Columbia (further subdivided into frauds perpetrated on persons in British Columbia, and frauds perpetrated on “any person anywhere” in connection with B.C. securities) and prohibited transactions by persons in British Columbia. By contrast, the provisions of Bill 38, supra note 9, read, in full:

A person must not engage in or participate in conduct relating to securities if the person knows, or reasonably should know, that the conduct

(a) results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security, or

(b) perpetuates a fraud on any person.
the B.C. capital markets to disclose all "material information" (here, replacing "material fact" and "material change") on a real-time basis.\textsuperscript{68} The BCSC argued that the complex rules characteristic of the existing prospectus regime did not help gullible investors or stop fraudulent actors, and it proposed that more effective tools for this purpose were investor education, compliance reviews, and enforcement action.\textsuperscript{69} As noted above, Canadian securities regulators have since taken a collective step in this direction through the use of National Instruments.\textsuperscript{70} Another sweeping principles-oriented move in the B.C. Model, relevant to this article's concern with regulatory oversight of compliance processes and procedures, was the establishment of a Code of Conduct for dealers and advisors.\textsuperscript{71}

The B.C. Model replaced detailed rules of conduct for dealers and advisors with an overarching Code of Conduct consisting of twenty-eight

\textsuperscript{68}See Part 5 of Bill 38, supra note 9. Canadian securities regimes do not require an equivalent document to the Form S-1 Registration Statement in the United States, so prospectuses must include all information that in the U.S. would be provided by way of Registration Statement. Under the Continuous Market Access approach, public companies would still have to file a detailed prospectus the first time they accessed the public capital markets, much as American issuers file a Form S-1. Bill 38 §1 defines material information as "information relating to the business, operations or securities of an issuer that would reasonably be expected to significantly affect the value or market price of the issuer or a security of the issuer." For a critical perspective on the impact of the move to a material-information standard, see MINISTRY OF FINANCE (ONTARIO), FIVE YEAR REVIEW COMMITTEE FINAL REPORT REVIEWING THE SECURITIES ACT (ONTARIO) (2003), http://www.fin.gov.on.ca/english/publications/2003/fyreview.pdf. The Committee's most compelling criticism is that material-information disclosure seems to impose a heavy burden on an issuer to be aware of information external to that issuer.


\textsuperscript{70}See supra note 16.

\textsuperscript{71}Other innovations included firm-only registration (which was abandoned before the project as a whole was abandoned), secondary market liability (which may be resurrected, accompanied by similar provisions in Ontario), enhanced enforcement powers, and replacing existing prospectus and continuous disclosure rules with a "Continuous Market Access" approach. See BCSC, INVESTOR REMEDIES IN SECURITIES LEGISLATION: A REGULATORY IMPACT ANALYSIS (2004), http://www.bcsc.bc.ca/uploadedFiles/RIA_Investor.Remedies(1).pdf; BCSC, ENFORCEMENT OF OUTCOMES-BASED SECURITIES LEGISLATION (2004), http://www.bcsc.bc.ca/uploadedFiles/RIA_Enforcement(1).pdf [hereinafter BCSC, ENFORCEMENT]; CHRISTINA WOLF, BCSC, BETTER DISCLOSURE, LOWER COSTS: A COST-BENEFIT ANALYSIS OF THE CONTINUOUS MARKET ACCESS SYSTEM (2002), http://www.bcsc.bc.ca/uploadedFiles/GBA_Report.pdf; CHRISTINA WOLF, BCSC, COST SAVINGS UNDER A FIRM-ONLY REGISTRATION SYSTEM (2004), http://www.bcsc.bc.ca/uploadedFiles/RIA_Firm-Only_Registration(1).pdf.
rules arranged under eight broad "standards." According to the BCSC, the B.C. Model requires those subject to securities regulation in British Columbia to use their own or industry experience to develop strategies, uniquely tailored to their business, for abiding by the regulatory requirements. The Code of Conduct provisions dealing with compliance systems are of particular interest here, and they impart a sense of the Code’s generality and its high-level (almost ethics-level) abstraction. As at the FSA, each provision is accompanied by nonbinding regulatory guidelines. The first two of the seven compliance-related provisions, which

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74Because the BCSC delegates frontline regulatory authority over most dealers and advisors to two self-regulatory organizations, the Investment Dealers Association (IDA) and the Mutual Fund Dealers Association, the practical impact of the Code is blunted. In addition to the existing Securities Act and Rules, most dealers and advisors (but not, for example, portfolio managers) are also subject to rules promulgated by those self-regulatory organizations (SROs). Participants in Commission-sponsored public consultations have argued that coordination with the SROs is required so that those organizations’ approaches do not divert the Commission’s. BCSC, DEREGULATION PROJECT: COMMENTS FROM TOWN HALL AND FOCUS GROUP MEETINGS (2002), http://www.bcsc.bc.ca/uploadedFiles/2002_ConsultationOverview_Feb.pdf. The IDA, in particular, also has been moving toward a principles-based approach. See Paul C. Bourque, Address at the IDA RED TAPE CONFERENCE: NEW APPROACHES TO REGULATING THE FINANCIAL SERVICES SECTOR (Sept. 25, 2002), http://www.ida.ca/Files/RecSpeech/2002RedTapeConference_en.pdf; see also Kane, supra note 52.

75The compliance systems provisions are not more broadly cast than most other provisions of the Code of Conduct. For example, the principal Code requirement with respect to conflicts of interest states, “Resolve all significant conflicts of interest in favour of the client. Use fair, objective, and transparent criteria. If there are conflicts of interest between or among clients, use fair, objective, and transparent criteria to manage those conflicts. Apply the criteria consistently in all cases." BCSC, SECURITIES REGULATION IN BRITISH COLUMBIA: GUIDE FOR DEALERS AND ADVISORS (2004), http://www.bcsc.bc.ca/uploadedFiles/Guide_Dealers_Advisors.pdf, at 25. This statement is one of four that, along with general interpretive "Guidelines" provided by the Commission, constitute the new regime's approach to conflicts of interest. This can be contrasted with the thirteen separate provisions of the B.C. Securities Rules that previously addressed conflicts of interest: B.C. Securities Rules, 194/97 B.C. Reg. §§ 16, 53, 54, 75–85.

76In Canada, as in the United States and the United Kingdom, administrative guidance is nonbinding. Its promulgation does not require that the administrative agency in question engage in notice-and-comment rulemaking. For a thoughtful discussion of the distinction between guidance and rules in the United States, see Peter L. Strauss, Publication Rules in the Rulemaking Spectrum: Assuring Proper Respect for an Essential Element, 55 ADMIN. L. REV. 803 (2001). Administrative guidance has not been the subject of widespread litigation in Canada. The notable exception is the Ainslie case, in which the Ontario Securities Commission was held to have issued binding policy statements governing the operation of penny stock dealers without regard to its notice-and-comment obligations. Ainslie Financial Corporation et al. v. Ontario Securities Commission et al, 14 O.R. (3d) 280 (Ont. Ct. Gen. Div.) 1993.
will be discussed later in an example involving dealer-firm account supervision.75 state:

19. Maintain an effective system to ensure compliance with this Code, all applicable regulatory and other legal requirements, and your own internal policies and procedures. (Associated guidelines begin, “You must develop, implement, and monitor a written compliance system that satisfies the requirements of the Code. . .”)

20. Maintain an effective system to manage the risks associated with your business. (The Guidelines begin, “You must think about the risks associated with your business that are additional to regulatory risks and design your compliance system to account for those additional risks. . .”).76

In support of its approach, the BCSC argues that prescriptive requirements emphasize the wrong things. That is, they encourage firms to focus on detailed compliance rather than to exercise sound judgment with a view to the best interests of their clients and the markets. Detailed and top-down requirements also calcify the regulatory system to reflect one-size-fits-all industry practice in a particular point in time. By contrast, the BCSC argues, general obligations subject to industry-driven reflection and amendment ensure sustainability, in that industry can evolve unhindered by overregulation. They also ensure flexibility, in that emerging issues that should be regulated are addressed in the general course, because market participants need to consider the purpose of the rules in the context of the objectives of securities regulation when making compliance decisions.77 The BCSC also argues that compliance will increase if rules are fewer, easily understood, and adequately communicated.78

75See infra Part II.D.

76BCSC, supra note 73 (emphasis added).


78BCSC, supra note 69. Another factor that makes British Columbia’s view on principles-based regulation controversial is the province’s history in securities regulation. The signaling effect of the new regime is different because British Columbia was once home to the now-defunct Vancouver Stock Exchange, notorious in the 1980s and 1990s as the “scam capital of the world.” Joe Queenan, Scam Capital of the World, Forbes, May 29, 1989, at 132 (describing the Vancouver Stock Exchange as “the longest-standing joke in North America” and “[r]umored to be a laundering vehicle for mobsters and undesirables”); The regulatory environment in British Columbia has changed profoundly since those years. See, e.g., Greg Potter, Digging in the Dirt, B.C. Business, Aug. 1, 2005, at 30 (describing the contemporary Vancouver-based mining industry as credible, scrupulous, and closely regulated). By contrast, when speaking of the SEC, the notion of principles-based regulation sometimes conjures up the opposite image.
The second essential component of the B.C. Model—implicit in its operation but not found on the face of Bill 38—is an outcome-oriented approach and the attendant rolling-in of some new learning about compliance and enforcement best practices.\textsuperscript{79} Industry involvement in developing the content of rules to which industry will be subject is integral to outcome-oriented regulation. The roots of outcome-oriented regulation are with the insights of the “reinventing government” or “new public management” movements in public service provision.\textsuperscript{80} In broad strokes, those approaches advocated a more results-oriented approach to public administration, including substantial devolution to industry, risk-based management, and transparency and accountability through continual reevaluation of government performance based on performance metrics.\textsuperscript{81}

\textsuperscript{79}The B.C. Model buttressed these innovations with enhanced enforcement and public interest powers, including a legislative prohibition on “unfair practices,” the Commission power to order disgorgement, and provisions allowing any “interested person [who] believes that another person has contravened” Bill 38 or the associated regulations to apply to the Commission to hold a hearing. Bill 38, supra note 9, §§ 29, 61 & 64. Proposed provisions that would have given the Commission the power to prohibit a professional from practicing before the Commission, if the professional had intentionally contravened the securities legislation, did not survive to the final version of Bill 38. See New Proposals, supra note 77, at 99–100.

\textsuperscript{80}The “New Public Management” reforms are commonly associated with the Westminster-style governments, while the term “Reinventing Government” refers to the reform movement in the United States. Corresponding public-sector innovations were known as “National Performance Review” in the United States under the Clinton Administration and “Program Review” in Canada under Prime Minister Jean Chrétien. See generally Peter Aucoc, The New Public Management: Canada in Comparative Perspective (1995); Donald F. Kettl, The Global Public Management Revolution (2d ed. 2005); David Osborne & Ted Gaebler, Reinventing Government: How the Entrepreneurial Spirit is Transforming the Public Sector (1992). There are, of course, important differences between the national movements. They are beyond the scope of this article.

\textsuperscript{81}Recently, Patrick Dunleavy and his colleagues have identified three overarching themes around which they suggest another diverse set of second-tier New Public Management-
One scholar who emerged in response to the Reinventing Government movement in the United States had a direct impact on the B.C. Model. Malcolm Sparrow's contribution was to incorporate the new learning processes, *mutatis mutandis*, into regulatory functions. His approach illustrates the application of outcome-oriented principles to the regulatory (as opposed to public-service provision) task. Sparrow described how the most effective modern regulatory techniques use sophisticated problem-solving methods and self-reflective analysis to do the difficult work of “pick[ing] important problems and solv[ing] them.” He found that certain common elements characterized the best innovations in regulation: (1) a clear focus on results and effectiveness, based on an expanded and more specific set of indicators including “big picture” high-level impacts, behavioral outcomes (compliance rates, agency activities), and resource efficiency; (2) adoption of a disciplined problem-solving approach; and (3) an investment in collaborative partnerships where feasible. Sparrow was an explicit muse for the BCSC in devising the B.C. Model.

**D. Examples: Investment Dealers’ Account Supervision and Cartaway**

In November 2003 the BCSC published a useful regulatory impact analysis that compared account supervision systems mandated by the current, rule-based approach with those of the proposed B.C. Model (the “Account Supervision Case”). The BCSC’s report analyzed the impact of the B.C.

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inspired approaches have been introduced: (1) disaggregation splitting up public-sector hierarchies into wider and flatter hierarchies; (2) competition separating purchaser and provision to create more competition and diversity among potential providers; and (3) incentivization rewarding performance, particularly with pecuniary incentives. Patrick Dunleavy et al., *New Public Management is Dead Long Live Digital Era Governance*, 16 J. Public Adm. Res. & Theory 467 (2006).


Id. at 99-122 & 155-70.

In a speech to the Task Force to Modernize Securities Legislation in Canada, the BCSC Vice Chair Brent Aitken stated that the BCSC had been “following Sparrow’s methodology since 2001.” BRENT W. AITKEN, BCSC, Another Way Forward for Securities Reform (Oct. 14, 2005), http://www.bcsc.bc.ca/uploadedFiles/Aitken_Presentation_IDA_Oct2005.pdf, at 6.

Model on four firms that were members of the IDA, the self-regulatory organization to which the various Canadian provincial securities commissions delegate frontline regulatory oversight of investment dealers. As such, the four firms were subject to the IDA’s rules governing account supervision. Each of the four firms studied had distinct operational characteristics: two were national dealers (one Toronto based and bank owned and one large but local and independent), and two were regional dealers (one medium sized and the other small). While account supervision was regulated both under the existing system and the B.C. Model, the firms believed they would change their practices significantly under the B.C. Model.

According to the BCSC’s analysis, existing IDA account supervision rules are much more detailed than the B.C. Model’s requirements. The IDA requires daily and monthly reviews of accounts for trading violations, suitability, and business risk factors. The IDA-mandated reviews are transactional in nature. Moreover, IDA policy requires the daily reviews to assess each trade against nineteen criteria (and more if the trade is in futures or options). The policy contains many thresholds that define which trades need to be reviewed. For example, every account with over $1,500 of commissions in a given month must be reviewed. The IDA enforced its specific procedures by auditing firms tightly for compliance.

The firms, however, did not find the transaction-based daily and monthly reviews useful in detecting abuses characterized by patterns of behavior, which is where they thought the biggest risks arose. Front running and stock manipulation, for example, may be ascertainable only by way of a review of trading patterns, which are not readily visible with the transactional focus mandated by the IDA’s daily and monthly reviews. The firms also felt that the daily and monthly reviews were duplicative and that the policy-derived thresholds governing the daily reviews were both too low and too rigid. For example, the $1,500 threshold caught thousands of

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80Because SRO rules are the dominant factor for such firms, see supra note 72, to be effective the B.C. Model would have to involve corresponding principles-based changes to those rules as well.

81WOLF, supra note 85, at 6.

82Id. at 7.

83Id. at 13.
self-directed trades, trades in blue chip stocks, and other sales transactions that did not carry large risks. Yet, the threshold failed to catch mutual fund trades, which do not generate commissions, even though very active trading in mutual funds could raise a red flag with respect to an account's treatment. According to one firm, up to 85% of transactions caught by the daily reviews did not warrant scrutiny. Out of ninety mandated criteria for daily transaction-based reviews, the firms would have eliminated twenty-three entirely and would have modified most of the rest. In particular, the firms felt that a supervision regime using risk-based sampling would be significantly more efficient. According to the BCSC’s analysis, the firms were unanimous in their view that the IDA-mandated system contributed significantly to their regulatory burden without providing meaningful investor protection. The burden was aggravated by the need to maintain extensive documentation of compliance (including maintaining separate paper records, even where electronic records were generated) for IDA audit purposes.  

The inefficiency of the mandated reviews was a concern for the firms, but the transaction-based reviews' failure to detect key forms of high-risk behavior was even more troubling. As a result of the perceived limitations in the mandated reviews, each of the firms already had developed its own parallel supervisory system, which it thought better managed compliance risks. One of the large dealers stated that it detected 90% of potential compliance problems through its proprietary system, which it ran first, and that daily reviews caught the remaining 10% of potential problems. Yet, each process took the same amount of time. The need to conduct the mandated reviews drained resources away from the more effective internal system. Regardless of the efficacy of their internal systems, dealers were still required to comply with procedures mandated under the IDA rules. Significantly, the dealers involved pointed out that they felt they needed to ensure their accounts were adequately supervised regardless of regulatory requirements, for civil liability reasons, for reputational ones, and because they considered it to be good business practice.

Certainly some of the problems with the IDA’s mandated reviews could be ameliorated by modifying the rules themselves; for example, the IDA could eliminate its requirement for paper records where suitable and

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90 Id. at 13-15 & 17.
91 Id. at 14-17.
secure electronic records existed. Perhaps following industry consultation, it could reconsider some of its ninety mandated criteria for daily reviews. However, this kind of tinkering does not solve the larger problem: that the regulator, based on its own incomplete knowledge base, had issued detailed and static requirements when the firm’s own experience and incentives would have produced more efficient and effective ones. The IDA requirements also treated each firm the same, even though each one worked in a different environment and carried a substantially different risk profile. For example, while each firm thought there was some continued utility to transactional reviews, the firms cited several different reasons for thinking so. Moreover, each firm suggested a different alternative to the existing policy-based thresholds for weighing out those daily transactions that warranted a closer look. While each of the firms would still use some form of analytical threshold, they would have modified the thresholds in different ways based on their own compliance experiences and their understanding of their own businesses. What is required, then, is more than retooling the rules. Static and detailed rules are blunt instruments, and they will necessarily be ill fitting in some situations. They are also incapable of reflecting new learning, including from the firms’ own proprietary risk-management systems. In that context, the BCSC’s regulatory impact analysis argued that the perceived consistency benefit of the existing system was at best outweighed by its cost and was at worst illusory.

In contrast, the principles-based and outcome-oriented B.C. Model would require adequate account supervision not by way of detailed rules, but through the Code of Conduct provisions dealing with compliance systems. The relevant provisions are the ones set out above: that a firm must “maintain an effective system to ensure compliance with the Code, other legal requirements, and its own internal policies and procedures,” and it must “maintain an effective system to manage the risks associated with its business.” The key advantages of the B.C. Model over the existing one, as the Account Supervision Case demonstrates, redound both to efficiency and effectiveness. Because the B.C. Model is outcome oriented rather than
process oriented, each firm would be in a position to develop the "effective systems to ensure compliance" that best suited its own risk profile. As the firms' own proprietary systems demonstrate, the firms are already using outcome-oriented mechanisms.\footnote{WOLF, supra note 85, at 19.} The principles-based model permits firm innovation in compliance processes, allowing firms to sharpen their compliance practices and procedures without fear of violating detailed (and potentially anachronistic and less effective) regulatory requirements.\footnote{Id. at 43-45; BCSC, ENFORCEMENT, supra note 71, at 10-13.} The BCSC's regulatory impact analysis did not acknowledge another consideration, though it is equally valid: that an outcome-based regulatory requirement relieves the regulator itself of the need to be possessed of perfect information about how to ensure compliance. Buttressed, always, by credible enforcement to deal with intransigents, outcome-oriented regulation resitusates the informational burden onto the parties generally best equipped and most motivated to bear it—the firms themselves.

Interestingly enough, the BCSC's regulatory impact analysis and a follow-up report issued in May 2004 also point out that in certain circumstances the principles-based approach would actually provide more clarity and certainty than the existing statutory regime.\footnote{B.C. Securities Act §§ 161 & 162. Other Canadian provinces' statutes have similar or equivalent provisions. See, e.g., Ontario Securities Act, R.S.O. 1990, c. S.5, §127.} Alongside its specific requirements, the existing regime accords the BCSC broad powers to act "in the public interest" in responding to misfeasance not covered by existing statute and rules.\footnote{2000 BCSECCOM 88 (Oct. 2, 2000), available at http://www.bccse.bc.ca/enforcement.asp (search Decisions and Orders). The Commission found that it was in the public interest to impose the maximum administrative penalty available under the B.C. Securities Act on two of the brokers. Its enforcement decision was appealed to the Supreme Court of Canada on the questions of what factors the Commission could consider in exercising its public interest powers and the standard of review for judicial review of the exercise of the Commission's public interest powers. See Cartaway Resources Corp. (Re), [2004] 1 S.C.R. 672.} \textit{Re Cartaway},\footnote{Id.} a notorious B.C. case, illustrates the problem. In brief, the respondents were among a group of eight individual brokers employed by a registered dealer. Without adequate disclosure, they personally invested in a small publicly listed company they intended to use as a shell, and they funneled some mining claims into it through a shelf company. They entered into a private placement, which
they split among friends, without disclosing to investors the material change in Cartaway's business from a company in the business of licensing residential garbage containers in the small city of Kelowna, British Columbia, to a mining exploration firm with claims in Voisey's Bay, Labrador, then the site of a major staking rush. A few months later they entered into another private placement, with the brokers' registered dealer as agent. Cartaway (through its principals, the respondents) disclosed the acquisition of the Voisey's Bay claims during this second offering but did not disclose the respondents' roles in acquiring the claims, the brokers' controlling shareholdings in Cartaway, or any of the related conflicts of interest. The offering was oversubscribed by a factor of four to one, and all of that offering was placed with the dealer's clients. ¹⁰¹

The BCSC found that the respondent brokers had contravened various specific sections of the British Columbia Securities Act and Rules, including disclosure requirements, but that some of the brokers' most egregious behavior did not contravene any specific provisions. The BCSC therefore relied on its public interest powers to sanction the brokers for acting contrary to the public interest, by putting themselves in a position of conflict of interest with their clients' best interests, by acting in their own interests rather than their clients', by failing in their duties as "gatekeepers," and by deceiving and intentionally misleading their dealer, its clients, the relevant exchange, and the public. ¹⁰²

In support of the B.C. Model, the BCSC points out that the facts in Cartaway would have implicated directly several specific principles in the proposed Code of Conduct for Dealers and Advisors, including prohibitions on deceptive and misleading conduct, conflicts of interests, and conduct damaging to the reputation of securities markets. ¹⁰³ The Cartaway case emphasizes that the B.C. Model should be analyzed not by comparison to a perfect rule-based system, but to the existing system, which is characterized by sometimes ill-fitting rules, necessarily accompanied by a sweeping residual public interest power. ¹⁰⁴

¹⁰¹2000 BCSECCOM 88.
¹⁰²BCSC, Enforcement, supra note 71, at 11–12.
¹⁰³Id., at 12–13.
¹⁰⁴This observation is also relevant to charges that principles-based enforcement raises concerns about procedural fairness or due process. Notably, the Canadian Supreme Court has been willing to accept that broadly worded regulatory requirements do not necessarily violate
III. IMPLICATIONS FOR FIRM COMPLIANCE

A. New Governance and the New Regulator

As the above example demonstrates, the B.C. Model imagines a substantially different relationship between regulator and industry—one that acknowledges the value of the specific, contextual knowledge that industry actors themselves have in establishing effective and appropriate regulatory standards. Correlatively, the B.C. Model also requires a somewhat reimagined regulator that is more pragmatic, more willing to devolve responsibility to industry, and perhaps humbler about how well informed and well equipped it is relative to industry itself. Rather than seeing the regulator as the central articulator of non-negotiable, specific requirements, the B.C. Model requires the regulator to define broad themes, to articulate them on a flexible and dynamic basis, to accept input from the ground level of regulated entities, and to effectively manage varied incoming information from industry actors.

New Governance imagines a similar role for the regulator. The term New Governance has emerged as an overarching moniker to refer to a new approach in legal scholarship that emphasizes not legal doctrine or formal jurisprudence, but rather how change actually happens within complex real-life social systems. 105 New Governance identifies ongoing deliberation constitutional protections. See Ontario v. Canadian Pacific Ltd., [1995] 2 S.C.R. 1031 (holding that a prohibition in the Environmental Protection Act on polluting the natural environment "for any use that can be made of it" did not violate section 7 of the Canadian Charter of Rights and Freedoms on the basis of vagueness or overbreadth); Canadian Foundation for Children, Youth and the Law v. Canada (Attorney General), [2004] 1 S.C.R. 76 (holding that a Criminal Code provision allowing parents and others to use force toward a child, "if the force does not exceed what is reasonable under the circumstances," did not violate section 7 of the Charter on the basis of vagueness or overbreadth).

as the most legitimate and most effective mechanism for making decisions in complex organizational structures. Deliberation is accomplished by decentralized, broadly participatory stakeholder groups that can access local knowledge and context-specific understandings of a situation. New Governance securities regulation, then, entails a regulatory structure that spans the so-called public/private divide, pulls industry experience into regulatory decision making, and establishes robust ongoing communication mechanisms (rather than an information-hoarding, adversarial relationship) between industry and regulator. The regulator establishes broad policy guidelines and regulatory goals for industry action. It cooperates with industry where possible in determining means to achieve those goals. However, on the basis that industry generally has access to superior contextual information, it refrains from describing the specific content of those principles, including the precise means by which industry ought to achieve the articulated regulatory goals. Individual firms thus are able to use their own superior knowledge of their particular firm needs and vulnerabilities to innovate, while remaining accountable for their performance. At the same time, the regulator collects and analyzes firms’ diffuse contextual knowledge to produce a system that is more adept at learning from its own experience.

A New Governance–style, principles-based approach has special relevance to firm compliance functions—meaning those policies, processes, and systems that firms themselves must have in place to prevent and detect internal wrongdoing and violations of law. In the compliance context, New Governance permits a dynamic and continually reevaluated internal understanding of compliance. Most firms will try to abide by most credibly enforced and reasonable regulatory requirements, in part for pragmatic business reasons. The enforcement of law, like law itself, serves an expressive purpose. Regulatory approval (or at least the absence of regulatory condemnation) confers legitimacy on firm operations, and it has currency with clients, suppliers, creditors, and industry peers.106 However,
a regulatory regime based on overly detailed and prescriptive rules sends the message, even to generally law-abiding firms, that observing the strict letter of the law is what matters and that responsible actors may take advantage of loopholes, perhaps even with a clear conscience. If adherence to externally defined, checklist-style compliance indicators confers the legitimacy that firms seek, then the firms have an incentive to adhere to those checklist-style compliance indicators and nothing more. Worse yet, firms may purchase compliance programs modeled on the prescriptive rules, regardless of their perceived efficacy, as insurance against enforcement action. In this way, compliance-related regulatory requirements might actually generate moral hazards that undermine corporate governance objectives.\(^{107}\)

Moreover, for that minority of industry actors that is inclined actively to seek out loopholes and to avoid regulatory requirements, a rules-based system will do nothing to address that inclination. Creating ever-longer lists of prohibited behavior or checklists of compliance-related best practices will not be effective if the basic culture of the firm does not foster law-abiding behavior.\(^{108}\)

By contrast, a principles-based regime sets out requirements governing, for example, "reasonable and effective" compliance programs and requires industry actors to take the responsibility for determining how to meet those outcomes in the particular context of their businesses. At a minimum, such an approach forces firms to turn their minds to their

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\(^{107}\)See Kimberley D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487 (2001) (arguing that placing excessive importance on compliance structures raises dangers of underenforcement and social waste); William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343 (1999) (arguing that the moral hazard will persist until prosecutors and firms share a consistent understanding of what an "effective" compliance system entails, as well as a workable metric for evaluating compliance systems). As is evident from the discussion above, this article disagrees with Laufer's and Krawiec's to the extent that they argue for more specification and more certainty as a response to problems of facial compliance.

\(^{108}\)For example, Enron's Code of Ethics, with its Vision and Values platform encompassing its RICE (Respect, Integrity, Communication, and Excellence) values statement, was once cited as a model corporate code of ethics. Bethany McLean & Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (2003).
compliance processes and those processes' relationships to their particular business risks. This attention forcing should reduce noncompliance associated with managerial distraction. Principles-based regulation also sends the important message that firms should orient themselves toward underlying principles of responsible business practice, rather than toward facial compliance with detailed rules. Principles-based systems, buttressed by meaningful regulatory oversight, make "cosmetic compliance" harder. Requiring firms to fill in the content of those principles themselves makes firms agents rather than subjects of regulation. It has the potential to dissipate firm resistance to externally imposed regulatory rules, which (according to some firms) fail to appreciate the particular nuances of their business and needs. Endogenous, engaged experience is more likely to produce real learning and a more genuine compliance culture within the firm.

Equally important is the regulatory system's ability to learn. Learning systems start from agreed premises of existing law, but they are pragmatic and open to promising new approaches. Effective regulatory learning entails, first, the ability to gather and analyze, in an open-minded way, experience from actual practice and input from industry actors and other stakeholders, including, of course, regulators' own experiences. Systems, including regulatory systems, also learn better and faster where they include some sort of mechanism for amplifying "local" learning, for example, by way of parallel experiments moderated and overseen by a clearinghouse-style regulator. With New Governance, the regulator serves as a centralized information-gathering body that aggregates experience and permits comparative learning between industry actors.

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111 See Cristie L. Ford, Toward a New Model for Securities Law Enforcement, 57 ADMIN. L. REV. 757, 791–92 & 806–10 (2005). See also Edward L. Rubin, Images of Organizations and Consequences of Regulation, 6 THEORETICAL INQ. L. 347, 376–77 (2005) (attributing to a "systems theory" approach the notion that "legal regulation of the corporation cannot rely on the imposition of specific stimuli, rather, it will be effective only if it can induce an internal process that integrates the corporation with other social systems").

112 See, e.g., Dorf & Sabel, supra note 105, at 287–89 & 354–56 (describing innovative regulatory strategies that combine local experimentation with a centralized standard-setting and
Governance envisions a "learning by doing" structure, meaning that industry and regulator continually revise both ends and their own process through their participation in it. Transparency and accountability, including accountability for adhering to non-negotiable participatory norms, are reinforced by the centralized comparative data analysis function.\footnote{Similarly, Jody Freeman describes "collaborative governance" in administrative rulemaking as a process characterized by: (1) a problem-solving orientation; (2) participation by interested and affected parties in all stages of the decision-making process; (3) provisional, revisable solutions subject to continuous monitoring and evaluation; (4) accountability that transcends traditional public and private roles in governance, in that parties are interdependent and accountable to each other; and (5) a flexible, engaged regulator that facilitates multistakeholder negotiations, provides appropriate incentives, acts as capacity builder, and takes its ultimate decisions recognizing that regulatory success involves industry collaboration (although it is not ultimately limited by industry consensus). Jody Freeman, \textit{Collaborative Governance in the Administrative State}, 45 UCLA L. Rev. 1, 21-22 (1997).}

In the Account Supervision Case above, each firm in question was running its own live experiment with supervision processes, considerably disciplined by real fears of civil liability and adverse reputational effects in the event of failure. The regulator collected their experience and analyzed the ways in which different actors reached different solutions to the problem of supervision, simultaneously learning about effective means for achieving regulatory goals. Generally, this demonstrates the need for firms
to disclose information about their methods and experience. More particularly, where one or another actor encountered difficulty in developing a workable supervision system, the regulator would be able to draw on others’ successful examples to help the struggling actor or pressure it to achieve better results. The regulator could also better identify and then query firms that seemed to be relying on pro forma and potentially suboptimal compliance responses that appeared imperfect relative to the particular environment and capacities of that firm.

Importantly, as the Account Supervision Case demonstrates, regulation is not the only force pushing firms toward compliance. On the contrary, the shift toward outcome-oriented and principles-based regulation reflects the reality that rules are fashioned in an iterative way, through a polycentric process, in which regulation is only one part.115 In other words, regulatory requirements are only one component going into what scholars Neil Gunningham, Robert Kagan, and Dorothy Thornton have called an organization’s “license to operate.”114 In the Account Supervision Case, reputational effects, network effects, and concerns about civil liability had already driven the firms in question to establish independent supervisory systems to address the failings of the mandated checks.

That said, a credible enforcement function writ large (meaning both compliance oversight and prosecution where needed) is a necessary component of principles-based and outcome-oriented regulation. New Governance theory is to be distinguished from industry self-regulation and also from so-called “soft law” options.115 In fact, meaningful and effective enforcement capacity is a precondition to New Governance regulation.116 An


115 New Governance models should not be confused with “soft law,” unreinforced by sanctions. See, e.g., Karkkainen, supra note 105, at 485–89.

important component of credible enforcement is the regulator’s own ability to specify, measure, and monitor its outcomes, interrogate and tinker with its own processes, and learn from and adapt to challenges. The regulator should operate along the same outcome-oriented, problem-solving, self-reflexive lines that it requires from industry. Outcome-oriented practice, in its best form, must mean something substantially different from unbridled regulatory discretion to interpret principles in any way the frontline regulator sees fit. The outcome-oriented approach, then, responds directly to worries that principles-based regulation could be arbitrary, inscrutable, or amount to regulatory overreaching. The continued investigatory mindset is also the principle-minded regulator’s defense against regulatory ossification over time.

Malcolm Sparrow’s model of problem-solving regulation is instructive both externally, in terms of the regulator’s relationship to industry, and internally, in terms of the regulator’s relationship to its own practices. Another promising analytical framework, described as “root cause analysis,” operates within the Toyota Production System as a problem-solving technique. It involves asking a series of nested “why” questions about a particular failure, each of which is meant to deepen the response to the last. It has clear application to organizational contexts such as securities law—for example, when the superficial reason for a regulatory failure is that a particular process was not in place. By asking subsequent “why” questions, one can access underlying causes. For example, a firm’s compliance processes did not operate effectively to prevent wrongdoing because the firm had not turned its mind to the scenario that occurred; it had not turned its mind to that scenario because its compliance department did not understand enough about its business processes; its compliance department did not understand enough because it was institutionally isolated; it was institutionally isolated because it was seen as a cost center and a “meddler”; it was seen this way because of a firm culture that reinforced “making the numbers at any cost.” Root cause analysis on

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also Ayres & Bratthwaite, supra note 27, at 35–41 (on regulators’ need for a “benign big gun,” or heavy sanctioning option, to make less intrusive self-regulatory options viable); Parker, Re-inventing Regulation, supra note 113, at 533–35 (identifying credible enforcement as a precondition to what she calls “compliance-oriented regulation”).

117 See Sparrow, supra note 82.

the heels of a compliance failure also illustrates the important role that enforcement learning and other forms of on-the-ground learning play in enhancing overall regulatory capacity.

Returning to the B.C. Model, certain fundamental priorities need to be kept in mind if the BCSC’s outcome-oriented approach is to remain credible and respected. These priorities are not new. The first is that regulatory conduct should be as transparent as possible. In addition to being good regulatory policy, transparency fosters credibility and trust. It reinforces the notion that BCSC action will not be arbitrary, which in turn encourages responsible firms to believe that they will be rewarded for their responsibility. Relatedly, the BCSC must resist the temptation to seize the low-hanging fruit of easy, technical violation cases in favor of more important (and often more difficult) cases. In the interest of allocating resources wisely, BCSC staff should cooperate with responsible firms where those firms continue to behave responsibly. The BCSC has multiple remedies available to it, and staff should tailor the nature of their response to the severity of the conduct at issue. They should be creative and pragmatic, within the limits of statutory power, in devising effective remedial or enforcement measures. Such measures may respond to the need for the corporation to internalize learning and reframe “punishment as persuasion.”

119The various Canadian provincial Securities Acts provide a range of remedial options, including administrative penalties (e.g., trade orders, director and officer bars, etc.), fines, the power to order disgorgement, plus quasi-criminal provisions. In addition, the Criminal Code of Canada contains provisions governing insider trading, capital markets fraud, and organizational liability.

120For example, a noteworthy innovation being adopted by the BCSC, along with the FSA in the United Kingdom and the New York Stock Exchange in the United States, is the notion of the selective business line shutdown. See, e.g., Kip Ietz, Comprehensive Penalty Review Underway at NYSE, Regulation, Official Says, 36 Sec. Reg. & L. Rep. (BNA) 2116 (Dec. 6, 2004); Patrick Hosking, FSA Plans to Get ‘Creative’ with Wrongdoers, The Times (U.K.), Feb. 23, 2006, at 48. The U.S. Federal Reserve has also barred Citigroup from engaging in any major acquisitions until the company had “fixed its regulatory problems.” Mitchell Pacelle et al., Fed Ties the Hands of Citigroup, Wall St. J., Mar. 18, 2005, at C1. Temporary business line shutdowns represent a new level somewhere near the upper end of the enforcement pyramid described in Ayres & Braithwaite, supra note 27, at 35–41. See also infra text accompanying notes 180–86 for a discussion of reform undertakings.

121Pablo De Greiff, Deliberative Democracy and Punishment, 5 Buff. Crim. L. Rev. 373 (2002) (arguing for a “communicative theory of punishment” under which a primary aim of punishment is to persuade offenders about the wrongfulness of their conduct). De Greiff’s insight applies here, even though strictly speaking the Commission cannot punish, but can only deter.
A regulator should hold its greatest fire for the firms against whom deterrent action is necessary, yet it should not hesitate to use that sanctioning power where necessary. Just as importantly, it should be able to tell the difference: the regulator’s credibility, and the so-called enforcement pyramid approach, is premised on the regulator’s ability to identify problem firms and noncompliance accurately and to distinguish them, respectively, from generally responsible firms that periodically make mistakes, as well as from market failures not associated with law violation. Risk analysis is a central tool here. The use and continual revisiting of appropriate risk factors will also make the BCSC better at identifying “bad actor” firms and at imposing its regulatory pyramid over industry appropriately. Publication of the BCSC’s risk factors would further transparency and credibility as well.

A closer relationship between industry and regulator is another part of this equation. In fact, each side has incentives to be trustworthy and open with the other. The regulator needs industry’s knowledge to remain credible and apprised of current industry practices. Regulated firms seek the legitimacy that regulatory approval confers, not only for culturally expressive reasons but also because that legitimacy can confer tangible benefits, including currency with clients and other industry actors. Moreover, industry and regulator are in a “repeat player” relationship, which ought to strengthen incentives to behave well toward each other. That said, it remains to be seen whether the BCSC’s relationship with its regulated entities reflects these incentives toward cooperation and mutual trust or

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122 John Braithwaite, To Punish or Persuade (1985); Ayres & Braithwaite, supra note 27, at 19-53 (advocating for a “minimal sufficiency principle” in the deployment of regulatory action, under which most firms are coaxed or persuaded into compliance and a progressively smaller number of progressively more difficult firms are met with a hierarchical set of increasingly severe sanctions). But see Sexabor, supra note 82, at 39-42 (cautioning that a pyramid approach should apply primarily in contexts where there is reason to believe that improving compliance is an effective method of decreasing risks, that is, where law violation rather than, for example, market effects, caused the harm in question).


exhibits something more like the cat-and-mouse mentality characteristic of, for example, tax law enforcement.\footnote{Sol Picciotto, \textit{Constructing Compliance: Game-Playing, Tax Law and the Regulatory State}, 29 Law & Pol'y 11 (2007).}

\textbf{B. Costs and Compliance}

Some scholars have noted that the theoretical rules-versus-principles dichotomy drains away an important evolutionary, iterative, contingent, law-in-action way in which legal prescriptions evolve and are implemented.\footnote{See Radin, \textit{supra} note 37. Obviously, laws are not always applied in keeping with the intent of statutory drafters. For example, Peter May found, in the context of state-level land use and development management mandates in the United States, that it is more difficult to foster conciliatory regulatory approaches among front-line implementation staff than it is to foster more formal, legalistic regulatory approaches. Peter J. May, \textit{Mandate Design and Implementation: Enhancing Implementation Efforts and Shaping Regulatory Styles}, 12 J. Pol'y Analysis & Mgmt. 634, 653 (1993). May's point applies most clearly to cases where mandates are developed by parties removed from those implementing the mandates. This is less the case when discussing the BCSC, a relatively small organization characterized by physical proximity and frequent interaction between commissioners, policy staff, and enforcement officers.} While this may be true of a rigid, essentialist understanding of rules and principles, the worry is really only valid at that level. Principles-based regulation actually goes a long way to \textit{permitting} an evolutionary, iterative, polycentric lawmaking process. It takes seriously the role of on-the-ground implementers in setting the content of the law on a rolling basis.

The advantage of regulatory principles, as opposed to detailed rules, is not that they will remain forever vague, but rather that their content can be filled in more dynamically and insightfully by those with the greatest understanding of the relevant situations. Even in principles-based regimes, the content of the principle will be filled in and will accrete with time. The difference is that their content is meant to remain flexible and up to date— that rather than ossifying, the principles' content will continue to evolve, discarding older formulations as newer, more comprehensive or effective ones emerge. Moreover, that content, as precisely articulated in a given context, is generated by direct reference to the operative principles rather than, as with a loophole mentality, in an attempt to avoid the spirit of the law in favor of its letter.\footnote{For more on this topic, see William H. Simon, \textit{After Confidentiality: Rethinking the Professional Responsibilities of the Business Lawyer} (Columbia Public Research Paper 06-119, Aug. 15, 2006), \textit{available at ssrn.com/abstract=924409}, at 14 (distinguishing between formalist and new}
evaluate a principles-based regime from the point of view of legitimacy or efficacy without understanding the mechanisms and actors chosen to fill in that content.

An outcome-oriented approach of the kind described here is not the only means for filling in content within a principles-based regulatory approach, but it is the best one. Another possibility would be to fill in the content of principles through regulatory discretion. For example, the BCSC could go the way of American criminal prosecutors: the black box of discretion. This is not a good solution. Relative to outcome-oriented practice, it is nontransparent, nonaccountable, and proceeds on an ad hoc basis without internalizing its own learning in any systematic way. At the other end of the spectrum would be industry self-regulation. In view of its troubled history, British Columbia may be even more keenly aware than other jurisdictions of the need to maintain credible regulatory oversight of its provincial capital markets, for obvious substantive reasons as well as with regard to the "optics." Of course, there are also compelling, normative, and pragmatic arguments, not specific to British Columbia, in favor of some more substantial degree of ongoing regulation of the securities markets.

Relative to these options, New Governance-style principles-based and outcome-oriented regulation spans the public/private divide, incorporating industry experience and perspectives into a still-resilient

128 Most of the literature on prosecutorial discretion emerged around mandatory minimum sentences and, later, the U.S. sentencing guidelines, which arguably increased prosecutors' power at the expense of judges' power. Prosecutorial discretion has been criticized for its lack of transparency and accountability and for the differentially negative effect of discretion on marginalized groups. See, e.g., Gerald W. Heaney, The Reality of Guidelines Sentencing: No End to Disparity, 28 AM. CRIM. L. REV. 161, 192-97 (1991); Cynthia K. Y. Lee, From Gatekeeper to Concierge: Reimagining the Federal Prosecutor’s Expanding Power Over Substantial Assistance Departures, 50 RUTGERS L. REV. 199, 235-40 (1997). See also Brandon L. Garrett, Structural Reform Prosecution, 93 VA. L. REV. 853 (2007) (citing concerns about prosecutorial discretion in forcing corporate structural reforms during settlement).

129 See supra note 78.

regulatory capacity.\textsuperscript{131} What this article envisions is shared implementation of principles-based regulatory mandates within which other actors, such as individual public issuers, broker/dealers, and portfolio managers—as well as, potentially, trade associations, industry councils, shareholders, and other stakeholders—may play a role in facilitating regulation and contributing provisional content to principles. Ultimate enforcement and coercive power remains with the regulator. The regulator uses its enhanced outcome-oriented analytical capacity to interrogate industry action, communicate results, provide ongoing guidance, and spur laggards with a view to effectuating its irreducibly public policy goals of safeguarding investors and promoting efficient capital markets.\textsuperscript{132}

This kind of approach could potentially impose additional costs on private actors as compared to a prescriptive, detailed, rule-based approach. Indeed, this was a central point made by opponents to Bill 38. Critics like David Brown, former chair of the Ontario Securities Commission, identified that, at least in its initial stages, a principles-based regime moves substantial costs from legislators to industry actors.\textsuperscript{133}

In the same vein, Louis Kaplow has posited that rules are costly ex ante, as their content must be already filled in when they are promulgated, while principles are costly ex post and those costs are imposed on a broader range of individuals.\textsuperscript{134} He has argued that the choice between rules and principles in statutory drafting should in part come down to the frequency with which a particular problem arises. Statutory directives


\textsuperscript{132} The accountability issues presented by shared public/private regulation are most fully canvassed in Freeman, \textit{Public Parties}, supra note 131.

\textsuperscript{133} Letter from David Brown, Chair Ontario Securities Commission, to Doug Hyndman, Chair British Columbia Securities Commission (June 27, 2003), available at http://www.bcsc.bc.ca/uploadedFiles/BCN2003-12_OSC.pdf, at 3 (charging, inter alia, that the B.C. Model "is focused on a reduced role for the regulator, but overlooks the increased costs of compliance for market participants . . .").

\textsuperscript{134} Kaplow, supra note 22.
governing frequently recurring situations should be drafted as rules, not principles, because economies of scale justify incurring the costs of determining the content of the law ex ante.\textsuperscript{155} By contrast, exceptional, isolated, or unusual situations should be governed by principles because there would be no point, and it would be a waste of resources, to try to anticipate the content of such laws in advance.

Whether principles-based systems really do impose greater ex post costs on private actors is an empirical unknown. An accurate measurement of relative costs would have to acknowledge, for example, that the cost of rules includes not only ex ante drafting costs, but also the ex post costs of periodically inappropriate, overly broad or overly narrow application of rules to unanticipated circumstances. Even leaving that observation aside, the Kaplow account fails to consider two important points, both of which go not to the frequency but to the content of the conduct in question.

First, it is not sensible to incur the ex ante costs of rule specification where the regulator or statutory drafter is operating under a serious information deficit. This may be the case on a relative basis vis-à-vis other actors or because events are too fast moving to be able to ascertain the proper content of rules in advance. In other words, the fact that a situation recurs frequently does not necessarily mean that the regulator has sufficient information to deal with it appropriately. In those situations, ascribing content to a legal prohibition or directive should be done by such actors or at such time as the greatest amount of information that can be feasibly gathered is available.\textsuperscript{156}

Edward Rubin has said that open-ended, learning systems are preferable to prescriptive, command-oriented regulatory systems where the regulator "knows the result it is trying to achieve but does not know the means for achieving it, when circumstances are likely to change in ways that the [regulator] cannot predict, or when the [regulator] does not even know the precise result that she desires."\textsuperscript{157} It is not an admission of weakness for a regulator to acknowledge that at least the first two of

\textsuperscript{155}Id. at 577.

\textsuperscript{156}At some point, of course, this statement runs into the general prohibition against retroactivity. The greatest information may only be available with the benefit of hindsight, but effective administration of justice and basic fairness principles require that some informational completeness be sacrificed in the interest of real-time clarity.

Rubin's conditions may reasonably exist, particularly in the context of corporate compliance. It does not have to be the business of a regulator to know the precise means for achieving corporate compliance in any given firm. It is the business of the regulator to try to ensure good compliance with law, but the corporations or firms themselves are in a better position, in terms of access to information, to determine appropriate means for reaching that end.

Second, Kaplow's thin, industry cost-oriented approach to the choice between rules and principles must be qualified where the nature of the directive is such that costs must be borne ex post, by a broader group of actors, in order to meet regulatory objectives. In those cases, costs should be borne ex post by that broader group of actors. In other words, there are times when firm engagement may be the sine qua non of regulatory effectiveness. Regulation concerning firm-compliance processes in particular depends on industry buy-in. Regulators in a functional system need not anticipate every form that (right- or wrongdoing can take, nor create exhaustive and detailed lists of prohibited conduct, because sanction alone is not and could not be what keeps the system functioning. If the most promising way to make a compliance policy work, for example, is for industry actors themselves to define and implement a firm-specific and firm-appropriate strategy for implementing it, then industry actors may well be expected to bear the attendant costs. Our concern should be to adopt the effective system with the lowest overall social costs, not the lowest costs to industry alone.

All of these considerations are more important with respect to compliance processes than to any other aspect of business conduct, because compliance processes are so deeply enmeshed with firm culture and the firm's sense of itself and its relationship to its environment and its regulator. Principles-based regulation is not a panacea, and it will not eliminate all problems. However, it brings with it the exciting potential to build the

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138 See, e.g., Tom R. Tyler, Why People Obey the Law (1990) (arguing that people obey the law if they believe it is legitimate, not because they fear punishment).

139 This does not necessarily preclude a subsequent decision to compensate particular parties for their compliance expenses. One of the assumptions behind having industry pay compliance costs is that, having introduced particular business risks into the world, it should be required to internalize the cost effect of those risks. However, where this approach turns out to impose disproportionate compliance costs on a particular party, regulators or society may still choose to address the inequity through some form of compensation.
buy-in from the regulated firm that is essential to a compliance program that actually works.

C. Rolling Best-Practices Rulemaking

One of the key underlying notions of New Governance theory is that regulators can improve industry conduct and stimulate a “race to the top” through “bootstrapping,” or “rolling best-practices rulemaking.” The idea is attractive in part because it describes a concrete mechanism for avoiding the specter—sometimes associated with incorporating industry standards into regulation—of a race to the bottom. Proponents of rolling best-practices rulemaking hope for more than simply avoiding a bad result. The rolling best-practices rulemaking approach suggests a mechanism for harnessing regulation to change the ground rules by which industry operates. In its strongest form, this kind of rulemaking shifts regulatory expectations off a static, industry-standards model toward a model that incorporates the best practices of the highest-performing actors as new industry-wide benchmarks. It is a fluid regulatory structure that forces firms to strive for improvement continually and in contextually appropriate, industry-generated directions. One of the regulator’s primary roles in such a regime is to aggregate and reflect industry actors’ experiences back to them, to establish careful matrices for assessing performance across firms, and to challenge laggards with the experiences of their higher-performing peers.

In securities regulation, the notion of rolling best practices runs into an immediate, but ultimately artificial, conceptual roadblock: the emphasis on light-touch regulation. Light-touch regulation—meaning regulation based on disclosure obligations and a relatively minimalist set of regulatory and registration requirements—is the dominant paradigm in securities

140 Dorf & Sabel, supra note 105, at 350–54 (explaining that “[s]uch rules require regulated entities to use processes that are at least as effective in achieving the regulatory objective as the best practice identified by the agency at any given time. . . . benchmarking establishes and periodically updates the standard to incorporate improvements . . .”).

141 Id. at 354–56. The regulator’s comparative and aggregative functions, and the provisional basis on which any particular practice is held to meet regulatory outcomes, are important components of New Governance theory. They establish a flexible system for ascribing content to regulatory principles. This means that, contrary to Cunningham’s assertion that the “new governance paradigm” is a trend favoring rules over principles in regulatory design, Cunningham, supra note 43, at 48, New Governance is actually more compatible with principles-based and outcome-oriented regulation.
regulation. The U.K. FSA’s explicit emphasis on its light-touch approach, in contradistinction to its characterization of the Sarbanes-Oxley-era American approach as costly and burdensome, gives this term contemporary relevance. Yet, even the Sarbanes-Oxley Act does not begin to approximate the interventionist regulatory schemes in some other areas of administrative law.\textsuperscript{142} It is an article of faith among both regulators and securities industry players that the capital markets ultimately are a dynamic and positive force and that regulation should limit itself to addressing market failures, such as information asymmetries. Regulation in this area seeks to foster efficient and trustworthy capital markets, not to set goals or direction for those markets.\textsuperscript{143} In this context, it is generally presumed that regulators should not be telling business how to do its business. The worry about rolling best-practices rulemaking, then, is that an approach that uses continually increasing best-practices benchmarks to ratchet up industry performance is fundamentally opposed to the prevailing conviction that the regulator’s role is to establish only minimum standards for industry.

In fact, rolling best-practices standards and light-touch regulation are not mutually incompatible. The regulatory goal of setting only minimum standards reflects a normative position, not a quantitative one, regarding the role of regulation in the securities markets. The light-touch approach need not (in fact, it should not, in its best form) try to describe a permanent, objective, process-based floor that firms must achieve. Similarly, rolling best-practices standards represent a method for identifying and leveraging information about effective means for achieving a regulator-determined goal. One may choose to regulate minimally according to a series of static checklists, or one may choose to regulate minimally by reference to evolving industry learning about the most efficient, fairest, most effective, and least costly means of achieving those minimum standards.


The Account Supervision Case, above, illustrates this point. Both the detailed IDA rules and the principles-based B.C. Model seek to require firms to meet minimum standards, in terms of establishing appropriate and effective compliance systems to detect questionable activity in client accounts. The IDA approach uses detailed, process-based rules as a means of forcing firms to meet those minimum standards. The B.C. Model uses the Code of Conduct for Dealers and Advisors as elaborated upon by administrative guidance and ultimately industry experience. Recognizing the IDA rules’ limited effectiveness in identifying questionable account activity, and mindful of civil liability and reputational risks, firms developed their own proprietary systems to meet their account supervision obligations. However, those supervisory systems were developed as better means for achieving the same perceived minimum level of effective supervision. The B.C. Model’s principles-based and outcome-oriented approach would not have demanded increasingly costly or elaborate account supervision systems from the dealers. The B.C. Model would simply have allowed those firms to achieve existing regulatory standards using more effective and context-appropriate methods, as those methods were generated through industry experience itself. It would also have allowed the BCSC to collect and disseminate that industry experience to other industry actors facing similar challenges.144

The Account Supervision Case also highlights two other important conceptual relationships: the connection between the regulator and broader...
social or economic factors as determinants of firm behavior and the connection between best practices and outcome-oriented regulation. On the first point, the way the BCSC uses industry learning both connects its regulatory agenda with, and distinguishes its regulatory agenda from, compatible compliance-generating forces beyond regulation. According to Sandy Jakab, Manager of Policy for the Capital Markets Division of the BCSC, the BCSC’s goal is to use best or good practices in an instructive rather than mandatory way. In fact, the BCSC prefers the term “good practices” to “best practices,” mindful that the latter can be misunderstood in the context of a light-touch regulatory approach. Jakab notes that, in the context of the BCSC’s role in setting minimum standards, “good” practices are those methods that work to achieve the minimum standard most consistently, most efficiently, and with minimal risk. Jakab emphasizes that, if implemented literally, such that every improvement in a particular firm’s practices automatically translated into a heightened process-based regulatory expectation across the board, a pure best-practices approach would also fall prey to potentially adverse firm-on-firm competitive effects. According to Jakab, the BCSC’s view is that one size will not fit all in setting regulatory standards and that regulators must be sensitive to the costs of any new regulatory requirement.

Jakab points out that the more literal meaning of best practices—in other words, the most state-of-the-art and highest, and perhaps the most comprehensive and elaborate, practices being used by industry leaders—is available to be put forward by other stakeholders, such as industry associations and trade councils. According to Jakab, industry councils and trade associations have a central role to play in articulating best-practices standards. But, it is not the place of the regulator to rank practices as “best” or “second best.” Rather, it concentrates on sharing information on those practices that have been shown to work in achieving regulatory goals. Significantly, by reconciling light-touch regulation and the desire for effective and improving standards, the notion of “best practices” becomes bifurcated between regulator and other third parties. The BCSC explicitly recognizes the role of other forces—social, reputational,

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145 Telephone Interview with Sandy Jakab, Manager, Policy, Capital Markets Division, BCSC (Feb. 22, 2007) [hereafter “Jakab Interview”].

146 Id.

147 Id.
economic, and legal—that go into ensuring that firms remain law abiding.\textsuperscript{148} While using the tools of industry-based good- or best-practices experience to disseminate learning about effective means for achieving regulatory goals, the BCSC is neither the overseer nor the repository for all industry learning.\textsuperscript{149} By tying its approach to industry best practices and establishing an ongoing dialogic relationship between its regulatory requirements and other standard-setting bodies, regulatory action becomes an organic piece of constantly moving, innovating industry action. In keeping with this, the BCSC’s industry-derived information on best practices may appear in guidance (policy papers, interpretive statements, and the like) but not in actual rules.

The Account Supervision Case also illustrates the connection between rolling good or best practices and outcome-oriented administrative action. That is, the more basic reason that best practices are not the subject of official notice-and-comment rulemaking is that an outcome-based system would not mandate any particular good or best practice. The B.C. Model’s principles-based and outcome-oriented approach seeks, by definition, to avoid prescribing process. Indeed, for this reason an outcome-based regulatory approach is the essential underpinning for making use of good or best practices in principles-based regulation. Outcome-oriented practice presumes that there may be more than one path to an acceptable compliance goal, thereby reconciling its best-practices approach with its light-touch regulatory mandate.

IV. CHALLENGES AND OUTSTANDING QUESTIONS

British Columbia has claimed that its principles-based and outcome-oriented approach is more flexible, more capable of learning from experience, and better at safeguarding investor interests, all while still minimizing unnecessary costs to industry. With respect to compliance, for

\textsuperscript{148}See CUNNINGHAM ET AL., supra note 114; Parker, Reinventing Regulation, supra note 113.

\textsuperscript{149}In Jakab’s view, industry actors also could be more proactive and effective if they understood that guidance does not set out mandatory standards and that they are free to develop their own tailored approaches to achieving regulatory outcomes. Jakab notes that the consulting industry can, unwittingly, be unhelpful when it concentrates on developing more comprehensive and elaborate means of achieving ever-increasing compliance standards, rather than on the most effective and efficient means to achieve minimum standards. Jakab Interview, supra note 145.
example, the aim has been to move away from a technical and literal, checklist-style approach to regulatory mandates, toward something more dynamic and geared specifically toward reaching underlying regulatory goals. The idea behind outcome-oriented regulation is that the securities regulator should not be policing technical rule violations, and industry should not be primarily concerned with technical compliance. Both regulator and industry should be focused on achieving good regulatory results on important issues, in the most efficient manner.

Even an optimist would agree, however, that challenges exist. The B.C. Model shares important features with other New Governance approaches to regulation and public service provision. As such, cautionary tales from other New Governance-style experiments, such as the ones emerging from the No Child Left Behind Act in the United States, are relevant. The decentralized, pragmatic, information-based, and participatory structures that New Governance uses to produce continually ratcheting standards of performance are vulnerable to many familiar regulatory failings, including lack of political will, failure of credible enforcement, and a potential misfit between means and ends. In the same way, making principles-based securities regulation in British Columbia work, and enabling it to leverage all the advantages of a New Governance regime, means paying careful attention to context.

The B.C. Model is promising and noteworthy because New Governance-style securities regulation opens the possibility of thoroughgoing change for the better, including meaningful reform of corporate compliance and the relationship between regulator and industry. However, making those changes stick requires that catalysts for change be embedded in institutional arrangements. There is more work to be done before one should venture to say whether principles-based and outcome-oriented securities regulation in general, and the B.C. Model in particular, operates on the ground in a way that can move industry compliance forward in measurable and sustainable ways. The purpose of this article is to develop a framework for pursuing those questions as part of a broader research

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150 The New Governance potential of the No Child Left Behind Act has been explored in, for example, James S. Liebman & Charles F. Sabel, The Federal No Child Left Behind Act and the Post-Desegregation Civil Rights Agenda, 81 N.C. L. Rev. 1703, 1794–97 (2003); Liebman & Sabel, supra note 105, at 184–85, 191–92 & 303–04. These authors also acknowledge the significant problems with that Act, including the weakness of the Act’s formal enforcement mechanisms. See Liebman & Sabel, supra, at nn. 78–86 and accompanying text.
agenda. The following sections flag two issues in particular that deserve closer attention: first, firm incentives to innovate in compliance practices (as opposed to, for example, product development) and, second, the problem of varied firm capacity to operate effectively under a principles-based regime, with special attention to using a hybrid rules-and-principles approach to help smaller and less-well-resourced firms cope. Provisional responses to these challenges, including a proposal for regulatory tripartism, are developed below.

A. Firm Incentives to Innovate

According to Stephen Bland, Director for Small Firms at the FSA, his agency is approached with some frequency to sign off, under its principles-based approach, on a firm’s assessment of the compliance bona fides of new business products. The wholesale market, in particular, is a sector that regularly seeks principles-based regulatory accord (which is something less than approval per se) to issue innovative products and business practices.\(^\text{151}\) The banks and private firms that regularly develop new structured finance products for sale into the wholesale market are likely to be among the most sophisticated of market players. They are the market actors most likely to have the capacity to work effectively within a principles-based system, to seek the competitive advantages offered to innovators under a flexible, discursive, regulatory approach, and to advocate on behalf of their products and those products’ consonance with regulatory goals. Principles-based regulation will be attractive to wholesale market participants to the extent that it helps them bring creative products to market more quickly and easily.

It is less clear that a market actor’s innovative mindset with respect to structured finance products will necessarily translate into innovation in the area of compliance. High-functioning firms will excel in both areas. However, the pressure to innovate and improve may not be uniformly as intense in compliance areas as in new product development. Among more problematic firms, one can even imagine an inverse relationship: the same drive for innovation that pushes a firm to create new products also pushes it to take risks and cut corners in corporate governance and compliance. Among firms that see their internal compliance departments

\(^{151}\text{Interview with Stephen Bland, Director, Small Firms at the Financial Services Authority, in Vancouver, British Columbia (Sept. 28, 2006).}\)
as cost centers or, worse, obstacles to be circumvented wherever possible, the mere presence of principles-based regulatory opportunities to improve their compliance practices, or to learn from others’ best practices, will not generate the internal will to do so.

This distinction between product development and compliance highlights a number of questions about principles-based regulation. Specifically, what makes rules “roll” under a rolling best-practices regime, and what prompts a revision to the content of a regulatory principle? Are revisions likely to be common where firms have obvious, built-in incentives to innovate, such as in creating highly profitable financial instruments for sale, and uncommon when it comes to compliance processes and procedures? How can regulators keep compliance on the agenda? Should compliance even be subject to a rolling deliberative process in this environment, or are prescriptive rules a better solution in terms of protecting investors and fostering fair and efficient capital markets?

Not all compliance rules should be subject to deliberation and argumentation. A participatory, principles-based regulatory regime should still maintain a phalanx of non-negotiable rules governing topics on which there is consensus, such as extreme misconduct and misbehavior. Circumscribing these outer boundaries of permissible conduct actually makes reasonable deliberation possible with respect to topics on which there is not consensus. Of course, this is not a full answer. The Account Supervision Case demonstrates that compliance processes, like other areas of firm conduct, benefit from an outcome-oriented, rolling best- (or good-) practices approach. Some rules may well roll more automatically than others, for perceived self-interest reasons. Therefore, part of the job of the regulator may be to help industry players see that meaningful compliance is in their self-interest.

Regulators can provide short-term incentives and rewards to firms that exhibit consistently good compliance. In particular, regulators encourage compliance when good actors benefit from a reduced regulatory burden and a more hands-off approach. High-risk actors—firms whose compliance systems have been shown to be materially inadequate to address the compliance risks posed by their particular business, whether or not that business is itself high risk—should be subject to increased oversight. They should attract more compliance visits, more scrutiny of their practices between visits, more explicitly defined outcomes emanating from regulators, and eventually even caution letters, potential conditions or restrictions on the firm’s license, or a referral to enforcement staff. The
BCSC does this. While somewhat instrumental, differential regulatory treatment based on a firm’s compliance history does establish clear incentives for firms to remain on good terms with the regulator.

Looking to more endogenous mechanisms, a firm is more likely to maintain good compliance processes and to exhibit a genuine culture of compliance where it is able to identify a link between its long-term business success and good compliance processes. For example, a firm’s compliance staff may be able to demonstrate that preventive compliance processes are less costly in the long run than enforcement and civil liability arising from a compliance failure. In the Account Supervision Case above, the fact that firms had created internal supervisory programs on their own initiative demonstrates that they were convinced of this calculation.

Also, one may hope for deeper points of convergence between compliance and profits. In other spheres of activity, finding the leverage points that establish, in the organization’s view, the connection between good internal practices and external success has effected measurable progress on previously intractable problems. Here, Neil Gunningham’s notion of the “license to operate” may be language that both compliance and business sides of the firm understand. The “license to operate” encompasses not only regulatory requirements, but also the full range of social, business, and environmental factors that go into a firm’s ability to flourish. Where firms are subject to pressures from a broad range of stakeholders to practice good corporate governance, that license to operate becomes thicker and more substantial.

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152 E-mail from Michael Sorbo, Manager, Examinations, BCSC Capital Markets Regulation Division, to author (Feb. 21, 2007, 13:54 PM PST) (on file with author) [hereafter Sorbo e-mail #1].


155 Gunningham et al., supra note 114.

156 Id. at 141. Business representatives participating in the Gunningham study also observed that the social license standards to which they are held may be higher than the regulatory ones. Id. at 52–55.
Broker-dealer firms may also be able to integrate the principles set out in the Code of Conduct for Dealers and Advisors, based as they are on a coherent set of ethical standards, with broader (and potentially status-conferring) professional standards. At the internal level, firms may come to see that good compliance processes actually improve the internal environment and make employees more committed and more willing to innovate, confident in the knowledge that the firm’s compliance safety net will prevent them from inadvertently engaging in impermissible conduct. Firms that explicitly live by and reinforce ethical principles for their employees may even come to be seen as more rewarding places to work, with associated benefits in the labor market. Locating the precise leverage points for this to happen in the securities regulatory context—including concepts, processes, and structures—is part of the work that remains to be done to understand and enable compliance standards to roll upward.

B. Capacity Issues and Hybrid Rules-and-Principles Models

As the BCSC recognizes, not all firms under its regulatory ambit will be possessed of equivalent capacity. The B.C. securities environment is characterized by a large number of junior-cap companies, small natural resource venture issuers, and small portfolio managers that do not have the means to engage large compliance departments. Neil Gunningham and Darren Sinclair have pointed out that many small and medium sized enterprises (SMEs) operate at the margins of profitability and cannot afford to devote many resources to such non-bottom-line issues as environmental protection, or as suggested here, to state-of-the-art compliance processes. Also, they often lack awareness and expertise; they may not have integrated compliance priorities into their business decisions; and they are likely to be less frequently inspected because as a group they are numerous, but each individual SME presents a quantitatively lower risk to

157Gary Hagland, A Critical Evaluation of the Compliance Administrative Control System Within Albert E. Sharp and its Motivational Impact Upon Those It is Supposed to Control, 3 J. Finan. Reg. & Compl. 28, 33 (1994) (early compliance-related case study of stockbrokers firm, noting that compliance controls were reinforced where firm equated corporate quality control with the codification of professional standards).

158See Jakab Interview, supra note 145.

regulatory objectives. SMEs' focus on economic survival means that they may lack the bandwidth to take action on issues like compliance, unless they are facing specific overt threats or pressure through, for example, regulatory action.160 Moreover, a principles-based regulatory regime may impose additional competitive pressures on smaller firms because larger industry actors with greater capacity to innovate are rewarded in such a system.

One option for responding to smaller firms' more limited capacity is to create a hybrid rules-and-principles system. Conceptually, this could entail either some sort of midpoint between two approaches or a system that gives industry actors a choice between principles-based and rules-based alternatives. The latter would effectively locate principles-based regulation adjacent to, rather than in lieu of, existing regulatory rules, such that firms that lack the desire or the capacity to innovate in compliance systems could rely on detailed, preexisting rules. This is the approach adopted by two regimes in Europe: the continental comply-or-explain regime for corporate governance161 and the U.K. FSA's approach. The U.S. Commodity Futures Trading Commission is also moving along what it calls a hybrid rules-and-principles spectrum, which includes the statutory core principles in the Commodity Futures Modernization Act.162 Under the FSA model, which is probably the most fully developed, firms have the option of either abiding by the safe harbor of established rules or applying innovative practices that nevertheless meet the FSA’s principles-based regulatory guidelines. If a firm chooses to use the principles rather than the rules, it must convince the FSA that its alternative mechanism is likely to achieve the same regulatory goal. If the firm succeeds, the FSA uses its exemptive authority to deactivate the operative rule, while giving effect to the operative principle and the firm’s proposed innovation.

160Ibid. at 13–14.

161See EUROPEAN CORPORATION GOVERNANCE FORUM, STATEMENT OF THE EUROPEAN CORPORATION GOVERNANCE FORUM ON THE COMPLY-OR-EXPLAIN PRINCIPLE (Feb. 22, 2006), http://ec.europa.eu/internal_market/company/docs/ecgforum/ecg-comply-explain_en.pdf. The European comply-or-explain model emphasizes transparency and disclosure, but leaves the details up to the particular issuer. As it stands, the principle is essentially a straightforward disclosure requirement. It assumes a high level of shareholder sophistication. Firms have the option of simply rejecting the nonbinding regulatory suggestion, which leaves it up to shareholders to discipline the firm. This hands-off approach especially does not make sense in a less transparent and liquid market arena such as British Columbia’s, which is characterized by a large volume of exempt transactions and closely held companies.

162Lukken, supra note 7.
This approach is not unlike the prophylactic-rules approach suggested by some New Governance scholars. In theory, it has the advantage of sharing with the regulators on-the-ground information about potential emerging best practices in real time. Regulators can then disseminate information about those best practices to other industry actors, including smaller or less well-resourced ones, who can benefit from the innovations without having to reinvent the wheel themselves. This approach also conserves each firm’s resources, allowing a firm to make incremental modifications to a compliance rule as it learns about what works. A hybrid rules-and-principles system may also allay industry fears about regulatory discretion and overreaching under a purely principles-based regime. As the FSA example demonstrates, the shift to a principles-based system, in

103 Dorf & Sabel, supra note 105, at 403. The concept also shares some ground with what Ian Ayres and John Braithwaite call “enforced self-regulation,” which permits firms to substitute their own privately devised compliance rules for the public ones. One difference, however, is that in the Ayres and Braithwaite model, the default public rules are more onerous, as well as being less tailored, than the privately developed alternative. Additionally, the enforced self-regulation model is useful primarily for large firms with the internal compliance capacity to develop a comprehensive set of compliance rules and to self-monitor for compliance with those rules and for lessons derived from experience with them. Ayres & Braithwaite, supra note 27, at 101–32. The hybrid FSA model permits a more piecemeal approach to substituting a particular innovation for a specific rule.

104 The sociological literature illustrates the important role that mimicry, or “isomorphism,” plays in disseminating new practices. Paul J. DiMaggio & Walter W. Powell, The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields, in THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS (Walter W. Powell & Paul J. DiMaggio eds., University of Chicago Press 1991). Depending on context, the phenomenon can be functional as well as dysfunctional.

105 Contrast this with, for example, the costs imposed by the Sarbanes-Oxley Act § 404, as ultimately implemented. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 779, 789 (codified as amended in 15 U.S.C. §§ 7261–7266 and scattered sections of 18 U.S.C. (Supp. II 2002)). Professor Langevoort has argued that Sarbanes-Oxley § 404 has been as expensive as it has in part because “accountants, lawyers and consultants captured the meaning of the statutory text early on in ways that . . . have generated large rents for their professional activities.” Donald C. Langevoort, The Social Construction of Sarbanes-Oxley, 105 Mich. L. Rev. 1817, 1828 (2007). Anecdotally this does not seem to have been a problem in the application of British Columbia’s principles-based requirements, at least so far, but it is a potential risk in British Columbia as well and one that calls for a more detailed examination than can be undertaken here.

106 Also relevant to fears about regulatory overreaching is the fact that capital markets internationally are now very much in competition with each other. See also Capital Ideas Conference, supra note 155, transcript at 87–89.
practice, is more evolutionary than it is revolutionary. Preexisting rules continue to provide a baseline, and change happens at the margins.

There is, however, one large danger in the use of such a hybrid system: it may be subject to being gamed. Specifically, noncompliant industry actors could choose to rely strategically on existing detailed rules whenever they had a colorable basis for arguing that they were in compliance with the rule, regardless of whether their actions were in keeping with the underlying principle. The firm could selectively look for loopholes in the rules, falling back on principles only if and when the regulator decided to challenge the conduct in question. In this context, the innovations for which principles-based regulatory approval would be sought in advance would be limited to those that were obviously impermissible under existing rules. Firms would avoid the delay, cost, and risk of seeking regulatory approval for innovations that could somehow be shoehorned into existing rules. This in turn would cut the regulator out of the learning loop. In effect, the rules-versus-principles choice would devolve to rules wherever possible. Principles-based regulation would be reduced to the service of last recourses and ex post justifications.

The response is as follows: first, while a principles-based regulatory approach may use existing detailed rules as prophylactic rules, it must be clear that industry actors are expected to abide by regulatory principles as well. Rules-based and principles-based regulatory expectations must operate serially, not in parallel. An enforcement response should be swift and unequivocal where a firm appears to be using a loophole in detailed rules to avoid abiding by a regulatory principle. And, enforcement sanction must be available for violation of principles themselves. Second, separate from the enforcement context, the regulator should be conscious of the need to maintain an ongoing dialogue with firms about their practices.

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167 This is reminiscent of the familiar phrase with respect to Project XL in the environmental arena: “if it ain’t illegal, it ain’t XL.” Sparrow, supra note 82, at 23.

168 Schauer, supra note 23.

169 See, e.g., Stephen Bland, Director, Small Firms, U.K. FSA, Remarks, in Capital Ideas Conference, supra note 153, transcript at 23–24 (describing the Citigroup case in which that firm was fined £11 million for breaching two FSA principles); David Wilson, Chair, Ontario Securities Commission, Remarks, in Capital Ideas Conference, supra note 153, transcript at 53–54 (discussing Canadian mutual fund market timing probe, which resulted in mutual fund firms disgorging $209 million to investors based on having violated their obligation to treat their clients fairly).
Where a firm has shown an historical propensity to operate close to the line or to abide by the letter rather than the spirit of the law, that firm should be supervised more closely. Firms that have demonstrated bona fides may be granted more leeway.\textsuperscript{170} Under this approach, the regulator may seek to enhance struggling firms' capacity by providing examples of others' good practices and refrain from pursuing formal enforcement where firms are engaged in a bona fide effort to abide by regulatory principles.\textsuperscript{171} Again, a renewed relationship between regulator and industry, based on trust and information sharing, is an important piece of regulatory effectiveness.\textsuperscript{172} And maintenance of an ongoing, regular, and collaborative dialogue between the regulator's compliance (not enforcement) function and industry actors could mitigate any relative delay, cost, and risk associated with seeking principles-based regulatory approval.

C. A Partial Proposal: Tripartism

The BCSC already recognizes a particular role for third-party industry councils and trade associations, as a way of encouraging firms to learn from each others' best practices while maintaining an explicit light-touch regulatory focus.\textsuperscript{173} More ambitiously, Ian Ayres and John Braithwaite have advocated for what they call "triplarism" as a form of responsive regulation.\textsuperscript{174} Ayres and Braithwaite describe regulatory tripartism as a regulatory policy that fosters the participation of third-party public interest

\textsuperscript{170} The BCSC's Capital Markets Regulation Division uses a risk-based matrix to assess the risks presented by different industry actors, and it accords more leeway to firms that have demonstrated compliance bona fides. Sorbo e-mail #1, supra note 152. This is consistent with the so-called "enforcement pyramid." Ayres & Braithwaite, supra note 27, at 35–40.

\textsuperscript{171} See, e.g., Capital Ideas Conference, supra note 153, transcript at 63; "For these small firms, sometimes they don't know what good business practice is, and we're not saying, of course, that we know. But what we do have the ability to do is go to a large number of these small firms, observe what works, what is good, what doesn't work, and then play it back to the community as a whole as a sort of service to them, if you like, to help them improve their standards and run their businesses in good business practice ways."

\textsuperscript{172} The BCSC's Capital Markets Regulation Division also works with trusted industry actors to develop principles-based win-win outcomes where possible. E-mail from Michael Sorbo, Manager, Examinations, BCSC Capital Markets Regulation Division, to author (Feb. 21, 2007, 13:19 PM PST) (on file with author).

\textsuperscript{173} See Jakab Interview, supra note 145.

\textsuperscript{174} Ayres & Braithwaite, supra note 27, at 54–100.
groups in three ways: by giving third parties access to all the information the regulator possesses, by giving them a seat at the negotiating table, and by giving them the same standing to sue or prosecute that the regulator has. Ayres and Braithwaite suggest that a strategy of meaningful tripartite dialogue can facilitate attainment of regulatory goals, prevent corruption, and prevent the kind of agency capture that is harmful to the public good and regulatory goals. At the same time, it encourages helpful capture in which the regulator saves enforcement resources by overlooking minor or technical compliance breaches, and the firm more efficiently spends its resources on meeting the underlying goals of the regulation, including even making extralegal beyond-compliance efforts, rather than meeting the literal rules of the regulation.\footnote{Ayres and Braithwaite also argue that the more complete “republican regulatory tripartism” they describe fosters democracy, both in terms of citizen empowerment and because the outcome under tripartism is more likely to be closer to the legal standard settled upon through the democratic process. \textit{Id.} at 81–94. Like many scholars working under the New Governance umbrella, broadly defined, Ayres and Braithwaite see in their proposal the possibility of furthering not only better regulation, but better governance at large and, ultimately, a more effective, equitable, engaged, and legitimate democracy. \textit{Id.} at 12–18. \textit{See also} Dorf & Sabel, \textit{supra} note 105; Michael C. Dorf, \textit{After Bureaucracy}, 71 U. Chi. L. Rev. 1245 (2004).}

The notion of tripartism also has been advanced in the work of Neil Cunningham and Darren Sinclair, with respect to SMEs in the environmental regulatory arena.\footnote{Cunningham & Sinclair, \textit{supra} note 159, at 13–40.} Cunningham and Sinclair propose that, where government’s capacity to regulate SMEs is limited, regulators may harness a credible third party to play a surrogate regulatory role. Regulatory surrogacy through trusted third parties may be particularly important in an environment like British Columbia, which is characterized by many small firms and junior-cap issuers. Third-party intervention is useful in this context as a means of helping SMEs meet regulatory requirements while not overstretching regulatory resources.\footnote{The costlier option (and one that is more interventionist than anything existing in securities regulation to date) would be to establish an information arm within the BCSC that is in a position to respond to inquiries and conduct one-on-one compliance audits, completely separate from enforcement. This option is by the U.S. Occupational Safety and Health Administration with respect to SMEs under its regulation. \textit{See U.S. Dep’t of Labor, Occupational Safety and Health Administration, OSHA’s Consultation Program, http://www.osha.gov/dsp/smallbusiness/consult.html} (last visited Sept. 7, 2007).} Third-party regulatory surrogates with commercial power or some other basis of authority relative to SMEs may also help break through SME resistance.
An appropriate third party might be a trade association or industry council, or it might include professionals like bankers or accountants who have preexisting relationships with the SMEs. Such a third party could provide face-to-face information, ongoing support, and clear practical guidance to SMEs, focusing on the ways in which good compliance practice is also good business practice. The third party could facilitate self-inspection and self-audit by publishing key criteria and communicating information about best and acceptable practices. Given the right incentives, an industry association, for example, could go further—requiring self-reporting; establishing awards for high performers; conducting audits; and supporting a streamlined, simple, inexpensive, and SME-appropriate accreditation process. An additional possibility for increasing the public effect of regulatory approval of a particular best practice would be to institute a reward program for compliance leaders, under which they are permitted to use a revocable certification mark. Certification marks have gained real currency as it has been shown that they have value in the marketplace.

Tripartite relationships may also be useful in the enforcement environment, as the use of what one might call “reform undertakings” at the U.S. SEC suggests. Reform undertakings are more open-ended, discursive problem-solving remedies embedded within traditional enforcement mechanisms. They seem to be a promising avenue. Under a reform undertaking arrangement, the regulator’s enforcement staff and the firm enter into a settlement agreement relating to an action that enforcement has initiated for violation of the securities laws. One term of the settlement agreement is that the firm shall retain, at its own expense, an independent third-party monitor to oversee its compliance processes and procedures for a period of time after the settlement has been concluded. That third


179 Consider, for example, the International Principles Organization’s ISO 9000 (management systems), 14001 (environmental), and 26000 (social responsibility) certifications. Certification regimes also have crossed the divide between “technical” matters like management systems or Kosher certification, and more political questions, like those underlying ISO 26000 social responsibility mark. See also Ian Ayres & Jennifer Gerarda Brown, Market[ing] Nondiscrimination: Privatizing ENDA with a Certification Mark, 104 Mich. L. Rev. 1639 (2006) (proposing a voluntary mark to designate businesses that do not engage in employment discrimination on the basis of sexual orientation).

180 Ford, supra note 110. See also Garrett, supra note 128 (describing the deferred prosecution phenomenon in criminal prosecutions).
party should have credibility and the right skill set and should be both independent and accountable. The third party’s role is to intervene in the firm over a more extended period of time, identifying compliance failures and reasons for the alleged law violation. It then reports back to the regulator on its findings, recommendations, and the steps taken by the firm in response to those recommendations. Reform-undertaking provisions are generally drafted in prospective, principles-based language, giving the firm and third parties substantial scope to interpret what constitutes a reasonable or appropriate remedial recommendation. In an ideal case, a reform-undertaking third party uses best-practices learning in other contexts to ratchet up compliance performance in the subject firm. It operates in a transparent, reasoned, problem-solving manner and engages firm employees and officers in a dialogic process, both as an information-gathering tool and as part of challenging existing assumptions and forcing positive endogenous change.

Returning to the B.C. Model, there is nothing about Canadian jurisprudence that would preclude such creative remedies. To the contrary, similar remedies exist in multiple Canadian regulatory arenas and are consistent with Canadian approaches to public policy. Reform-undertaking–style remedies have already been used by the IDA\textsuperscript{181} and Market Regulation Services, Inc. (another SRO),\textsuperscript{183} as well as the Ontario Securities Commission. Reform undertakings or something approximating


\textsuperscript{183} Market Regulation Services Inc., commonly known as RS, is the independent regulation services provider for Canadian equity markets. See Offer of Settlement, In the Matter of UBS Securities Canada Inc. (Oct. 8, 2004), available at http://docs.rs.ca/ArticleFile.asp?Instance=100&ID=4CDF42F183D6455D903D528E03DF0330 (settlement agreement wherein UBS Securities agreed, inter alia, to retain an independent consultant to review its supervisory and compliance systems to ensure that they comply with Universal Market Integrity Rules).

\textsuperscript{184} See Order, In the Matter of Agnico-Eagle Mines Limited (Apr. 28, 2005), available at http://www.osc.gov.on.ca/Enforcement/Proceedings/RAD/rad_20050428_agnico-eagle-mines.pdf (settlement agreement wherein Agnico-Eagle Mines agrees to “initiate a review of its disclosure and reporting practices and procedures by an independent third party, acceptable to
the deferred prosecution agreement in the United States also are a clear possibility under the organizational sentencing provisions of the Criminal Code.\footnote{Criminal Code of Canada, Part XXIII: Sentencing: Probation. §732.1 (3.1) states, in relevant part, The court may prescribe, as additional conditions of a probation order made in respect of an organization, that the offender do one or more of the following: \(\ldots\)

(b) establish policies, principles and procedures to reduce the likelihood of the organization committing a subsequent offence; \(\ldots\)

(d) report to the court on the implementation of those policies, principles and procedures; \(\ldots\)

(g) comply with any other reasonable conditions that the court considers desirable to prevent the organization from committing subsequent offences or to remedy the harm caused by the offence.}

In their recent treatise on risk management, authors Todd Archibald, Kenneth Jull, and Kent Roach make a case for “embedded auditors” as a component of sentencing. Such sentencing orders would provide, under authority of court order, that regulatory inspectors be placed on site of the convicted corporation to monitor compliance for a period of time.\footnote{Todd L. Archibald et al., Regulatory and Corporate Liability: From Due Diligence to Risk Management**, 12:20:10.20, 12:50:60.20 (2005) (describing the statutory basis for, and rehabilitative potential of, placing state compliance auditors in companies convicted of criminal or regulatory offenses).} Thus, reform-undertaking-style third-party involvement already has roots in Canadian soil.

Regardless of the specific tripartite mechanism in question, involving a third party in governance increases the scope of perspectives available to the regulator. It also permits broader participation from stakeholders and others that typically do not have a voice in securities regulation, notwithstanding the importance of securities regulation to individuals and broader

both Agnico-Eagle and Staff, at the expense of Agnico-Eagle” and “implement any recommendations made by the independent third party referred to above that are approved by Staff, within a reasonable period of time, as approved by Staff”). Order, In the Matter of Murray Hoults Pollitt and Pollitt & Co. Inc. (Nov. 17, 2004), available at http://www.osc.gov.on.ca/Enforcement/Proceedings/RAD/rad_20041117_pollitt.pdf (settlement agreement wherein Pollitt & Co. agrees to “forthwith retain Cassels Brock Regulatory Consulting Inc., at its sole expense, to ensure that its revised practices and procedures have been properly implemented and to ensure that compliance staff and trading officers are properly trained in their obligations, roles and responsibilities”). The brevity of both Orders, and the absence of detailed terms governing the third party’s retainer and obligations, is striking relative to those from the IDA, the RS, and the U.S. SEC. See Ford, supra note 110, at nn. 140–43 and accompanying text.
social interests. The examples above involve third-party expertise actors like compliance consultants and industry associations, but depending on the context this does not necessarily represent the universe of potential third parties. Tripartism plays a role in providing transparency and enhancing accountability, as examples from the larger world of corporate governance and corporate social responsibility activism demonstrate. For example, third-party–certified best or good practices affect consumers, as Forest Practices Certification has shown in the forestry industry.\textsuperscript{187} Entire corporate compliance and corporate social responsibility consultancy industries now exist, and ethical investing funds and advocates pressure for triple-bottom-line reporting.\textsuperscript{188} Other potential third parties include industry associations like the Canadian Bankers Association, nonprofit corporate social responsibility organizations like the Global Reporting Initiative, or for-profit firms like Innovest or Institutional Shareholder Services, which operates the Investor Responsibility Research Center.\textsuperscript{189} Shareholder representatives and major accounting firms could even play a role. One should resist trying to identify the right third parties ex ante. One should also resist dismissing any potentially suitable third party out of hand, given the important role these actors could play in broadening the regulatory conversation beyond the dyadic.


V. CONCLUSION

Principles-based regulation and outcome-oriented regulation are responses to a visceral recognition that traditional, rule-oriented legal regimes are limited in their ability to deal with some broader organizational and cultural problems. Resistance toward effective compliance and other forms of corporate cultural dysfunction are not easily dislodged. Principles-based regulation forces agency on firms, making them active participants in defining the compliance processes that will best address their particular business risks and situation. Some version of outcome-oriented regulation is a necessary correlative to principles-based regulation, in that it is a responsible way to force accountability into a system that leaves articulation of the content of those principles to on-the-ground actors. Securities regulators can do quite a bit to advance their vision of modern securities regulation without statutory change. The decision of the BCSC to proceed with a principles-based and outcome-oriented regulatory approach, despite the fact that Bill 38 has not come into force, is a prime example of this option. Securities commissions have substantial discretion and extensive rulemaking powers. The practice of securities regulation can continually improve notwithstanding its statutory architecture in the implementation phase.

Principles-based regulation is important primarily because it identifies that on-the-ground implementation is more important than idealized (principles-based) statutory design. A principles-based and outcome-oriented regulatory approach consistent with New Governance, like the B.C. Model, does not advocate simply removing rules, leaving the capital markets to self-regulation or subject to the whims of a regulator’s discretion. Rather, it provides a rational, systematic alternative to an unscripted layering-on of rules on rules to deal with each new situation and their corresponding adverse system effects. The most promising aspect of the B.C. Model is not the opportunity for open-ended and flexible securities regulation, viewed from the stratospheric level of statutory drafting and policy making. Rather, it is the opportunity for dialogic and transparent securities regulation, viewed from the ground occupied by industry, frontline regulators, corporate social responsibility advocates, and shareholders.
PRINCIPLES-BASED SECURITIES REGULATION IN THE WAKE OF THE GLOBAL FINANCIAL CRISIS

Cristie Ford*

The recent global financial crisis contains cautionary lessons about the risks associated with principles-based regulation when it is not reinforced by an effective regulatory presence. Our response to the crisis, however, should not be a rush to enact more rules-based regulatory approaches. On the contrary, principles-based securities regulation offers more viable solutions to the challenges that such a crisis presents for contemporary financial markets regulation.

The author draws on the lesson of the global financial crisis to identify three critical factors for effective principles-based securities regulation. First, regulators must have the necessary capacity in terms of numbers, access to information, and expertise in order to act as an effective counterweight to industry. Second, regulation needs to grapple with the impact of complexity on financial markets and their regulation. Third, increased diversity among regulators and greater independence from industry are required to avoid conflicts of interest, over-reliance on market discipline, and "groupthink". The paper calls for a continuing commitment to principles-based regulation, accompanied by meaningful enforcement and oversight.

La récente crise financière mondiale nous invite à tirer une leçon de prudence quant aux risques associés à la réglementation fondée sur des principes lorsque cette réglementation n'est pas renforcée par une présence réglementaire efficace. Nous ne devrions toutefois pas nous empresser d'adopter davantage de réglementations fondées sur des règles. Au contraire, la réglementation des valeurs mobilières basée sur des principes offre des solutions plus viables aux défis que pose une telle crise.

En se fondant sur les leçons tirées de la crise financière mondiale, l'auteure identifie trois facteurs critiques pour assurer l'efficacité d'une réglementation des valeurs mobilières fondée sur des principes. Premièrement, les organismes régulateurs doivent disposer des moyens nécessaires en termes d'effectifs, d'accès à l'information et d'expertise s'ils veulent contrebalancer l'industrie de façon efficace. Deuxièmement, la réglementation doit être aux prises avec l'impact de la complexité sur les marchés financiers et sur leur réglementation. Troisièmement, une plus grande diversité des organismes de réglementation et une plus grande indépendance face à l'industrie sont requises pour éviter les conflits d'intérêts, la confiance excessive en la discipline du marché et la "pensée de groupe". L'article appelle à un engagement continu envers la réglementation fondée sur des principes, accompagnée d'une application et d'une surveillance significatives.

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Introduction

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Conclusion
Introduction

These remain early days to try to assess the impact of the global financial crisis (GFC) and subsequent regulatory reform efforts on national and transnational financial markets regulation. That said, it is important to continue to assess events “on the fly” given how quickly reform efforts are evolving, how uncertain the future continues to be, and how pressing the need is to implement reforms in Canada and abroad.

This paper considers a particular aspect of regulatory design: principles-based regulation. It seeks to re-examine (and indeed to restate the case for) principles-based securities regulation, in light of the GFC and related developments. It argues against an overly hasty rush to more rules-based formulations. Prior to the onset of the crisis, the concept of more principles-based financial regulation was gaining traction in regulatory practice and policy circles.1 In Canada, steps were being taken to develop more principles-based securities regulation under the leadership of a proposed new national securities regulator. The federal government’s Expert Panel on Securities Regulation (Expert Panel), chaired by the Honourable Tom Hockin, was struck in February 2008 with a mandate to provide independent recommendations on how to improve the structure, content, and enforcement of securities regulation in Canada. It released its final report on 12 January 2009, recommending inter alia that Canada adopt a more principles-based approach.2 On 22 June 2009, Doug Hyndman, longtime Chair of the British Columbia Securities Commission (BCSC), was appointed to a two-year term as chair of Canada’s transition office for a new national securities regulator.3 Hyndman, along with Vice Chair


Brent Aitken, has been the driving force behind the BCSC's principles-based approach and could be expected to bring that commitment to his new role.

In the interim between the Expert Panel's creation and its final report, of course, global credit markets froze, stock market values went into free fall, Wall Street investment banks collapsed, major financial institutions were bailed out on an unprecedented scale, and financial regulatory systems internationally were cast into doubt. A flurry of ambitious reform proposals followed. Among others, in March 2009 Lord Adair Turner released the Turner Review in the United Kingdom, subtitled A Regulatory Response to the Global Banking Crisis, and major financial markets regulatory reform has been proposed in both the United Kingdom and the United States. Several major domestic and international policy bodies and a number of scholars have contributed to the conversation. Along with such reform proposals came a turn, in some quarters, against principles-based regulation.

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9 See e.g. Felix Salmon, "The US move to principles-based regulation" Reuters (17 June 2009), online: Reuters <http://blogs.reuters.com/felix-salmon/2009/06/17/the-us-move-to-
This paper argues that the GFC does not discredit principles-based regulation, as that form of regulation is properly understood. On the contrary, principles-based securities regulation remains a viable and even necessary policy option: it offers solutions to the practical and theoretical challenges that the GFC presents to contemporary financial markets regulation. What the crisis actually demonstrates is how damaging a laissez-faire mindset on the part of regulators can be to any form of regulation, including principles-based regulation. Adopting principles-based regulation does not mean doing away with rules. Rather, it is a particular approach to structuring regulation that includes rules. It gives legislatures the power to set high-level regulatory goals and outcomes, and leaves the articulation of processes and details to front-line regulators in collaboration with industry itself. Fundamental to principles-based regulation is the development of a functional and effective “interpretive community” that includes industry participants, regulators, and other stakeholders in ongoing communication around the content of regulatory principles.

The experience of the GFC is a lesson about what happens when regulators fail to participate actively and skeptically in that interpretive community. Principles-based regulation is premised on concepts of “co-regulation”, or “enforced self-regulation”, but the GFC illustrates how such models can slide into bare self-regulation in the absence of meaningful regulatory oversight and engagement. Our response should not be to re-embrace more rules-based regulatory approaches. Financial markets are too fast-moving and complex to be regulated in a command-and-control manner, and the risk of Enron-style “loophole behaviour” associated with rules is too great.\(^\text{10}\) Instead, we can draw on the lessons of the GFC to identify three critical success factors for effective principles-based securities regulation.

First, regulators need to have the necessary capacity in terms of numbers, access to information, expertise, and perspective to act as an effective counterweight to industry as the content of principles is developed. Second, regulation needs to grapple with the impact of complexity on financial markets and their regulation. Effective regulation should reflect an appropriately granulated understanding of kinds of complexity and their effects, and reject the notion that innovation is by definition beneficial. It may also mean considering whether some regulatory requirements (e.g., capital requirements) are best cast as bright-line “prophylactic rules”, which at least in the short term may limit complexity and conserve regulatory resources. Finally, this paper suggests that the lack of diver-

\(^{10}\) (the author notes that in his newsroom, he is in “a minority of one” for continuing to advocate for principles-based regulation).
sity and independence among regulators and industry may have contributed to conflicts of interest, overreliance on market discipline, and “group-think” in the run-up to the GFC. The appropriate response may be a move away from an expertise-based, technocratic model toward a more broadly participatory one. The paper closes with a call for a continuing commitment to principles-based regulation, accompanied by the indispensable implementation piece—meaningful enforcement and oversight.

I. Principles and Rules in Theory and Practice

Principles-based capital markets regulation has been a salient policy topic in recent years in many jurisdictions including Canada, the United States, and the United Kingdom. In terms of actual practice, the U.K. Financial Services Authority (FSA) has been a thought leader on principles-based financial regulation. In Canada, the province of British Columbia tried to promulgate a new, more principles-based Securities Act in 2004. Although that proposed act has not been brought into force, the BCSC has since adopted a more principles-based approach to how it administers its existing act. Derivative products in the United States and Canada also tend to be regulated in a more principles-based manner.

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11 See e.g. Purdy Crawford et al., eds., Crawford Panel on a Single Canadian Securities Regulator: Blueprint for a Canadian Securities Commission (7 June 2006), online: Crawford Panel <http://www.crawfordpanel.ca> ("to provide Canadian capital markets with a competitive advantage globally, it is desirable to have as much principles-based regulation as is feasible" at 12); Task Force to Modernize Securities Legislation in Canada: Canada Steps Up, vol. 1, online: Task Force to Modernize Securities Legislation in Canada <http://www.tsml.ca> (recommending that securities regulation be based "at every available opportunity" on "clearly enunciated regulatory principles which do not need a detailed set of interventionist rules for sound implementation" at 50); U.S. Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure (Washington: Department of the Treasury, 2008) at 106-16 (recommending a merged Commodity Futures Trading Commission (CFTC)-Securities and Exchange Commission (SEC) entity that adopts the CFTC’s principles-based approach); U.S., Committee on Capital Markets Regulation, Interim Report of the Committee on Capital Markets Regulation (Cambridge, Mass.: 2006), online: Committee on Capital Markets Regulation <http://www.capmktssreg.org> (arguing that the SEC and self-regulatory organizations should move to a more “risk-based and principles-based” process (at 8)).

12 *Focusing on the Outcomes, supra* note 1; Black, “Making a Success”, *supra* note 1; Cristie Ford, “Principles-Based Securities Regulation” (2009), online: Expert Panel on Securities Regulation <http://www.expertpanel.ca> [Ford, “Securities Regulation”] (describing the main components of the FSA regulatory approach as: a hybrid rules and principles structure; extensive consultation with industry actors; a management-based, outcome-oriented, and risk-based regulatory approach; and an emphasis on compliance and supervision as opposed to ex post enforcement).

13 See Submission of the British Columbia Securities Commission, online: British Columbia Securities Commission <http://www.bcsc.bc.ca> [Submission BCSC].

14 See e.g. Walter Lukken, “It’s a Matter of Principles” (Lecture delivered at the University of Houston’s Global Energy Management Institute, 25 January 2007), online:
Most recently in Canada, as noted above, the Expert Panel chaired by the Honourable Tom Hockin has recommended that a proposed national securities regulator adopt a more principles-based approach to securities regulation.\(^{15}\)

At the theoretical level, the distinction between rules and principles, and their relative advantages and disadvantages, have been quite well canvassed.\(^{16}\) Generally speaking, rules are considered to have the advantages of being more precise and certain, but the consequent disadvantages of being potentially rigid, reactive, and insensitive to context and therefore inevitable over- or under-inclusive. They may also promote or permit “loophole” behaviour, and be more easily “gamed” by sophisticated actors. In comparison, principles are more flexible, more sensitive to context, and therefore potentially fairer when applied. On the other hand, principles can be uncertain, unpredictable, and difficult and costly to interpret. Because they allocate substantial decision making to front-line decision makers, they can also permit arbitrary conduct and regulatory over-reaching.

A simple example that has been used to illustrate the difference between rules and principles involves speed limits.\(^{17}\) A speed limit framed as a rule will prohibit driving faster than a precise numerical limit, for example, 90 kilometres per hour. The rule sets out, in advance and with precision, the boundary of acceptable conduct. This leaves very little discretion to the front line decision maker, who only needs to determine


\(^{17}\) See Kaplan, supra note 16 at 559-60; Sullivan, supra note 16 at 58-59.
whether the car in question was exceeding that predetermined and non-negotiable limit. By contrast, a speed limit framed in principles based terms would be something like a prohibition on driving faster than is “reasonable and prudent in all the circumstances.” This was, in fact, how the state of Montana framed its speed limits for several years. The non-numerical “reasonableness” standard has the ability to take context — such as road and environmental conditions, time of day, driver’s experience, etc. — into account. As a consequence, it also allocates substantial decision making power to the front line decision maker, who must use her judgment to determine what “reasonable and prudent” driving constitutes in all the circumstances. It should be emphasized that speed limits involve very different background conditions than securities regulation does in terms of (among other things) the complexity of the subject matter, the scope for and fluidity of potential wrongdoing, and the expertise of the front line decision maker. The two are not really analogous. That said, it is noteworthy that Montana repealed its principles based speed limit in 1999, after the Montana Supreme Court held it to be so vague as to violate the Due Process clause of the state constitution.

The terms are also useful at the systemic level, for describing practical regulatory approaches. No workable system consists entirely of rules or of principles, but different systems can be comparatively more rules- or principles-based—a point the FSA has made by calling its world-leading

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18 In the years prior to 1974, and from 1995 to 1999, Montana used a non-numerical, “reasonable and prudent” speed limit. The limit was subsequently repealed when it was found to be so vague as to violate the Due Process Clause of the Montana Constitution. See State of Montana v. Rudy Stanko, 1998 MT 321, 292 Mont. 214 (Mont. Sup. Ct.). On the potential vagueness of principles in the securities law enforcement context, see Ford, “Securities Regulation”, supra note 12 at 31-34.

19 This paper contests the idea that rules are more certain than a principles-based system that is supported by a well-functioning interpretive community and adequate regulatory capacity. See “Complexity and Prophylactic Rules” below. However, it does not contest the idea that rules are more certain and principles more flexible in the abstract (i.e., in the absence of a mechanism such as a careful, structured, ongoing multiparty dialogue for working out the content of principles in a responsible manner). Of course, even under ideal conditions, application will influence theory in direct and indirect ways. For example, through application to real-life situations, principles acquire specific content on a constant, ongoing basis. Decision makers may interpret a rule “up” or “down” (making it look more like a principle or more like a detailed rule) to make it fit a specific situation. Principles, as well, when interpreted by multiple human beings in multiple situations, may lose their high-level character, slide closer to rules, get fuzzy around the edges, and otherwise drift and change (see e.g. Schauer, supra note 16). Therefore, whether a regulatory system fosters clarity and predictability, for example, is not entirely related to whether it is rules-based or principles-based. The real question is whether regulators and regulatees have a shared understanding of what the regulations entail.

approach simply "more principles-based". Statutory drafters and regulators can choose to regulate the same issues by way of different proportions of detailed checklists, bright-line rules, or open-ended goal statements. In the context of statutory drafting, principles-based regulation means legislation that contains more directives that are cast at a higher level of generality. A principles-based system looks to principles first and uses them, instead of detailed rules, wherever feasible. When confronted with a new situation, a principles-based system first determines whether it can be regulated under existing principles, and it resists the temptation to create new, purpose-built rules. Yet even within a system that is generally principles-based, rules will always serve an essential purpose in enhancing clarity at key junctures, and buttressing ex post enforceability.

Rules and principles are also best understood as points on a continuum rather than discrete concepts, and there is a good deal of overlap and convergence among them. Any complex regulatory system will be (and should be) an amalgam of rules and principles. Here, the public perception of "principles-based regulation" exhibits considerable confusion. For example, 87.5 per cent of the seventy-five written submissions from stakeholders to the Expert Panel were in favour of principles-based regulation. But of these submissions, a substantial number seemed to as-

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21 Focusing on the Outcomes, supra note 1 at 4-5.

22 See Black, "Making a Success", supra note 1 (identifying the distinction between bright-line rules and detailed rules).

23 See e.g. BCSC on responses to the GFC:

To the extent that market professionals misrepresented the features or risks of investment products, or sold unsuitable investments to unsophisticated investors, we already have rules against that type of conduct. Rather than devising new rules for what is already illegal, we need to maintain and adapt our compliance and enforcement processes to detect and deter this activity.

This is not to say that we should not consider rule changes ...

Any new rule, however, should be based on thorough analysis that shows it to be the best option for achieving a desired regulatory outcome. All too often, policymakers start with the presumption that a situation demands new rules, and they lose focus on other options like enforcing existing requirements that could deal with the problem more quickly and effectively (08/09 Annual Report, online: British Columbia Securities Commission <http://www.bcsc.bc.ca> at 3).


sume that principles-based and rules-based regulation were at opposite extremes, and that a move to a more principles-based system meant substantially eliminating rules, no matter how efficient or necessary they might be. Several stakeholders argued forcefully against exclusively principles-based or rules-based approaches, even though no such drastic move was being proposed.

A. A Time for Principles, A Time for Rules

Almost three decades ago, Colin Diver discussed what he called the "optimal precision" of administrative rules—meaning, the degree of specificity in statutory or regulatory drafting that would best avoid the worst problems of either imprecision or rigidity.\textsuperscript{26} He identified three elements of regulatory precision: transparency (i.e., the words chosen have well-defined and universally-accepted meanings within the relevant community), accessibility (i.e., the law can be applied to concrete situations without excessive difficulty), and congruence (i.e., the substantive content communicated by the words produces the desired behaviour). Not surprisingly, Diver found that no single "sweet spot" of precision exists. On some questions, flexibility and sensitivity to a particular context will be more important than certainty or the need to limit discretion. More general, principles-based drafting would make sense in that context. Elsewhere, a different mix would be called for. Diver also pointed out that these qualities are difficult to measure, and there are often direct trade-offs between them. Therefore, settling upon a particular mix between rules and principles requires that choices be made, and public priorities be established.

In particular, where these lines are drawn depends on public priorities that the legislator has the mandate to establish. For example, a legislator that is concerned about regulatory overreach or lack of transparency in a particular area would see it that the regulator had very little discretion (i.e., that expectations are cast as rules rather than principles and are enshrined in a statute) when it comes to such things as access to information, the handling of complaints, or accountability to Parliament. A legislator concerned about individual rights would limit discretion (i.e., would craft rules not principles) regarding hearings, procedural fairness, and participation or consultation rights. A legislator concerned about ensuring that the regulator can keep up with fast-moving events would give that regulator principles, not rules, to work with, and would devolve substan-

\textsuperscript{26} Colin Diver, "The Optimal Precision of Administrative Rules" (1983) 93 Yale L.J. 65 [Diver]. Diver does not use the terms rules and principles, but his understanding of precision maps neatly onto the theoretical rules-versus-principles scholarship discussed in the previous section.
tial decision making to the regulator’s rule-making power. A legislator concerned about ensuring a high correlation between regulatory goals and effective application to particular cases would ensure that the regulator had the power to flesh out the content of principles on a rolling basis, rather than trying to draft specific details in advance.

Important external considerations also come into play. For example, how much scope does the legislator want to leave to the interpretation of regulators, as well as potentially of courts or tribunals? Where does existing regulatory practice (whether principles-based or rules-based) seem to be well-established, to be working well, and to have created expectations on which stakeholders rely? Would a particular drafting approach foster harmonization between existing regulatory regimes, or nudge regulatory practice in a desirable new direction? Are some issues particularly important to the proper functioning of Canadian capital markets (i.e., regulating effectively the many small, closely held public companies, or addressing the rumoured Canadian “market discount”), which call for well-tailored and highly adaptive—that is, principles-based—solutions? On what specific issues does the political will exist to move decisively away from the status quo? What messages does Canada, through its regulatory regime, want to send internationally? All of this requires that policymakers develop a set of criteria reflecting policy calculations for deciding when to use rules and when to use principles.

Context also matters. An appropriate balance between rules and principles in securities regulation may look quite different from the appropriate balance in other regulatory arenas. The nature of the industry being regulated, the roles of the various players in it, and the risks associated

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with that area of conduct will inform the regulatory design process. It is relevant that securities regulation is a disclosure-based system that relies heavily on ensuring reasonable access to information as a means for protecting investors. This suggests that congruence is important in this context, so that core definitions of materiality and disclosure should be broad and principles-based. Other areas where the over- or under-inclusiveness of rules is particularly problematic, and where flexibility and congruence are especially important, is preventing fraud and minimizing "cosmetic" compliance and "loophole behaviour". This is the rationale for broad statutory definitions of fraud, and commissions' sweeping public interest powers. Financial markets are also complex, fast-moving environments marked by constant product-level innovation. Principles recommend themselves in this environment, when underpinned by effective information-gathering and analytical mechanisms, since detailed rules may only add to complexity and opacity. Principles also make sense where a flexible approach is needed to ensure good corporate conduct—for example, with regard to internal compliance processes, corporate culture, or risk assessment by management. Like the deference accorded to securities commissions under administrative law, principles-based regulation also

29 See also Black, “Making a Success”, supra note 1 at 200-201.

30 See Committee for the Equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission), 2001 SCC 37, [2001] 2 S.C.R. 132 at para. 41, 199 D.L.R. (4th) 577 [Asbestos Minority Shareholders]; Anita Anand, “Carving the Public Interest-Jurisdiction in Securities Regulation: Contributions of Justice Iacobucci” (2007) 57 U.T.L.J. 293. Even considering the substantial deference to securities commissions, courts (and commissions themselves through their policies) should establish standards and explicit rationales for the application of public interest powers to ensure that they are exercised in a predictable way, as well as to ensure that those applying them consider relevant factors, do not consider inappropriate factors, and behave fairly.

31 See discussion in “Four Points on Regulatory Capacity” below.


33 Edward Rubin, “The Myth of Accountability and the Anti-Administrative Impulse” (2005) 103 Mich. L. Rev. 2073 (arguing for open-ended formulations where the regulator “knows the result it is trying to achieve but does not know the means for achieving it, when circumstances are likely to change in ways that the [regulator] cannot predict, or when the [regulator] does not even know the precise result that she desires” at 2131); see also Ford, “New Governance”, supra note 1. Colin Diver has suggested that the registration of persons should fall at the more principles-based end of the spectrum, because registration and licensure do not deter or influence conduct and try to make predictions about future conduct about which little can be known at the time of licensing (supra note Error! Bookmark not defined. at 79).

reflects legislative faith in regulatory expertise, objectivity, fairness, and capacity.

One can also identify situations where rules may make particular sense in securities regulation. Consistency in form is important in disclosure documents, for example, to make it easier for potential investors to compare investments. Prospectus requirements should therefore contain detailed form requirements. Securities commissions are also powerful administrative agencies, with broad mandates and the ability to impose heavy sanctions. For rule of law reasons, process requirements associated with investigatory powers and enforcement conduct should be clearly set out. Provisions around notice, rights to hearings, time limits, and procedural fairness should presumptively be more rules-based. Rules also make sense where the sheer cost of applying a principle outweighs the principle’s flexibility benefits—for example, where the regulator needs to manage large numbers of relatively small matters. Accessibility is also important if lay individuals will be interpreting the law on their own. This is a concern in capital markets like Canada, within which many small actors with limited compliance resources operate. During a transitional stage between rules-based and principles-based regulation, for example, maintaining legacy rules may help keep compliance costs down. Finally, rules may be appropriate in situations where the regulator or statutory drafter is confident that it can devise an easy to describe, easy to verify, and fairly stable rule-based requirement that will serve as an effective proxy for a broader regulatory goal, such as ensuring good corporate conduct.

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35 As technology improves, for example through the mandated use of Extensible Business Reporting Language (XBRL), consistency in form may be seen as less important than ensuring the most effective possible disclosure. See “An Introduction to XBRL”, online: XBRL International <http://www.xbrl.org>.

36 Kaplow, supra note 16. Kaplow also argues that the determining factor should be the frequency of regulated action. Where frequency is low, standards are preferable; where frequency is high, the costs of promulgating rules are justifiable (ibid. at 621). Trading rules are a good example of a rules-based treatment of high-frequency events.


38 Clayton P. Gillette, “Rules, Standards, and Precautions in Payment Systems” (1996) 82 Va. L. Rev. 181 (“Precise directives are more appropriate when we have the greatest confidence in our capacity to inform target actors (those at whom legal directives are aimed), to describe antiscial forms of behavior (so that target actors know the scope of permitted and prohibited activity), and to recognize the occurrence of such behavior (for
B. Actual Principles-Based Securities Regulation: Key Characteristics

In producing a research report on principles-based regulation for the Expert Panel,36 I reviewed and compared (1) the Ontario Securities Act;37 (2) Bill 38, the proposed British Columbia Securities Act, and associated proposed securities rules (collectively, the "B.C. Model");41 (3) the Quebec Derivatives Act;13 (4) the United Kingdom Financial Services and Markets Act;43 and (5) the United States Commodity Futures Modernization Act44 with a view to determining how principles-based regulation differed from more rules-based regulation at the level of statutory drafting.45 The OSA was chosen to represent the legislative status quo across Canada. The Quebec statute and the B.C. Model are generally understood to be more principles-based. The FSMA was not explicitly principles-based when it was drafted, but the FSA adapted its statutory mandate to develop a world-leading model of principles-based regulation.46

Without claiming to be comprehensive, the report identified some overarching themes at the level of statutory drafting.47 There were several commonalities across regulatory schemes, regardless of whether the re-

31 Securities Act, R.S.O. 1990, c. S.5 [OSA].
33 QDA, supra note 14.
34 Financial Services and Markets Act 2000 (U.K.), 2000, c. 8 [FSMA].
36 The report also occasionally considered the in-force B.C. Securities Act.
37 See Julia Black, "Forms and Paradoxes of Principles Based Regulation" (2008), online: <http://www.scribd.com> at 12 [Black, "Forms and Paradoxes"] (distinguishing among the following: "formal PBR", meaning principles in the rule books; "substantive PBR", which has some of the operational elements of PBR but not principles on the rule books; "full PBR", exhibiting both principles in the rule books and a principles-based operational approach; and "polycentric PBR", which is full PBR with the additional element of incorporating third parties into the regulatory process).
38 Note that the report compared statutes only. A comprehensive comparison of these regulatory regimes is neither feasible nor very helpful, given the number of different factors that go into the drafting of any statute. Just as importantly, national and multilateral instruments, regulations, and rules play central roles in real-life securities regulation. On this larger plane, this report concurs generally with Professor Stéphane Rousseau's description of which aspects of securities regulation are rule-based and which are principles-based, as referred to in the Brief submitted by the Autorité des marchés financiers to the Expert Panel on Securities Regulation. See Autorité des marchés financiers, Single Regulator: A Needless Proposal, online: Autorités des marchés financiers <http://www.lautorite.qc.ca> at 26-27.
gime was more rules- or principles-based, and the draft securities act issued by the Expert Panel (based as it was on the existing Alberta Securities Act) reflects the same choices. For example, disclosure and fraud provisions tend to be drafted in a more principles-based manner because these are areas where congruence is essential (i.e., the definition of fraud must be able to capture even novel forms of fraudulent behaviour) and loophole behaviour cannot be tolerated. Compliance provisions—which require registrants to maintain effective systems and controls to manage the risks associated with their businesses, and prevent and detect internal wrongdoing—also tend to be principles-based. More detailed rules cover topic areas where power is uneven and transparency is not otherwise ensured, or where fairness and basic administrative law underpinnings are at stake. For example, every securities scheme has provisions that govern administrative proceedings such as hearings and investigations, and they are all substantially process based and rule oriented. The statutes are less detailed around areas that change quickly or that require specialized expertise. In general, these overarching commonalities accord with the Diver analysis as to where transparency, flexibility, or congruence should be the dominant concerns.

The Expert Panel research report also identified particular ways in which more principles-based and rules-based regimes differ. Some differences are essentially stylistic. For example, principles-based regulation is consistent with a move toward plain language drafting. Other differences, while consistent with a principles-based regulatory philosophy, are not essential to it. In particular, the proposed B.C. legislation originally imagined much more streamlined processes in its proposals for firm-only registration and continuous market access. Another element common to

49 But see QDA, supra note 14, cls. 26-31, 61-62. See also the compliance provisions in Registration Requirements and Exemptions, B.C.S.C. NI 31-103 (advanced notice, effective 28 September 2009) at Part 11 [NI31-103], online: British Columbia Securities Commission <http://www.bcsc.bc.ca>.
50 The best examples here are OSA, supra note 40, ss. 3.5, 8-9; and Bill 38, supra note 40, cls. 65, 70(2)-(3), 75. The FSMA and QDA do not contain direct analogues. Because the FSMA establishes an independent oversight body, the Financial Services and Markets Tribunal, it treats administrative proceedings somewhat differently. However, the process-based and rule-driven structure persists. See e.g., FSMA, supra note 43, s. 13. The QDA is a more circumscribed statute that borrows many provisions from the Quebec Securities Act, though it contains some process-based provisions at ss. 115-17.
51 See Bill 38, supra note 41. Section [...] would have replaced existing prospectus disclosure rules, short form prospectus provisions, the entire exempt market transaction structure, and existing continuous disclosure obligations, as they then were, with an overarching “Continuous Market Access” structure. Continuous Market Access would have required all companies accessing the British Columbia capital markets simply to disclose all “material information” (here, replacing “material fact” and “material
the principles-based statutes considered is the inclusion of a small number of high-level principles guiding the conduct of regulated entities.\(^{53}\) Consistent with the principles-based approach, how exactly those principles translate into specific business-conduct expectations in context is left to be filled in through techniques such as administrative guidance, enforcement example, the incorporation and dissemination of good or best practices, and ongoing communication between regulator and registrant.\(^{54}\)

The most profound structural differences between the more principles-based and more rules-based statutes are found in two areas: (1) the proportion of decision making and interpretive power that is explicitly left to be filled in through the rule-making function, rather than statutory drafting; and (2) the proportion of outcome-oriented versus process-oriented statutory requirements.

All four statutes studied grant rule-making power to the regulator in question.\(^{55}\) To be clear, securities law statutes in every jurisdiction contain notable principles-based provisions.\(^{56}\) By contrast to regulators in other fields, securities regulators already have extensive notice-and-comment rule-making powers and enjoy substantial deference from courts on judicial review.\(^{57}\) As between the more rules-based and principles-based systems, however, the difference lies in how much detail is provided in the statute, and how much is left to be filled in through the Authority’s or Commission’s rule making. The difference between a traditional, more rules-based approach to statutory drafting and the B.C. version of more principles-based drafting is strikingly illustrated in the Table of Concor-

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\(^{53}\) The FSA refers to its set of principles as the “Principles for Business” (Principles for Business, online: Financial Services Authority [http://www.fsa.gov.uk]); British Columbia’s Bill 38 would have contained a “Code of Conduct for Dealers and Advisors”; and, the CPMA (supra note 44) and QDA (QDA, supra note 14) both refer to theirs as “Core Principles for Derivative Markets.” Many of the principles contained in B.C.’s Code of Conduct have since found their way into NI 31-103 (supra note 49), though that instrument also contains detailed rules.

\(^{54}\) For a more detailed description of these techniques and their use in ascribing content to regulatory principles, see Ford, “Securities Regulation”, supra note 12 at 9-13.

\(^{55}\) See OSA, supra note 40, s. 143; Bill 38, supra note 41, s. 170; QDA, supra note 14, ss. 174-75; FSMA, supra note 43, s. 138. Rule making needs to be distinguished not only from statutes, but also from regulations, which, though subordinate, must go through the legislative process rather than being largely or entirely under the control of the regulator itself.


\(^{57}\) See Pezim, supra note 34; Asbestos Minority Shareholders, supra note 30.
dance prepared by BCSC staff in September 2004.\textsuperscript{58} Large chunks of the Securities Act currently in force simply have no equivalent in the proposed B.C. legislation, in large part because the proposed legislation allocates the authority over more context-specific, detailed decision making to the Commission, pursuant to its rulemaking power.\textsuperscript{59}

Consider, for example, Canadian prospectus requirements. Both Ontario and British Columbia (under both the existing Act and the proposed legislation) require that issuers file a prospectus and obtain a receipt for it before distributing or offering a security. The statutes’ overarching provisions are quite similar.\textsuperscript{60}


\textsuperscript{59} See Securities Act, R.S.B.C. 1996, c. 418 [BCSA]. The other important factor was substantive reform under the proposed B.C. Model, including especially its Continuous Market Access approach (Bill 38, supra note 53).

\textsuperscript{60} Bill 38, supra note 41, ss. 18(1)-18(2); BCSA, supra note 60, ss. 61(1)-61(2); OSA, supra note 40, s. 59(1).
| Bill 38 (the proposed B.C. legislation) | 18 (1) A person must not make an offering of a security unless a prospectus for the security has been filed and the commission has issued a receipt for the prospectus.  
(2) A prospectus filed under subsection (1) must be in the required form. |
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| B.C. Securities Act, R.S.B.C. 1996 (in force) | 61 (1) Unless exempted under this Act or the regulations, a person must not distribute a security unless a preliminary prospectus and a prospectus respecting the security  
(a) have been filed with the executive director, and  
(b) receipts obtained for them from the executive director.  
(2) A preliminary prospectus and a prospectus must be in the required form. |
| Ontario Securities Act | 53 (1) No person or company shall trade in a security on his, her or its own account or on behalf of any other person or company where such trade would be a distribution of such security, unless a preliminary prospectus and a prospectus have been filed and receipts therefor obtained from the Director. |

Where the more rules based and principles based approaches diverge, however, is in the additional detail provided in the statute itself. In the OSA and the existing BCSA, the general requirement above is accompanied by additional provisions concerning, inter alia, amendments to preliminary and final prospectuses (each of which receives distinct treatment), certification requirements for issuers, directors, officers, underwriters, etc., receipts, waiting periods, and distribution.  

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61 See OSA, supra note 40, ss. 57 (prospectus amendments), 58 (certificate by issuer), 59 (certificate underwriter), 61 (prospectus receipt), 63 (waiting period), Part XVI (distribution); BCSA, supra note 38, as at 2004, ss. 66 [repealed] (preliminary prospectus amendment), 67 [repealed] (prospectus amendment), 68 [repealed] (certificate of issuer).
proposed B.C. legislation locates many of those issues within its proposed Securities Rules, instead of the proposed statute. A similar shift toward greater reliance on Commission rule making powers is evident in the proposed B.C. legislation around takeover and issuer bids, proxies, continuous disclosure, and primary market civil liability.

The second major distinguishing feature of more principles-based legislation is that it tends to be structured in a more outcome-oriented, as opposed to process-oriented, manner. The notion of outcome-oriented regulation is so connected to the principles-based approach that in its submission to the Expert Panel, the BCSC expressed a preference for the term “outcomes-based” rather than “principles-based” to describe its approach. Outcome-oriented regulation measures performance against regulatory goals, whereas process-oriented regulation measures compliance with detailed procedural requirements. For example, both the OSA and

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[69] [repealed] (certificate of underwriter), 65 (prospectus receipt), 78 (waiting period), Part XI (distribution).


[63] One of the wrinkles concerns where each principles-based regime locates its "core principles" (see Ford, “Securities Regulation”, supra note 12 at 60-65). British Columbia and the FSA issued their Code/Principles through rule making, while the CFMA (supra note 44), and the QDA (supra note 14) chose to embed them directly into legislation. It seems that nothing substantive turns on the choice.

[64] Submission BCSC, supra note 13 at 4. See also Business Plan: 2009/10, online: Financial Services Authority <http://www.fsa.gov.uk> at 9. These regulators prefer the terms “outcomes-oriented” or “outcomes-focused” primarily due to confusion around the term “principles-based”, and not because they see the terms as interchangeable. Principles-based and outcome-oriented regulation are different concepts and should not be conflated; for example, one could have a system that is rule-based and outcome-oriented. However, principles-based and outcome-oriented regulation share philosophical convictions about the purposes of regulation and the most effective means for achieving regulatory goals.

Secondary market civil liability was not part of the existing BCSA in 2004, when the proposed legislation was drafted, so we cannot compare the structure there. Note, also, that the principles-based regimes diverge in terms of where they locate their “core principles” (see Ford, “Securities Regulation”, supra note 12, at 60-65). British Columbia and the FSA issued their Code/Principles through rule making, while the CFMA (supra note 44), and the QDA (supra note 14) chose to embed them directly into legislation. All of those Codes/Principles are actually pitched at similar levels of precision—i.e., they are all cast in terms of high level principles. There is no intention that they should be regularly amended based on regulatory experience. Therefore purely in terms of regulatory design they should probably be part of the statute rather than the rules, although there may have been practical considerations at play as well. It seems that nothing substantive turns on the choice.

[65] In actual practice, there is no necessary disconnect between outcome-oriented regulation and a third approach that some scholars call management-based regulation. See Cary Coggles & David Lazer, “Management-Based Regulation: Prescribing Private Management to Achieve Public Goals” (2003) 37 Law & Soc’y Rev. 691. There are differences between the two concepts regarding the stage of firm conduct at which the regulator intervenes, but both place responsibility for detailed decision making with in-
one part of the B.C. Model, its Code of Conduct for dealers and advisers contain provisions that try to ensure that customers receive timely disclosure of trades conducted on their account. However, the OSA establishes a strict procedure whereas the B.C. Code of Conduct only specifies an outcome. We see similar differences in their approaches to dealer conflicts of interest.

Another example is account supervision by broker-dealer firms. In 2004, the BCSC commissioned a regulatory impact analysis that compared the detailed, process-based account supervision requirements established by the Investment Dealers Association (IDA), as it then was, with the more outcome-oriented requirements imagined under the proposed B.C. Code of Conduct for dealers and advisers. The Code of Conduct would have required a firm to “[m]aintain an effective system to ensure compliance with this Code, all applicable regulatory and other legal requirements, and [its] own internal policies and procedures,” and to “[m]aintain an effective system to manage the risks associated with [its] business.” The four firms studied were of the view that the IDA rules, which mandated transaction-based daily and monthly reviews, contributed significantly to their regulatory burden without providing meaningful investor protection. From their perspective, the reviews were duplicative, rigid—and, worst of all—not effective in detecting abuses characterized by patterns of behavior, which is where they thought the biggest compliance risks arose. As a result of these perceived limitations and in response to what the firms described as concerns about civil liability, reputation, and good business practice, each of the firms had already, by the time of the study, developed its own parallel risk-based supervisory

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67 See OSA, supra note 40, s. 36; Christina Wolf, Strong and Efficient Investor Protection: Dealers and Advisers under the BC Model—A Regulatory Impact Analysis (24 November 2003), online: British Columbia Securities Commission <http://www.besc.bc.ca> at 72 (Principle 8).

68 Compare OSA, supra note 64, s. 39 and Wolf, supra note 65 at 66 (Principle 6).

69 Wolf, supra note 65 at 48-57. Of course, primary responsibility for overseeing dealers and advisers is subdelegated to self-regulatory organizations (SRO) – most prominently IIROC and the Mutual Fund Dealers Association of Canada. Those SROs would have to be active participants in any change to a more principles-based approach.

70 See Code of Conduct, supra note 64, Principle 19. See also Guide, supra note 64 at 31-32.

The regulatory impact analysis concluded that relative to the existing system, B.C.'s proposed Code of Conduct would, by permitting firms to focus their energies on their effective internal risk-management systems, improve investor protection, allow firms to innovate to achieve regulatory objectives in the ways that were most efficient for their businesses, and reduce compliance costs.

We return to some of the difficulties associated with reliance on internal risk models below. The point here is that outcome orientation has important implications for the approach to regulation. By definition, outcome-oriented regulation accepts that there may be more than one means (i.e., more than one process) to achieve a regulatory goal. It transfers decision making about process from regulators to industry. The essential assumption underlying both principles-based and outcome-oriented regulation is that legislators and regulators are in the best position to develop regulatory goals, but may not be in the best position to devise process-based means for achieving those goals. One of the reasons that outcome-oriented regulation is attractive is that it establishes a more direct relationship between regulatory goals and regulatory requirements. Outcome-oriented regulation translates regulatory goals directly and transparently into the outcomes that industry is required to meet. By contrast, process-oriented requirements that are developed by regulators in advance, even though regulators possess less contextual information than industry actors, may not be perfectly tailored to regulatory goals. Process-oriented regulation can also permit market participants to abide by the letter of the law while ignoring its spirit. This is especially the case when it comes to highly complex instruments, or in areas where events are fast-moving and regulators on their own could not hope to keep up with the pace of innovation.

Fundamental to an outcome-oriented system is the existence or development of an "interpretive community" that collectively develops, on a rolling basis, the detailed content of statutory principles. In order to function transparently and predictably, a principles-based system must build in mechanisms that allow regulators to communicate with industry about

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72 For an example of the limitations that the firms found frustrating, see generally ibid. at 14-17.

73 Reliance on internal risk-management analysis in the context of Basel II and the Consolidated Supervised Entities Program at the United States Securities and Exchange Commission are discussed in "The Global Financial Crisis," below.

their expectations, and that both allow and require industry to speak openly and regularly with regulators about their processes. Communication can take place through a number of channels including official administrative guidance, speeches, “no action” or “Dear CEO” letters, compliance audits, comments on industry standards, or specific enforcement actions. Over time, such communication can help develop an interpretive community that understands regulatory expectations, and can usefully interpret regulatory pronouncements about “reasonableness” or “effectiveness” in different situations.

Principles-based securities regulation is thus a particular way of structuring regulation, not a decision to do away with rules. Principles-based regulation is based on the conviction that while legislators and statutory drafters have the public legitimacy to establish broad regulatory goals, they are not in the best position to develop detailed guidelines for industry conduct, especially in fast-moving arenas like securities regulation. Those powers are allocated to frontline regulators at the securities commissions, whose expertise derives from their proximity to industry and whose accountability derives from the notice-and-comment aspect of their rulemaking powers. Moreover—and this is the crucial point today—even those front line regulators are limited in their access to information by comparison to the industries they regulate. In order to remain relevant and informed about fast-moving industry practice, to keep regulation sufficiently flexible, and to avoid inhibiting productive innovation, regulators need to establish open and perpetual communication lines with industry. They need to use industry’s own good and best practices to add the “meat” of detail to the “bones” of their principles-based regulatory expectations.

Described another way, principles-based regulation is a two-tiered approach, in which principles-based legislative drafting provides flexibility, to which constantly evolving industry experience and regulatory rules add certainty on a rolling basis. In this formulation principles-based regulation, as applied, avoids the biggest problems associated with both principles and rules, at the level of theory. Moreover, it can produce more effective regulation by ensuring that the party that has access to the best information is the one that provides the detail on any particular issue.” What the GFC may suggest to us is that this “beyond theory” perspective is still idealized, and that its promise was not achieved in practice. How real-life experience fell short of expectations is described in the next part, followed by a discussion of three large lessons learned.

II. The Global Financial Crisis

At least three major arguments contend that the GFC does not represent even a superficial challenge to principles-based securities regulation. First, the most alarming problems originated with complex securitized
products that were distributed through exempt private-market placements, entirely bypassing the public securities markets where the full panoply of regulatory safeguards would have applied. Second, the GFC has far more to do with gaps in regulation than with drafting choices. Gaps in regulation, especially around prudential regulation of players in the so-called “shadow banking system” in the United States, were surely the most obvious and consequential aspect of regulatory failure. The asset-backed commercial paper (ABCP) crisis in Canada in August 2007 revolved around paper sold under an exemption from securities regulation. Credit-rating agencies, which utterly failed as gatekeepers, were drastically under-regulated. Third, the GFC was a global event. The complex securitization technology that increased risky lending, decreased transparency, and multiplied and spread risk was not unique to principles-based jurisdictions. Even within the core concerns of securities regulation, national systems traditionally described as rules-based—specifically, that of the United States—demonstrably fared no better than the more principles-based system at the United Kingdom’s FSA. While many specific components of financial and securities regulation, ranging from prudential regulation and systemic risk analysis to the basic usefulness of the ex-

76 See Department of the Treasury, Financial Regulatory Reform, supra note 7; Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, “Systemic Risk through Securitization: The Result of Deregulation and Regulatory Failure” (2009) 41 Conn. L. Rev. 1327. Observers have also pointed out that the SEC, which had primary oversight of most Wall Street investment bank functions, was not well equipped to conduct prudential financial regulation (Coffee & Sale, supra note 8).

76 See Prospectus and Registration Exemptions, NI 45-106, B.C. Reg. 269/2005, s. 2.35. This Instrument exempts trades in commercial paper maturing not more than one year from the date of issue, and having an approved credit rating from an approved credit rating agency.


78 Historically, credit-rating agencies in Canada and the United States have operated with relatively little regulatory scrutiny. In the United States, oversight has largely fallen upon the SEC, which has chosen to rely solely on ratings from “nationally recognized statistical rating organizations” (NRSRO). The SEC imposes stringent requirements before an agency can be recognized as a NRSRO. This, coupled with high entry barriers, has produced a situation in which three agencies dominate the market for credit ratings. For further information on the regulation of credit-rating agencies in the United States, see Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets: As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002, online: Securities and Exchange Commission <http://www.sec.gov> at 5-10. Legislation has recently been proposed in the U.S. to introduce additional regulatory oversight and to curb many of the failings associated with the current rating regime. See U.S., Bill H.R. 3817, Investor Protection Act of 2009, 111th Cong., 2009.

79 See e.g. McCoy, Pavlov & Wachter, supra note 75.
isting disclosure-based model are legitimately being re-examined, they are being re-examined globally.

A. Risk and Reward: Devolution of Details to Industry

Where the GFC should provoke reflection, however, is with regard to the role of devolution to industry. Here, the GFC does represent a challenge (though I would argue not a fundamental one) to principles-based regulation. Principles-based regulation works by devolving the details of regulation to industry, on the assumption that industry has the best information and is in the best position to both assess and bear its own risks. While not essential to principles-based regulation, this devolution is a central reason for the advantage of principles-based regulation over rules-based regulation in fast-moving environments. Devolution of the details to industry, however, went on to play a central role in enabling some of the most painfully aggravating conditions associated with the U.S. subprime mortgage meltdown. This need not have been the case. Crucially, devolution does not automatically imply weak public oversight. Nevertheless, devolution accompanied by an ideology of self-regulation contributed to insufficient oversight of the massive expansion of the over-the-counter market for derivatives within which credit default swaps (CDS) traded, following the passage of the CFMA. Other examples of devolution included Basel II and, correspondingly, the United States Securities and Exchange Commission’s (SEC) approval in 2004 of alternative net capital requirements for the leading investment banks under the Consolidated Supervised Entities Program (CSE Program). These initiatives allowed banks and investment banks to maintain capital reserves based on their own internal risk-assessment models, with very little scrutiny from regulators.


Regulatory faith in industry actors’ competence, if not literally their bona fides, proved to have been misplaced to catastrophic effect. George Soros has charged that the GFC reflects a “shocking abdication of responsibility” on the part of regulators. Investment banks and others engaged in originating, structuring, and selling financial products engaged in breathtakingly bad behaviour. There was real dishonesty. The firms also made grave errors in safeguarding even their own interests. In the hands of in-house financial economists, academic caveats about the limitations of efficient markets theory (EMT) models as well as limits of valuation models were ploughed under. Predictable psychological irrationalities seem to have been at work within firms, including groupthink, overconfidence, self-serving biases, and excessive faith in “hard” numbers, which were not accounted for in the regulatory decision to devolve the details to industry. There is also a strong public-choice narrative: banks had little incentive to behave prudently in building tranches of consumer debt-based securities because they sold them to third parties, in a market eager to buy them. At a structural level, banks may have focused on short-term gain at the expense of long-term value because they were public corporations, not partnerships, and because bank CEOs were compensated based on short-term earnings.

Regulators also seem to have underestimated the degree to which industry actors would try to avoid or circumvent regulatory oversight. Whether out of short-term self-interest, economic pressure, or simple lack

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85 See e.g., Lowenstein, supra note 77; Les Christie, “Mortgage fraud still soaring: A crackdown on underwriting has failed to halt an explosion of fraudulent home loans” CNNmoney.com (26 August 2008), online: CNNmoney.com <http://money.cnn.com>

86 For a discussion of the future of the “efficient-markets hypothesis”, see “Efficiency and beyond; Financial economics” The Economist (18 July 2009), (QL) (“Efficiency and Beyond”).


of understanding, firms within the CSE Program that applied the alternative net capital requirements valued illiquid assets too generously, underestimated long-tail risks, and maintained inadequate capital buffers, all the while arguing that their behaviour was reducing rather than exacerbating risk. Firms innovated in structured products, not only to reflect increasing sophistication or in order to make their product more attractive to purchasers, but also sometimes to avoid regulation. They avoided comparability in order to reduce transparency and make it harder for regulators to understand what they were selling.

Each of these factors, even in isolation, represents a considerable challenge to what Julia Black has termed the "regulatory Utopia", within which the self-examining, responsible firm, possessing the greatest contextual information, helps to elaborate the content of principles-based regulation through ongoing dialogue with a flexible and outcome-oriented regulator, in the service of the mutual goal of optimized regulation. What follows below is a dissection of the ways in which the self-regulatory regimes that gained so much traction in the past decade differ from principles-based regulation when buttressed by an active regulatory presence. Only after we have a sense of the underlying structure of the principles-based project can we assess what it slipped to in recent practice, and what aspects of it remain vital.

90 See David Brooks, "Greed and Stupidity" The New York Times (3 April 2009) A29 (contrasting two theories explaining decision-making failures at financial institutions). Precisely why financial institutions managed risk so poorly is an important question, the answer to which is also multi-factorial and varies from one firm to another.

91 This may be the least of it. As Martin Wolf has pointed out, "an enormous part of what banks did in the early part of this decade—the off-balance-sheet vehicles, the derivatives and the 'shadow banking system' itself—was to find a way round regulation" “Reform of regulation has to start by altering incentives” Financial Times (U.K.) (24 June 2009).


93 Black, “Forms and Paradoxes”, supra note 46 at 10.
B. Enforced Self-Regulation and Principles-Based Regulation

Principles-based regulation is not the same thing as self-regulation. Nevertheless, the distinction between principles-based regulation and self-regulation has not always been adequately emphasized. Competition between jurisdictions for increasingly mobile global capital played a role in obscuring the distinction. Large financial firms' ability to relocate to more "competitive" regulatory environments provoked regulators and policy makers to focus on the costs of substantive regulation. The rhetoric of principles-based regulation became enmeshed with the rhetoric of efficiency and the need to control the regulatory burden. Arguments in favour of principles-based regulation from Henry Paulsen, for example, tended to emphasize the free-market benefits and reduced regulatory burden associated with the FSA approach—not its asserted regulatory oversight benefits.94 Some, concerned about London’s increased capital market share in the last few years, asserted that its success with principles-based approach was the result of lower standards and lax oversight under principles-based regulation, especially in its junior market.95 London-based regulators naturally disputed this assessment.96

The March 2009 Turner Review insightfully describes the regulatory worldview that failed to anticipate the problems identified above.97 Lord Adair Turner, now FSA Chairman, was commissioned by the Chancellor of the Exchequer in October 2008 to review the causes of the financial crisis and make recommendations about regulatory changes. According the Turner Review, the FSA did not fail because it embraced principles-based regulation. Indeed, principles-based regulation is barely mentioned.98 In-

96 See e.g., Clara Pulser, “Sox is not to blame · London is just better as a market” Financial Times (U.K.) (19 September 2006); John Tiner, “Better Regulation: Objective or Oxymoron” (Speech delivered at the SII Annual Conference, 9 May 2006), online: Financial Services Authority <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0509_ft.shtml>.
97 Turner, supra note 5.
98 Notwithstanding premature and ultimately inaccurate reports by credible U.K. media sources that principles-based regulation would be abandoned. See Peter Thal Larsen & Jennifer Hughes, “Sants Takes a Fresh View of Regulator’s Principles,” Financial Times (13 March 2009), online: FT.com <http://www.ft.com/cms/s/b06eccc49d0-0770-11de-ba10-0000779fd2ac.html>.
stead, Lord Turner ascribes blame to flaws in FSA philosophy—that is, to
a hands-off, market-based regulatory approach that assumed: markets
were generally self-correcting; market discipline could be trusted to con-
tain risk; primary responsibility for managing risk lay with senior man-
agement not regulators, because senior management has better informa-
tion; and consumers were best protected through unfettered and trans-
parent markets, not product regulation or direct intervention.\footnote{99}

Lord Turner is correct to draw a distinction between the FSA's stance
in favour of industry self-regulation and its principles-based approach. To
equate principles-based regulation unequivocally with self-regulation
would be to misunderstand both. The two are not inconsistent, nor are they
synonymous. Self-regulation refers to the degree of public interven-
tion in private industry. Neither principles-based nor rules-based regu-
lation guarantees any particular stance toward self-regulation. Principles-
based regulation is a particular regulatory approach that may or may not
be highly interventionist, depending on how it is implemented, even
though its effectiveness relies on pulling industry's own experience and
information into regulatory expectations. Indeed, some opponents to prin-
ciples-based regulation are primarily concerned about the possibility that
such an approach would allow regulators to overreach, especially in the
enforcement context.\footnote{100} Whether a principles-based approach amounts to
lax regulation, overzealous regulation, or (impossibly) pitch-perfect regu-
lation is a function of how, and how well, it is implemented.

Principles-based regulation as properly understood inevitably requires
a robust and capable public role, including meaningful enforcement.\footnote{101}
Principles-based regulation is not code for a position that promotes allow-
ing industry to do an end run around the regulator. It is a conceptually
consistent outgrowth of the loose group of regulatory perspectives vari-
ously known as new governance,\footnote{102} co-regulation,\footnote{103} enforced self-

\footnote{99} Equally fundamental, but best put in the category of regulatory gaps rather than regu-
lar regulatory approaches, was failure in the oversight of systemic risk. See Turner, \textit{supra} note 5 at 52.

\footnote{100} See e.g. Briefing from Freshfields Bruckhaus Deringer (February 2007) \textquoteleft FSA Prin-
ciples-Based Regulation: What Should Firms Be Doing Differently?\textquoteright, online: Freshfields

\footnote{101} Ford, \textquoteleft New Governance\textquoteright, \textit{supra} note 2 \textquoteleft(a credible enforcement function writ large
(meaning both compliance oversight and prosecution where needed) is a necessary
component of principles-based and outcome-oriented regulation\textquoteright at 32); see also Cristie
L. Ford, \textquoteleft Toward a New Model for Securities Law Enforcement\textquoteright (2005) 57 Admin. L.
Rev. 757 (arguing for continued focus on enforcement within new governance scholar-
ship).

\footnote{102} Ford, \textquoteleft New Governance\textquoteright, \textit{supra} note 2 (arguing that principles-based securities
regulation is a new governance innovation). The term \textquoteright principles-based regulation\textquoteright is
the dominant one in securities regulation, likely for path-dependent reasons stemming
from post-Enron concerns about whether the United States' Generally Accepted Ac-
regulation, or "responsive regulation." New governance and its variants are not the same as self-regulation. According to its proponents, new governance scholarship exists explicitly for the purpose of making the public state more, not less, central and relevant. To use Jerry Mashaw's recent formulation, new governance represents a different balance between the available public, market, and social mechanisms for ensuring

counting Principles (GAAP) rules were too rules-based. However, some scholars would argue that new governance methods transcend the rules-versus-principles debate. See Kathleen G. Noonan, Charles F. Sabel & William H. Simon, "Legal Accountability in the Service-Based Welfare State: Lessons from Child Welfare Reform," (2009) 34 Law & Soc. Inquiry 523 (arguing that new governance, or "experimentalist", practice resolves "the rules/standard antinomy" debate through a "simultaneous emphasis on articulation and flexibility" at 536-37, 551-56). In spite of differences in terminology and emphasis, the fully articulated version of what I call principles-based regulation is not in tension with what Noonan, Sabel and Simon describe. These authors find it most useful to frame the phenomenon as a pragmatic, practical method that bypasses an unproductive theoretical conversation. I find it most useful to focus on principles-based regulation as a first-order decision that reflects an appreciation of the relative capacities of legislative drafters, regulators, and industry actors. Nevertheless, my version of principles-based regulation calls for careful attention to implementation mechanisms that pull detailed industry knowledge into the articulation of those principles, in a way that is strongly similar to what Noonan, Sabel and Simon describe. See also Ford, "New Governance", supra note 2 at 30, n. 111.


Ian Ayres & John Braithwaite, Responsive Regulation: Transcending the Deregulation Debate (Oxford: Oxford University Press, 1992). I am not suggesting that these perspectives are coterminous in terms of precisely how "top-down" or "bottom-up" they are designed to be, among other things. For a description of the difference between co-regulation and (enforced) self-regulation in the European Union, see e.g. Linda Senden, "Soft Law, Self-Regulation and Co-Regulation in European Law: Where Do They Meet?", online: (2005) 9:1 Electronic Journal of Comparative Law <http://www.ejcl.org>. A full dissection of the differences is beyond this paper's scope. The point for present purposes is that each of these approaches, like principles-based regulation, tries to identify an effective regulatory method located between rigid and unresponsive command-and-control regulation on one hand, and voluntary self-regulation on the other.


accountability, putting greater emphasis on the latter two.\textsuperscript{108} It imagines a different role for the regulator than rules-based, command-and-control regulation does. However, it does not suggest that public accountability, in the form of state action, could ever be ignored.

How exactly to best enforce self-regulatory models is a matter of some debate. Different models exist. \textit{Ex post} enforcement actions play a much larger role in U.S. securities regulation than they do in the United Kingdom, which focuses more on \textit{ex ante} supervision and compliance work.\textsuperscript{109} The impact of civil liability also needs to be considered.\textsuperscript{110} When it comes to principles-based regulation, Black is probably correct when she writes that “principles need enforcement to give them credibility but over-enforcement can lead to their demise.”\textsuperscript{111} A growing body of scholarship exists concerning how to make enforced self-regulatory systems effective and credible using supervision, outcome-oriented problem solving, negotiated compliance, and firm penetration through compliance audits.\textsuperscript{112} Enforcement in a principles-based system (including referral for criminal prosecution if necessary) likely works best as the culmination of a series

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{110} Some have also argued that principles-based regulation is not viable in the United States because of the extraordinary civil liability risks in that jurisdiction. See Peter J. Wallison, “Prol or Reform: Can Principles-Based Regulation Work in the United States?” Financial Services Outlook (June 2007), online: American Enterprise Institute for Public Policy Research \texttt{<http://www.aei.org/>}. This is probably less of a concern in Canada. There may be a risk, however, that courts will become closely involved in defining the meaning of principles, if civil liability becomes the driving force for such interpretations. This will affect the regulator’s ability to develop those principles within the regulatory sphere (Ford, “Securities Regulation”, \textit{supra} note 12 at 24-25).
\item \textsuperscript{111} Black, “Forms and Paradoxes”, \textit{supra} note 46 at 29.
\end{enumerate}
\end{footnotesize}
of such interactions with an industry actor, ratcheted up through an enforcement pyramid approach. Once at the enforcement stage, especially when dealing with cases based on violation of a principle alone, bringing enforcement actions successfully calls for substantial confidence and fortitude on the part of regulators. Enforcement staffers must also be watchful for potential procedural fairness concerns.

The GFC represents an important lesson for some new governance scholarship, which has not always been particularly interested. Indeed, the shortfall between the promise of an inspiring theoretical model and its application to real-life regulation makes the problem more, not less, important to solve. What was missing from many aspects of financial regulation, in retrospect, was meaningful accountability. The pressing questions now are why pre-GFC systems did not incorporate adequate public accountability mechanisms, and how principles-based securities regulation in Canada might avoid similar pitfalls. What follows are three recommendations for charting a path forward for principles-based regulation in Canada in the wake of the GFC. These recommendations take as a starting point that principles-based regulation must be buttressed by meaningful regulatory oversight, and then they move beyond that to a closer review of what accountability demands. The recommendations focus on problems of complexity and capacity, and the compromising effect that a lack of diversity and independent mindedness can have on effective regulatory oversight.

III. Lessons Learned and Steps Forward

A. Four Points on Regulatory Capacity

It turns out, as if there were ever any doubt, that how principles are implemented is at least as important as how legislation is drafted. As observed earlier, certainty in a principles-based regulatory regime has less to do with how a particular provision is drafted and more to do with the development of an interpretive community that defines the content of

113 Ayres & Braithwaite, supra note 103.
114 See Ford, “Securities Regulation”, supra note 12 at 32-34.
116 Indeed, implementation may be more important than optimal statutory design, given that both the United Kingdom’s FSA and the BCSC have adopted more principles-based approaches, notwithstanding enabling statutes that are not particularly principles-based. See Focusing on the Outcomes, supra note 1 (discussing the FSA regulatory philosophy), 2004 B.C. Securities, supra note 1 (“Although the 2004 act is not in force, the BCSC has moved ahead with changing its regulatory processes and approach in much the same way [it] would have done under the 2004 act”).
that provision.\footnote{117} What is required is a regulator that is capable of functioning as an independent and credible member within that interpretive community—that is, a regulator that has a clear sense of its distinct role as a voice on behalf of the public interest. Moreover, because so much interpretive discretion rests in the regulator's hands, regulatory capacity, training, judgment, and philosophy are critically important to effective implementation. It is therefore crucial to think carefully about the structure through which principles will be translated into regulatory practice.

Working well with principles-based regulation requires considerable changes to traditional regulatory culture. Moving to a new model would take time and training.\footnote{118} A principles-based regulator focuses on defining broad themes, articulating them in a flexible and outcome-oriented way, accepting input from industry, and managing incoming information effectively. This requires expertise, a more ongoing communicative relationship with industry, restraint in providing administrative guidance, and the continued use of notice-and-comment rule-making where appropriate.\footnote{119} Principles-based regulation relies on good and best practices emerging from industry to help define the content of principles-based regulatory requirements. Using good and best practices, which evolve, as opposed to potentially static industry standards, allows regulatory expectations to evolve and remain flexible. It also builds-in a learning process for both regulators (who are learning from industry about what works in different contexts) and regulatees (who are learning from each other.) This shift in emphasis does not, however, require that regulators "roll over and play dead" in the face of industry demands.

1. Lesson One: Effective Regulatory Capacity Requires Adequate Number of Staff

At the first and most fundamental level, regulatory capacity in this new environment requires an adequate number of staff. As Black has pointed out, principles-based regulation (like risk-based regulation) may be more hands-off in its approach to the details, but this does not mean that it requires fewer regulatory resources. Depending on choices about implementation, principles-based regulation may actually require inten-

\footnote{117 Black, Rules and Regulators, supra note 70; see also Capital Markets, supra note 2.}
\footnote{118 See Robin Ford, "Principles-Based Regulation: Financial Services Authority (U.K.)" in Task Force to Modernize Securities Legislation in Canada: Canada Steps Up, vol. 7, online: Task Force to Modernize Securities Legislation <http://www.tfmslc.ca> 101 at 105-108 (describing the former BCSC Commissioner's experience with change management at the FSA, including obstacles the FSA faced in implementing an outcome-oriented, principles-based system and the tools the FSA used to help staff adjust).}
\footnote{119 See e.g. Black, "Making a Success", supra note 2.
sive interaction with firms, at least around certain issues or situations.\textsuperscript{120} Yet, as the Northern Rock debacle in the United Kingdom highlighted, the FSA was far from adequately staffed.\textsuperscript{121} Its Major Retail Groups Division was reduced by some twenty staff between 2004 and 2008, notwithstanding the Division’s responsibility for substantial and complex FSA priorities such as Basel and the Treating Customers Fairly initiative, in addition to its core firm risk-assessment work.\textsuperscript{122}

2. Lesson Two: Regulators Must Have Transparent and Reliable Information about Industry

The example of the SEC’s CSE Program is even more striking.\textsuperscript{123} Its Division of Trading and Markets had only seven staffers and no executive director, yet since March 2007, it was charged with overseeing five otherwise unregulated major broker-dealer firms, which formed the backbone of the American-based shadow banking industry, based on an alternative capital adequacy method. One of the effects of understaffing was that Trading and Markets staff had not completed any inspections of the Division’s subject firms in the eighteen months prior to the collapse of Bear Stearns in September 2008.\textsuperscript{124} This lack of oversight would have been problematic in any event, but it was even more catastrophic in an outcome-oriented system where so much of the detailed procedural design for achieving regulatory goals was delegated to industry. As we all now know, the firms’ models, which assessed largely illiquid assets operating both in the absence of price discovery and of backstop prudent regulation, proved woefully inadequate.

Second, regulators must have the ability to obtain transparent and reliable information about the industry actors they oversee. Even today, there can be no disputing that industry actors have better and more up-

\textsuperscript{120} See \textit{ibid}, (describing U.K. Treat Customers Fairly rules, which require registrants to demonstrate that they are in fact treating customers fairly at every stage.)

\textsuperscript{121} The FSA acknowledged extraordinarily high turnover of FSA staff directly supervising the bank, inadequate numbers of staff, and very limited direct contact with bank executives among the reasons for its “unacceptable” regulatory performance. See FSA Internal Audit Division, \textit{The Supervision of Northern Rock: A Lessons Learned Review} (March 2008), online: Financial Services Authority <http://www.fsa.gov.uk> [FSA, Northern Rock].

\textsuperscript{122} \textit{Ibid}.

\textsuperscript{123} This is also a regulatory gap story. The CSE Program was voluntary, reportedly designed as a response to the fact that no U.S. agency had regulatory authority over certain investment-bank holding companies. See \textit{SEC’s Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program, Report No. 446-A, (25 September 2008) at 81, online: Securities and Exchange Commission <http://www.sec.gov>} (Chairman Cox’s comments) [SEC \textit{Oversight}].

\textsuperscript{124} \textit{SEC Oversight, supra} note 123 at 49-50.
to-date information on their operations than regulators could hope to obtain. The larger firms also have far superior resources. Yet these same actors have an interest in casting facts to their advantage, in making their products look as attractive as possible, and in reducing regulatory oversight where possible. Again, as hard experience at the FSA and the SEC demonstrates, simple information collection is a crucial first step. The post-mortem account of regulatory failure in the Northern Rock case identified a number of instances in which the FSA failed to collect, or did not have access to, the information necessary to accurately assess the risk that bank posed. Supervisors were found not to have been “proactive in ensuring there was a robust process allowing them a complete picture of issues.” The post-mortem analysis of the CSE Program recorded similar weaknesses. Among other things, the analysis identified instances in which the CSE staff failed to adequately track material issues in regulated firms, approved changes to capital requirements before completing full inspections, and failed to exchange information with other SEC divisions. In a system where information is power, such as in the regulation of the sale of complex derivative instruments, a regulator without the ability to obtain direct information effectively cedes the field to those it regulates.

125 FSA, Northern Rock, supra note 121 at 7. The findings of an internal audit into the FSA’s conduct in the Northern Rock affair demonstrated “a level of engagement and oversight by supervisory line management below the standard we would expect for a high impact firm” (ibid. at 4). But see Norma Cohen & Chris Giles, “Northern Rock Risk Revealed in 2004” Financial Times (30 May 2009), online: FT.com <http://www.ft.com/cms/s/0/cc9637a-4c8a-11de-a6c5-00144fabe0c0.html?nclick_check=1> [“Northern Rock Risk”] (reporting that the FSA had conducted “war games” in 2004 that identified the systemic risk that Northern Rock posed.)

126 SEC Oversight, supra note 123 at 37-41. The SEC’s failures in oversight do not appear to be limited to the CSE Program. That agency’s review of its failure to detect and prevent Bernard Madoff’s fraud also records that Mr. Madoff’s funds were overseen by inexperienced or unsuitably skilled staff who conducted inadequate examinations, failed to verify information, and failed to respond to “red flags”. Additionally, investigations were delayed, questions were left unresolved, and SEC offices failed to communicate with each other. See Investigation of Failure of the SEC to Uncover Bernard Madoff’s Ponzi Scheme: Report of Investigation Case, Report No. OIC-809, Public Version, (31 August 2009), online: Securities and Exchange Commission <http://www.sec.gov> [Investigation of Failure]. The SEC’s post-Madoff reforms include many of the initiatives recommended here, such as conducting surprise exams, recruiting staff with specialized experience, improving staff training, and seeking more resources. See “The Securities and Exchange Commission Post-Madoff Reforms”, online: Securities and Exchange Commission <http://www.sec.gov>. Donald C. Langevoort has described the SEC’s failings around the Madoff scandal sympathetically, though by no means optimistically, as a function of chronically inadequate resources (Don Langevoort, “The SEC and the Madoff Scandal: Three Narratives in Search of a Story” (2009) Michigan State Law Review [forthcoming in 2010]).
Principles-based regulation in conditions of complexity requires that regulators have and use robust investigatory powers where necessary, and that they conduct regular and adequate compliance audits. Like staffing adequacy and information-gathering capability, effective compliance mechanisms are even more central in a principles-based environment. Compliance efforts give regulators access to essential, fine-grained information about particular firms, and promote regulatory credibility and engagement with industry. They are an important tool for developing and communicating the precise content of principles-based requirements to industry actors. As noted above, they are also part of a coordinated, multifaceted oversight approach for public companies and regulated entities, based on a carefully designed "enforcement pyramid" approach that also includes other supervisory strategies, as well as civil and criminal enforcement.\textsuperscript{127}

3. Lesson Three: Regulators Must Independently Scrutinize Information  

Third, regulators in a principles-based system must have the capacity to independently scrutinize information.\textsuperscript{128} This requires considerable capacity in terms of information management systems. It also calls for quantitative expertise and industry experience. The FSA's responses to Northern Rock, and its challenges in meeting them, may be instructive to Canadian securities regulators as they contemplate moving toward more principles-based regulation. The FSA plans to enhance its supervisory teams through increased staff, better training, a mandatory minimum number of staff per high-impact institution, and closer contact between senior staff and the biggest firms. It also plans to improve the quality of its staff, hiring risk specialists to support front-line supervision teams by focusing on the complex models used by banks to gauge financial risk.\textsuperscript{129}

\textsuperscript{127} Ayres & Braithwaite, \textit{supra} note 104; see also Ford, "New Governance", \textit{supra} note 2 (consistent with the so-called enforcement pyramid, the "BCSC's Capital Markets Regulation Division uses a risk-based matrix to assess the risks presented by different industry actors, and it accords more leeway to firms that have demonstrated compliance bona fides" at 54, n. 170). See also Poonam Puri, "Enforcement Effectiveness in the Canadian Capital Markets: A Policy Analysis" (Presentation given to Capital Markets Institute, Rotman School of Management, University of Toronto, 14 June 2005), online: Rotman School of Management <http://www.rotman.utoronto.ca/emi/papers/Puri%20CMl%20Enforcement%20Presentation.ppt>.

\textsuperscript{128} See Ford, "Securities Regulation", \textit{supra} note 12 at 23.

\textsuperscript{129} The FSA implemented a "supervisory enhancement program" in response to the failure of Northern Rock. See Hector Sants, "The FSA's Supervisory Enhancement Programme, in Response to the Internal Audit Report on Supervision of Northern Rock" (26 March 2008), online: Financial Services Authority <http://www.fsa.gov.uk>. See also Turner, \textit{supra} note 5 (describing the FSA's new approach as "intensive supervision" at 88). Lord Turner describes intensive supervision as entailing significantly greater resources devoted to the supervision of high-impact firms, more intense focus on
As one commentator observed, the regulator will now be pursuing “the same PhD rocket scientists the banks are chasing. ... As Northern Rock shows, it’s not just about evaluating the problems, but having the people who can follow them up and forcefully make the case to the bank.”

The need to hire “PhD rocket scientists” may seem peculiar, given that flawed quantitative analysis by in-house bank economists so drastically exacerbated the GFC in the first place. The fact that quantitative analysis has been abused, misapplied, and overgeneralized in the past, however, does not mean that banks will not use it in the future. In spite of its theoretical limitations and the recent catastrophe, quantitative analysis continues to have substantial predictive value, and it will continue to serve as a central tool for financial industry actors. Securitization has brought too many benefits, and too much profit in good times, for modern financial markets to eschew it in the future. Indeed, financial innovation continues. A regulator that does not have the capacity to challenge firms’ models will not have the capacity to engage in an important ongoing conversation.

4. Lesson Four: Regulators Must Have Healthy Skepticism about Industry

Finally, in addition to having the numbers, the information, and the analytical skills, regulatory staffers must have sufficient confidence in their own judgment and a healthy degree of skepticism about industry. This difficult problem is discussed further below.

B. Complexity and Prophylactic Rules

One of the striking lessons of the GFC has been the impact of complexity on the financial markets, and the degree to which existing regulatory structures failed to manage those effects. Steven Schwarz even suggests, plausibly, that complexity is the “greatest financial market challenge of the future.” He first describes the complexity in the assets that underlie
modern structured financial products, which is overlaid with complexity in the design of the structured products themselves and exacerbated by complexity in modern financial markets. He then examines how these multiple complexities can lead to inappropriate lending standards, failures of disclosure, a lack of transparency and even comprehensibility, and—perhaps most difficult to manage—the creation of a complex system characterized by intricate causal relationships and a “tight coupling” within credit markets, in which events tend to amplify each other and move rapidly into crisis mode. Prior to the GFC, there was a general failure by all concerned to appreciate the myriad interrelated ways in which complexity can impair markets and financial regulation.

It is unrealistic to think that we can now unwind complexity from our financial markets. Instead, we must develop a more comprehensive and fine-grained understanding of how complexity manifests and for what reasons. Schwall’s incisive analysis of the sources of complexity is a first step. We should also be evaluating varieties of complexity in terms of their costs and benefits, both to real economies and financial markets as a whole and to various constituencies.

Some of the complexity deriving from innovation in structured product design is the result of increasing sophistication and fine-tuning, and has considerable beneficial effects for investors. After a certain point, however, either by design or in effect, the overall benefits flowing from ever-increasing complexity become outweighed by their overall costs. As suggested in the Turner Review, the GFC has challenged the “underlying assumption of financial regulation in the US, the UK and across the world … that financial innovation is by definition beneficial, since market discipline will winnow out any unnecessary or value destructive innovations.” In retrospect, some recent forms of financial innovation delivered few benefits but permitted rent-seeking and contributed to significantly increased systemic risk. As noted in the Turner Review:

it seems likely that some and perhaps much of the structuring and trading activity involved in the complex version of securitised credit [over the last ten to fifteen years], was not required to deliver credit intermediation efficiently. Instead, it achieved an economic rent extraction made possible by the opacity of margins, the asymmetry of information and knowledge between end users of financial services and producers, and the structure of principal/agent relationships between investors and companies and between companies and individual employees.

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135 Ibid. at 7-32.
136 Turner, supra note 5 at 47.
137 Ibid. at 109.
138 Ibid. at 47.
One of the common arguments in favour of principles-based regulation is that it supports innovation. While this continues to be an important value, more thought needs to go into precisely how it supports innovation, to what point innovation confers net benefits, and to whom those benefits flow. A fundamental risk associated with principles-based regulation is that, in the absence of the (at least putatively) immovable markers that rules represent, there will be “creep” around the meaning of a term.139 Without regulatory oversight to ensure that terms are interpreted in a reasonable and accountable manner, self-interested actors can be expected to define terms in their own interest. Where there is already underlying uncertainty—for example, around a new or extraordinarily complex product or line of business—or where there is no metric for evaluating something (e.g., a compliance program, a product, or a risk) across institutions, the problem can be exacerbated.140 “[R]isky shift”141 can occur, especially when markets are experiencing a bubble or competitive pressures push actors toward greater risk-taking.142 Without countervailing, independent-minded regulatory power to push back against self-interested industry conduct, the “creep” may run downwards—toward more risk, less transparency, less systemic stability, and less consumer protection.

Meaningful regulatory oversight is therefore an important consideration, and complexity makes that oversight harder to achieve. We know now that our financial regulatory approaches were not built to handle the effects of complexity and constant innovation that characterize modern financial markets. Principles-based and collaborative regulation is, of course, a response to those very phenomena. But as Jack Coffee and Hillary Sale have argued, even an optimal regulatory model will not work

139 The argument is reminiscent of Ronald Dworkin’s defence of a written constitution as building strong fences around fundamental rights. See Ronald Dworkin, A Bill of Rights for Britain (London, U.K.: Chatto & Windus, 1990). I believe that rules are only putatively immovable. More precisely, rules can provide temporary or superficial clarity, but under the surface they are as subject to contestation and change as are principles. See Dorf, supra note 107 at 146-52.


if it is too complex for regulators to implement.\footnote{Coffee & Sale, supra note 8 at 55 (indicating that optimal rules may be beyond the effective capacity of many bureaucracies to implement).} In terms of the rules-versus-principles debate, this means taking into account both theory and implementation when deciding how to structure particular regulatory provisions. Ease of implementation by regulators may be an important consideration. This consideration may weigh especially heavily where we can identify that additional complexity resulting from structured product design innovation is of diminishing marginal utility. There may be contexts in which (subject to the caveats below) rules’ greater ability to contain complexity helps justify a rules-based formulation over a principles-based one, notwithstanding the significant costs to flexibility, innovation, congruence, and prospectivity.

Capital requirements are a concrete example of where firms with more rigid requirements weathered the acute phase of the fall 2008 credit crisis better.\footnote{Andrea Beltratti & René M. Stulz, “Why Did Some Banks Perform Better During the Credit Crisis? A Cross Country Study of the Impact of Governance and Regulation” (July 2009) European Corporate Governance Institute Working Paper Series in Finance 254/2009, online: Social Science Research Network <http://papers.ssrn.com> (finding that banks in countries with stricter capital requirement regulations and more independent supervisors performed better in the July 2007 – December 2008 period).} As has been well documented, Canadian capital requirements for financial institutions are comparatively high, and even tend to be exceeded by the actual practice of Canadian banks. Asset-to-capital ratios are capped at a comparatively low level.\footnote{See e.g. Kevin G. Lynch, “Public Policy Making in a Crisis: A Canadian Perspective” (Speech delivered to the Hertie School of Governance, Berlin, Germany, 7 May 2009), online: Privy Council Office <http://www.pco-bcp.gc.ca>.} Canadian financial institutions’ overall success in weathering the GFC has been often attributed to these regulatory restrictions.\footnote{But see Lev Ratnovski & Rocco Huang, “Why Are Canadian Banks More Resilient?” IMF Working Paper WP/09/152 Western Hemisphere Department (July 2009) at 4, online: International Monetary Fund <https://www.imf.org> (identifying the “key determinant” of Canadian banks’ success as having a larger base of insured retail depositors). Other factors contributing to the success of Canadian banks include steadier housing prices, a more unified regulatory structure, and the fact that mortgage lenders in Canada tend to hold the mortgages they extend. See Lynch, supra note 141; Ratnovski, supra note 147 at 16-18; Fareed Zakaria, “Worthwhile Canadian Initiative: Canadian banks are typically leveraged at 18 to 1 – compared with U.S. banks at 20 to 1” Newsweek Magazine 153: 7 (16 February 2009) 31.} Another example, beyond the rules-versus-principles conversation, is contract term standardization. Especially with respect to derivative contracts, standardization can help rein in complexity, make innovation subject to a degree of price discovery and oversight, and make derivatives easier to regulate.\footnote{Most OTC derivative contracts are documented under standard forms, known as Masters, created by the International Swaps and Derivatives Association, Inc. (ISDA) (See}
To use Colin Diver's terms, capital requirements may be an area in which, taking into account all the factors (e.g., poor regulatory oversight, gaps in regulation, etc.), transparency and accessibility prove to be more important than perfect congruence. In other words, if there is no clear and forceful regulatory voice in the interpretive community around a regulatory principle, then the (ultimately superficial) certainty provided by (inevitably imperfect) rules will still prove more valuable than the flexibility and contextuality provided by principles. This is especially the case when one considers to whom benefits have flowed. The benefits of flexibility will flow to those in a position to apply the principles. When there is no close conversation with regulators about, for example, what constitutes meaningful disclosure with respect to complex structured products in the retail market, then firms developing those products will decide on the meaning of disclosure principles in light of their own interests.

We should also consider the role that particular regulatory requirements play in overall systemic stability and efficiency. Rules around capital requirements, like much of prudential regulation, are so fundamental to effective functioning of the system that they should not necessarily be subject to contestation, innovation, and potential "creep" through collaborative regulatory practice. The analogy in democratic theory would be to participation rights, seen by some to be so fundamental to deliberation that they should not themselves be subject to the risk of erosion in the process of that deliberative exercise.¹¹⁸

¹¹⁸ See e.g., Joanne Scott & Susan Sturm, "Courts as Catalysts: Re-Thinking the Judicial Role in New Governance" (2007) 13 Colum. J. Eur. L. 565 at 576-78; Lisa T. Alexander, "Stakeholder Participation in New Governance: Lessons From Chicago's Public Housing Reform Experiment" (2009) 16 Geo. J. on Poverty L. & Pol'y 117 at 127-28, 180-84. There is an analogous debate in new governance scholarship about the degree of "hard-law" background measures needed (or assumed to exist) to safeguard participatory rights or address power disparities. On one end of the spectrum are those who believe that substantial participation and hard-law protections oriented towards equality are preconditions to the proper functioning of any deliberative model. On the other end are those concerned that hard-law principles are fundamentally inconsistent with the deliberative project, potentially meaningless, and not necessarily in the long-term inter-

International Swaps and Derivatives Association, Inc. online: ISDA <www.isda.org>. The United States Department of the Treasury recently presented a bill to Congress that would significantly augment private standardization initiatives. The Treasury's bill would allow bank regulators to establish margin and capital requirements for banks entering into derivatives contracts, require standardized OTC derivatives contracts to be cleared by a derivatives-clearing organization regulated by the CFTC or the SEC, and require banks to have their standardized contracts centrally cleared and traded over regulated exchanges. Dealers would no longer be able to directly trade standardized derivatives contracts among themselves. They would be required to use an exchange or equivalent trading platform. See Department of the Treasury, Press Release, TG-361, "Administration's Regulatory Reform Agenda Reaches New Milestone: Final Piece of Legislative Language Delivered to Capitol Hill" (11 August 2009), online: Department of the Treasury <http://www.ustreas.gov>.
We should be careful not to overstate the lesson here. The fact that systems with rigid, mandatory capital requirements performed better during the financial crisis does not mean that such capital requirements will necessarily be better than any more flexible alternative, or that we can generalize from capital requirements to other areas of financial regulation. We did not learn that rigid capital requirements are better than any mechanism we could possibly imagine. They may not even be better than the CSE Program might have been, had it been buttressed by adequate regulatory capacity. Rigid requirements impose costs, too. What we learned is that rigid capital requirements worked better than the flawed and basically unaccountable capital adequacy system that was in place under, for example, the SEC’s CSE Program.

It is helpful to see our current struggles with complexity as epistemological ones.149 Complexity is worrisome right now in part because, as was the case in the frozen credit markets in the autumn of 2008, we do not know what we do not know. In time, based on greater understanding, we may be able to develop a more sophisticated approach to complexity, with more and different safeguards in place, which does not seem to force us to choose so starkly between flexibility and systemic stability. In other words, existing bright-line capital requirements should be seen as prophylactic, not permanent, rules. Prophylactic rules are clear and generally overdrawn requirements, like the Miranda rights-reading requirement for police in the United States, which serve as placeholders to protect an important interest until and unless a better, more tailored method for achieving the same end can be implemented.150 A “better” approach to capital requirements would have to improve flexibility and congruence, but not at the expense of the transparency, accountability, and ease of ap-


150 The term derives from American constitutional law theory and is controversial in that context. Miranda v. Arizona held that certain warnings must be given before a suspect’s statement made during custodial interrogation could be admitted in evidence (384 U.S. 436, 86 S. Ct. 1602 (1966)). The decision invited legislative action to protect the constitutional right against coerced self-incrimination, but it stated that any legislative alternative must be “at least as effective in appraising accused persons of their right of silence and in assuring a continuous opportunity to exercise it” (ibid. at 467). The Miranda warning requirement was upheld in Dickerson v. United States, but its prophylactic nature was severely narrowed and the warning requirement was constitutionalized (530 U.S. 428, 120 S. Ct. 2326 (2000) [Dickerson]). For a new governance perspective on prophylactic rules, see Dorf, supra note 107 at 452-59.
plication that rigid requirements provide in this crucial aspect of financial markets regulation.\(^\text{151}\)

Prophylactic rules are helpful in keeping essential systems functioning and in conserving regulatory resources. However, under conditions of underlying factual uncertainty, rigid rules cannot resolve that uncertainty. Rigid rules will paper over uncertainty, forcing difficult interpretations underground—or alternatively forcing rule revisions through legislative processes that are far too cumbersome to be serviceable in “live”, fast-moving systems. Principles-based regulation is a more promising long term response to extreme complexity and consequent uncertainty, because it allows us to examine and discuss its effects explicitly, directly, and openly. New governance generally is about designing the problem-solving architecture required for handling situations of extreme uncertainty, in which neither the precise ultimate goal nor the means for achieving it can be determined in advance.\(^\text{152}\) This is the kind of environment in which it makes sense to enlist the context-specific knowledge of a broad band of stakeholders in a collective, comparative, learning-by-doing regulatory project, while not being naïve about the impact of self-interest and power.

To summarize this paper’s recommendations thus far: in order to be credible, principles-based regulation requires considerable regulatory capacity. It requires greater regulatory capacity in terms of numbers, resources, and expertise than has been allocated to it in some of the infamous examples of regulatory failure in the past two years—the failure of Northern Rock in the United Kingdom, and of the the SEC’s CSE Program. At the same time, one should be realistic about regulatory capacity when designing a regulatory regime. One should not design a system that is too complex for actual regulators to implement. Bright-line prophylactic rules, along with contract term standardization and other similar techniques, can help to conserve regulatory resources. Such rules around, for example, capital requirements will be useful in the near future as we continue to grapple with the implications of complexity in the financial markets. Over the long term, however, a credible, principles-based, collaborative structure will be more robust and effective.

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\(^{151}\) In Dickerson (supra note 151) arguments concerning costs and workability for law enforcement personnel were successfully made in support of upholding the Miranda (supra note 151) warning requirements, notwithstanding the “undeniable[e] instances in which the exclusionary rule of Miranda imposes costs on the truth-seeking function of a trial, by depriving the trier of fact of ‘what concededly is relevant evidence’” (Dickerson, supra note 151 at […]).

C. Building Independence and Diversity into the Regulatory Architecture

A principles-based approach also has repercussions for the deep structure of regulation. For many, the GFC represents a fundamental challenge to the efficient market hypothesis, and indeed to the very place of economic theory in developing public policy. This paper suggests that we consider, instead, recent learning about macro-level regulatory design. The task now (the completion of which is beyond the scope of this paper) is to identify the structural and dialogical components that are essential to ensuring that the principles-based regulatory architecture is robust and credible. Chief among those components are mechanisms to ensure parties’ accountability and to validate information.

Principles-based regulation replaces many tightly defined, statutorily entrenched, and hard-to-revise legislative requirements with an ongoing, information-based, pragmatic dialogue about good practices and regulatory goals. The shift itself is not determinative of choices between, for example, industry self-regulation or intensive supervision. Nevertheless, it has practical implications for those policy choices. Under principles-based regulation, many of the bulwarks of detailed statutory law are replaced by more easily revisable requirements. Recall the Table of Concordance between British Columbia’s existing and proposed Securities Acts, which serves as a clear illustration of the volume of detailed decision making that is moved out of the statute and into rule making under a principles-based approach. At its best, principles-based regulation therefore makes possible a more sophisticated, informed, collaborative, flexible, and transparent development of regulatory goals and means. At the same time, such a deliberative, iterative process increases the number of “moving parts”, and makes the act of law-making more porous to external social forces and trends. What must replace detailed statutory precommitments is serious attention to the capacities, predispositions, and situation of front-line decision makers, and to how the various participants in the interpretive community can be expected to function together.

One way to think about the GFC is as a product of the marginalization of overarching regulatory design considerations in favour of overbroad faith in market discipline. There were obvious gaps in shadow banking industry regulation. Great weight was placed on the shoulders of credit

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154 This is the case whether the replacement happens through explicit statutory drafting or through choices at the level of implementation. See discussion supra note 55.

155 See discussion in “Enforced Self-Regulation and Principles-Based Regulation” above.

156 Supra note 58.
rating agencies, without adequate thought to ensuring that those agencies were impartial and accountable. Regulators were not an effective counterweight against the banks in the Northern Rock and CSE Program examples. In retrospect, programs like the CSE are paradoxes: on one hand, regulators delegated risk assessment to firms explicitly because they did not and could not possess the knowledge those firms had about their own operational risks. Yet, the compensatory steps that might have reduced the knowledge gap and ensured more meaningful oversight—compliance audits, close supervision by adequate numbers of well-trained staff—were not taken. Whether because the regimes’ regulator-level architects accepted too unthinkingly the laissez-faire ethos of recent years, or because they had no choice given their lack of regulatory mandate from legislators (and these two are connected), regulatory programs like the SEC’s CSE Program lacked a commitment to a robust public role in either design or implementation.

Both the conflict of interest story and the overreliance on market discipline point to a troubling question that applies not only to the Northern Rock failure or the CSE Program, but also to much of the bond and securities markets. The question is: from which quarter, exactly, was the independent critical thinking supposed to come? Jack Coffee’s memorable insight that the “gatekeepers” were one of the weak links that led to the Enron debacle resonates again today, but it needs to be generalized. These are industries that are tightly enmeshed with their regulators and reputational intermediaries. Credit rating agencies were remunerated handsomely for giving good ratings to mortgage-backed securities. British regulatory and financial services communities are characterized by con-

157 See Lowenstein, supra note 72; Partnoy, supra note 72.

158 See FSA, Northern Rock, supra note 121; see also discussion, supra note 125. The internal audit into the conduct of the FSA, during its supervision of Northern Rock, identified a number of situations in which FSA staff failed to appropriately challenge and scrutinize information provided by Northern Rock. For example, the audit identified a number of instances in which supervisors failed to conduct a “comprehensive analysis of the risks inherent in the [Northern Rock] business model” (FSA, Northern Rock, supra 121 at 30). See also Turner, supra note 5 (discussing “intensive supervision” at 88-89).

159 See SEC Oversight, supra note 123; see also discussion supra note 126.

160 See Turner, supra note 5 (criticizing the FSA for adopting a “laissez-faire” mentality); Stephen Labaton notes that “[t]he commission’s decision effectively to outsource its oversight to the firms themselves fit squarely in the broader Washington culture of the last eight years under President Bush” (supra note 85).

161 SEC Oversight, supra note 123 at 81-82 (Chairman Cox’s Comments justifying the CSE Program on the basis that it was voluntary and the SEC did not otherwise have a mandate to regulate the CSE).

siderable social overlap. Much has been written about the positions of public power in the United States occupied by individuals formerly working in the private sector, and the potential adverse effects on public policy.164

In a provocative article in *The Atlantic* magazine, Simon Johnson has argued that one of the causes of the financial crisis in the United States was that the financial industry was dominated by oligarchs with ties to government.165 Drawing on his experience working with developing nations at the International Monetary Fund, Johnson predicted that the power of the oligarchs would also impede economic recovery because the necessary bold steps to regulate industry would not be taken. The author concludes that a destabilizing total collapse could be the “cleanse we need” and that piecemeal steps taken to avoid confrontation with the oligarchs would only prolong the pain. Without accepting that a “cleanse” is the necessary course, Johnson’s experience underscores how damaging the lack of an external, skeptical perspective can be when operating on an industry-wide (or even economies-wide) scale.

This paper does not argue that individuals with industry experience should be barred from assuming positions of responsibility overseeing those industries. The benefits of employing regulators with industry experience, in terms of expertise, perceived legitimacy with industry, and persuasive force, are irreplaceable. Nor does this paper focus on the possibility that industry-regulator ties will consistently compromise prosecutions and enforcement actions.166 Beyond these important arguments

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164 Alumni of the investment bank Goldman Sachs have occupied key government positions not only in the United States, but also at the Bank of Canada (Governor Mark Carney), and the World Bank (President Robert Zoellick). See Jenny Anderson & Landon Thomas, Jr., “Goldman Sachs Rakes In Profit in Credit Crisis” *The New York Times* (19 November 2007) A1. The Obama administration has not been immune from allegations that it was not aggressive enough in its reform of the financial industry as a result of overly close ties to that industry. See e.g. Heidi Przybyla, “Obama Embrace of Wall Street Insiders Points to Politic Reforms” (19 November 2008), online: Bloomberg [http://www.bloomberg.com]; Joe Hagan, “Tenacious G” New York Magazine (26 July 2009), online: New York Magazine [http://nymag.com].


about agency capture is a subtler worry about perspective. As Joseph E. Stiglitz has observed, "[i]f those who are supposed to regulate the financial markets approach the problem from financial markets' perspectives, they will not provide an adequate check and balance."167 Neither gatekeepers nor regulators will serve their function effectively if they are not firmly rooted in an independent source of authority and meaning, which is in active tension with their allegiances "within the circle" of those they oversee. Such anchors help them resist the pull of groupthink, cascades, and collective confusion that can take hold within a particular community—phenomena that are especially dangerous in principles-based regulation because of the degree of built-in fluidity.

An absence of diversity in perspective may also have implications for an industry's ability to self-regulate. Leaving aside regulatory failure, one may ask why investment banks themselves did such a poor job of quantifying and managing the risks they were running. In multiple and intricately connected ways, firm culture can affect the degree to which a firm is capable of acting independently in the face of competitive pressures and behavioral cascades. Goldman Sachs famously managed to avoid some of the worst excesses in mortgage-backed securities, arguably as a result of its culture of "contrary thinking" relative to the rest of its industry.168 Internal diversity may also influence a firm's stance toward risk-taking, as Michael Lewis's analysis of Icelandic banks and culture,169 as well as studies of the influence of gender in the financial services industry,170 suggest.


168 See Anderson, supra note 164; Przybyla, supra note 164. The latter article suggests that Goldman Sachs' behavior has been contrary to its competitors, but that its internal culture is actually conformist and homogeneous.


170 Linda McDowell, Capital Culture: Gender at Work in the City (Oxford: Blackwell, 1997); Paola Sapienza, Luigi Zingales & Dario Maestripieri, "Gender Differences in Financial Risk Aversion and Career Choices are Affected by Testosterone" (2009) 106 Proceedings of the National Academy of Science 15258.
Enforced self-regulation also stands the best chance of success when industry actors genuinely care about their broader reputations, something that requires commitments and allegiances beyond one’s own firm and industry.\textsuperscript{171} All of this should lead us to wonder whether institutions that draw on a broader range of perspectives may be better able to maintain some cognitive distance from group pathologies, to their own advantage, and to the advantage of an enforced self-regulatory approach.

This suggests a few specific reform recommendations. To begin with, careful thought needs to be given as to how the various pieces of a principles-based regulatory approach will function together; where each actor’s strengths and vulnerabilities lie, who is or is not participating in the interpretive community, and what is required to build checks and balances into the system’s functioning.\textsuperscript{172} Credit rating agencies are an obvious example. If they are to continue to fulfill a central role as reputational intermediaries, they obviously need to be more independent and better regulated than they recently have been. Regulators should also consider making hiring decisions based not only on applicants’ relevant industry and legal expertise, but also with a view to whether applicants seem to have sufficient confidence and independence of mind (however obtained) to keep them mindful of their distinct public role in the face of well-resourced and coordinated action from industry. Regulators in a principles-based or enforced self-regulatory regime should also watch for group-think and behavioral cascades within their industry, and they may want to give additional recognition or leeway to the views of industry outliers when a cascade appears to be developing.\textsuperscript{173} This may ultimately call for a richer description of the relationships between capital markets actors and the other crucial social, institutional, and historical milieus in which they are embedded—to understand which actors might “keep their heads” and how to ensure their participation to that end.

Finally, a diversity of perspectives is important to principles-based regulation at the macro level. Principles-based regulation will not function well if it is purely technocratic, closed, and expertise based. Technical

\textsuperscript{171} Balleisen & Eisner, supra note 103 at 131. Balleisen and Eisner describe the other prerequisites to effective co-regulation as: “the relevance of flexibility in regulatory detail”, “the existence of sufficient bureaucratic capacity and autonomy on the part of nongovernmental regulators”, “the degree of transparency in the regulatory process”, and “the seriousness of accountability.”


\textsuperscript{173} Regulators in a principles-based system can influence industry behavior in a variety of ways, such as public recognition of good practices or reduced regulatory oversight for firm-developed approaches that carry indicia of reliability.
expertise is not necessarily politically or socially neutral, and expertise-based models can shut down useful discussion. By contrast, principles-based regulation is a system whose evolution depends not on modelling, but on ongoing dialogue with stakeholders based on their real-life experience. Principles-based regulation is actually a different model from that based on technical expertise: it derives its legitimacy from its collaborative, dialogic experience, and it operates on the basis that pragmatic, learning-by-doing experience is a more reliable foundation than abstract theory for regulatory policy development. The quality of the decisions that emerge from its collaborative process, as well as the basic legitimacy of that process, require broad participation. It also matters whether the interpretive community that is engaged in filling in the details around a principles-level regulatory requirement is sufficiently inclusive and diverse. That community must have enough common ground that its constituent parts can speak to each other and a certain degree of trust can exist. At the same time, too much homogeneity limits the range of possibilities capable of being imagined. This calls for a regulatory architecture that specifically builds in opportunities for all key stakeholders to participate.

For Julia Black, principles-based regulation at its fullest is a polycentric process that pulls in a wide variety of stakeholders. For the Expert Panel as well, principles-based regulation needs to be supported by greater investor participation guarantees, in the form of an independent investor panel and dedicated investor issues groups. Broader stakeholder participation does not guarantee good regulatory outcomes, of course. The FSA’s Consumer and Practitioner Panels did not prevent the Northern Rock debacle. Stakeholder participation also introduces its

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176 Black, “Forms and Paradoxes”, supra note 46 at 23-24. In this article, Black particularly mentions trade associations and industry representatives, nominated advisers (NOMADs) on the London Stock Exchange’s junior market, the Alternative Investment Market (AIM), and consultants and advisors, including lawyers.


178 The FSMA requires the FSA to consult practitioners (i.e., registrants) and consumers, to establish a Practitioner Panel and a Consumer Panel, and to consider their representations. See FSMA, supra note 43, ss. 8-11.
own significant challenges. At the same time, one may ask what might have happened, had the secret “war games” that revealed the risks that Northern Rock posed to systemic stability been made public back in 2004.

Conclusion

The GFC contains cautionary lessons about the risks associated with principles-based regulation when it is not reinforced by a meaningful regulatory presence. However, the response cannot be a knee-jerk reversion to either a more rules-based or a more command-and-control approach. Principles-based regulation accompanied by input from industry was a direct response to a situation where regulators were underinformed, always playing catch-up, and made fools of not only by Enron-style corporations engaging in “loophole behaviour,” but also (to harken back to the negative image of 1970s bureaucracies) by their own rigid, seized-up processes. The costs of a system that is too rule-based are also considerable: it can stifle innovation, create loopholes and loophole-oriented behaviour, drive uncertainty “underground” and make problem-solving less explicit, and impose costs related to inflexibility. Principles-based regulation needs to be understood as a response to those very real problems.

Nor should we imagine that a return to older regulatory strategies would avoid future frauds. There is no hope of returning the genies of financial innovation and complexity to the bottle. Under conditions of such extreme uncertainty, ongoing reinterpretation of underlying principles is the only feasible option. Facially straightforward rules cannot make a complex situation simple. Detailed rules will be out of date by the time they are drafted. Principles are attractive because they can adapt to emerging events, and can adapt in a transparent and accountable way. By contrast, rules must evolve either through time-consuming statutory

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179 Poorly managed, participatory processes can degenerate into interest-group politics and unprincipled horse-trading, as well as reproducing existing power imbalances. Expertise and information can serve as an important counterweight to these urges. While success is not easy to achieve, an ever-growing body of scholarship and practice around deliberative decision making has helped to identify critical success factors and best practices. An internationally significant experiment in deliberative democracy took place in British Columbia in 2004, around electoral system redesign. See Mark E. Warren & Hilary Pearse, eds., Designing Deliberative Democracy: The British Columbian Citizens’ Assembly (Cambridge, U.K.: Cambridge University Press, 2008).

180 “Northern Rock Risk”, supra note 125. According to this article, FSA regulators concluded at the time that they could not force Northern Rock and HBOS to change their practices. Actively pulling in other stakeholders may also enhance existing regulatory capacity.
amendment, or through selective or non-enforcement that conceals the exercise of substantial regulatory discretion.

However, thought needs to be given as to how principles-based regulation perpetuates or even amplifies existing structural flaws in regulation. To be effective, principles-based regulation must call for increasing regulatory resources, develop a thoughtful response to complexity (including a place for prophylactic rules), and consciously incorporate a broader and more independent range of perspectives into the regulatory discussion. As Canada’s Expert Panel well appreciated, careful implementation and meaningful enforcement are everything in building a strong principles-based regulatory approach.\footnote{\textit{Capital Markets, supra} note 2 at 19-22.}
Can Corporate Monitorships Improve Corporate Compliance?

Cristie Ford* and David Hess**

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I. INTRODUCTION

The use of corporate monitorships as part of settlement agreements with the Department of Justice (DOJ) and Securities Exchange Commission (SEC) is now a common feature of corporate crime enforcement.\(^1\) These agencies have placed monitors in such well-known corporations as America Online, Bank of New York, Boeing, KPMG, and Monsanto. The monitor's role is to ensure that the corporation meets the terms of its settlement agreement, such as a deferred prosecution agreement (DPA),\(^2\) which typically requires that the corporation end its wrongful practices and develop and implement an improved compliance program to prevent future violations.\(^3\)

Some argue that settlement agreements with monitorships are a "stroke of genius," since the government can achieve all it wants out of a conviction (e.g., admission of guilt by the company and the implementation of reforms) without the

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2. For the purposes of this Article our reference to DPAs refers to both deferred prosecution agreements and no prosecution agreements.

3. Orland, supra note 1, at 72.
costs of a complete investigation and trial; critics abound. Some argue that the terms of these settlement agreements are too lenient and corporations should be criminally convicted for their actions. Others take the opposite view and argue that these agreements are too punitive and that monitors have the potential to run amok over corporations. Critics also claim conflicts of interest have led to the selection of monitors based on personal or political connections rather than competency. Members of Congress have noted these controversies and have taken action, including a hearing by the House Judiciary Committee and the proposal of two bills to regulate the use of monitors. In response, the DOJ attempted to stave off legislative interference by issuing new guidelines on the use of monitors.

Missing from this debate, however, is research into the critically important question of whether or not monitors actually achieve their intended goals. This Article takes a first step toward addressing that question and focuses on the basic issue of whether settlement agreements with corporate monitors actually work to improve corporate behavior going forward. That is, can monitorships be justified on the basis of improving a corporation's development and implementation of an effective compliance program? Also, if monitorships are falling short of these goals, are there reforms that can be implemented to improve their performance? Thus, the goal of this Article is to provide an initial exploration into how monitorships actually work in practice. To do


6. See O'Hare, supra note 1, at 90 (noting the possible consequences of a corporate monitor's interference with a company's operations).

7. See infra note 154 and accompanying text (noting the controversy resulting from the selection of former U.S. Attorney General John Ashcroft as a corporate monitor).


9. See infra note 155 (citing two proposed congressional bills).

10. See infra note text accompanying notes 156–58 (discussing the DOJ guidelines and monitor selection process).

11. Exceptions of academic research focused specifically on corporate monitors include O'Hare, supra note 1, and Vikramaditya Khanna & Timothy L. Dickinson, The Corporate Monitor: The New Corporate Czar, 105 MICH. L. REV. 1713 (2007). O'Hare, however, focuses on only one example—Richard Breeden's monitorship at WorldCom. See O'Hare, supra note 1. Khanna and Dickinson focus primarily on a theoretical analysis of when monitorships should be used instead of financial penalties and whether or not monitors should have duties to the corporation. See Khanna & Dickinson, supra. Other research has focused on the issue of whether the government is abusing its power in reaching settlement agreements (e.g., by requiring corporations to waive attorney-client privilege). See Earl J. Silbert & Demme Doufekias Ioannou, Under Pressure to Catch the Crooks: The Impact of Corporate Privilege Waivers on the Adversarial System, 43 AM. CRIM. L. REV. 1225 (2006) (arguing that a waiver "inappropriately endangers the adversarial process").
this, our analysis is based in significant part on our interviews with individuals directly involved in the monitorship process, including corporate monitors, regulators, and compliance consultants.\textsuperscript{12}

This Article proceeds by first providing a brief description of monitorships as currently used. Part II also provides a discussion of the use of similar monitor-type arrangements in other settings that have influenced the current use of monitorships. Part III then shows the evolution of corporate compliance programs over time, which have gone from a focus on technical compliance with specific issues to broader programs that are integrated into the corporation's culture and business operations. This is an important discussion, since monitorships are intended to ensure that corporations have implemented an effective compliance program. Part IV provides an analysis of monitorships in practice. Based on interviews with those involved in monitorships and on secondary data, we investigate the entire monitorship process including the scope of the monitor's duties under the agreement, the selection of the individual to serve as monitor, how the monitor conducts his work in practice, and finally, what occurs after the monitorship ends. In general, we find that the cumulative result of decisions made with respect to each of those issues during the process leads to monitorships that are significantly less ambitious than government pronouncements behind them, and are at risk of not achieving their goals on any consistent basis. Part V then provides recommendations for reforms to help ensure that monitorships are crafted to meet the challenges at hand in any specific case and to create a process to allow them to improve over time based on experience.

II. THE PAST AND PRESENT OF MONITORSHIPS

A. Current Use of Monitorships

The use of corporate monitorships as currently structured is relatively new. The DOJ has imposed at least 44 monitorships as part of settlement agreements with corporations, almost all of which date from 2003 or later\textsuperscript{13}—the post-Enron, post-Sarbanes Oxley Act era. The SEC has often participated with the DOJ in its monitorships,\textsuperscript{14} along with using them on their own.\textsuperscript{15} As discussed further below, the SEC has a longer history with monitorships that has evolved over time. Although

\textsuperscript{12} See infra Part IV (analyzing monitorships in practice).

\textsuperscript{13} Our count of the number of DOJ monitorships comes from the DOJ's letter to the House Committee on the Judiciary. The letter listed 41 monitorships, with all but three of those occurring in 2003 or later. Letter to John Conyers Jr., Chairman of the H. Comm. on the Judiciary, from Brian A. Benczowski, Principal Deputy Assistant Attorney General 5 (May 15, 2008) (copy on file with authors). The DOJ noted in the letter that this may not be a complete list. Id. at 2. Since the letter, and as of the time this Article was originally drafted, the DOJ has entered three additional monitorships. See infra note 175 and accompanying text (discussing the cases of AGA Medical, Faro Technologies, and Willbros).


different terminology is used to describe the monitorship; and there is variation in the
details of the monitor’s duties, they all have the same basic structure. This basic
structure is that the corporation is to retain at its own expense a monitor to oversee its
compliance with the settlement agreement and its implementation of required reforms,
such as an improved compliance program. Over a period usually between 18 and 36
months, the monitor will continue to review the corporation’s implementation of the
reforms and report back to the relevant government agents on the corporation’s
progress.

In the Parts that follow, we will provide more detail on the use of monitorships in
theory and in practice. This Part, however, provides a brief history of monitorships and
how they have evolved over time in their use in corporations and other organizations.
This history helps provide a lens through which to view the current use of
monitorships.

B. Forerunners to Corporate Monitorships

1. Mobs, Prisons, and Private Inspector Generals

Corporate monitorships have a direct history in public law litigation and in labor
union corruption cases brought under the Rackets Influenced and Corrupt
Organizations Act (RICO). Public law litigation refers to lawsuits filed against such
public institutions as schools, prisons, police and fire departments, and mental health
facilities, where the plaintiffs seek court involvement in restructuring the organizations
involved and monitoring of the implementation process. To monitor a consent
decree, the court appoints an independent third party to oversee the defendant’s
implementation efforts. The third party—such as a referee, monitor, or special
master—could be assigned different powers ranging from simply reporting back to the
court on the defendant’s performance to making adjudicative decisions. In certain
cases, such as with prisons, the court-appointed trustees have experience in other
prison trusteeships and can possibly work multiple trusteeships at the same time.

In addition to cases involving public institutions, monitors were imposed in DOJ
lawsuits against labor unions under RICO that were resolved with consent decrees. These
monitors served as trustees that were charged with attempting to reform unions that
were under the control of organized crime. The trusteeships varied considerably

16. In some cases the monitor is referred to as an “independent consultant” or “independent examiner,” for example.
17. See infra Part IV.A.3 (discussing the monitor’s role in corporate rehabilitation).
19. For a general review of public law litigation, see generally Charles F. Sabel & William H. Simon,
“the remedial process in public law litigation”).
Ill. L. Rev. 725, 732-35, 746-49 (distinguishing between the powers of a monitor and a special master).
22. Id. at 142.
23. Id. at 154-60.
in terms of how they operated and the powers granted to the trustees. In some cases, the trustees had powers equivalent to the union's officers, including the power to negotiate contracts and initiate strikes. In other cases, the trustees did not even have the power to remove corrupt union members. The duration of the trusteeship could be indefinite or for a fixed term as short as 18 months.

The trustees—who were almost always ex-prosecutors—had to develop reform strategies on their own, since they did not issue public reports and had very little, if any, contact with each other. Thus, trustees were largely unable to learn from the successes and failures of others. Overall, some of these cases were successful, but others were not. They were influential, however, as many of the monitors we interviewed believed that the idea for monitorships came from union trusteeships.

The Independent Private Sector Inspectors General (IPSIG) model is similar. These monitors got their start in the 1990s helping New York City ensure that companies contracting with the city were not engaging in fraud, overbilling, or other violations of law. The individuals were placed with contractors to oversee their billing practices, ensure the completion of work, and other practices. One offshoot of IPSIG is the International Association of Independent Private Sector Inspectors General (IAIPSIG), which seeks to promote the use, integrity, and professionalism of Independent Inspector Generals.

2. Corporations and Monitors

a. The Securities and Exchange Commission

The SEC has used court-ordered receiverships as part of its civil enforcement suits since at least the 1960s. The receiverships initially served as a traditional asset preservation role, ensuring that the assets of the corporation were not subject to misappropriation or waste by management. Over time, SEC receiverships evolved to serve the goal of ensuring the corporation would comply with securities laws in the future. Although receiverships were used for solvent, ongoing corporations, as

24. Id.
26. Id. at 428 n.49.
27. Id. at 426–27.
28. Id. at 424.
29. Id. at 433–34.
31. Id. at 452; see also JACOBS, supra note 21, at 242–45 (providing a list of the trusteeships and a review of whether or not each was successful).
35. Id. at 1787.
36. Id. at 1787–88; Comment, Equitable Remedies in SEC Enforcement Actions, 123 U. PA. L. REV.
opposed to receiverships in bankruptcy, the receiver was an officer of the court with duties to the "receivership estate." These duties made it difficult for the receiver to carry on the business in an entrepreneurial fashion. In addition, the presence of a receiver often gave the company a poor reputation among its various stakeholders. Both factors harmed the ongoing business of the company.

In cases where a receivership was viewed as unnecessary, but there were willful violations of securities laws, SEC settlement decrees included the appointment of independent directors (with or without a change in management), a "special counsel," or an "advisor." The appointment of independent directors was a way to have the benefits of a receivership, but limit the drawbacks associated with excessive negative publicity and receivers' obligations to act as officers of the court. Special counsel were typically attorneys given broad investigative and other powers. It was not uncommon for special counsel to be used simultaneously with court-appointed directors. The special counsel typically conducted an investigation and filed a report with the SEC and the court, but in some cases they had the power to bring suits on behalf of the shareholders based on their investigations. Advisors, on the other hand, had no power to act independently of the board and were often experts who only provided advice in specific areas (e.g., auditing). Corporations agreed to "special counsels" or advisors because it was a more attractive option than the alternative of a receivership. Associated with these agreements could be the requirement to adopt certain practices and internal controls designed to prevent the future recurrence of the securities violation at hand.

This approach was popular with the SEC prior to 1984, when the agency had very limited authority to impose civil penalties. Thus, the SEC relied on "remedial undertakings[,] such as procedural reforms and independent monitors, to enforce compliance with the securities laws."

1188, 1200 (1975) [hereinafter Equitable Remedies].
37. Equitable Remedies, supra note 36, at 1201–02.
38. id. at 1202.
39. Id. (noting the harm to investor and consumer confidence).
40. Id. at 1205. The court-appointed directors typically could not be voted out by the shareholders during a specified time period and would only be liable to the shareholders for gross negligence. Id. at 1206.
41. Farrand, supra note 34, at 1793–94.
42. Equitable Remedies, supra note 36, at 1206.
43. Farrand, supra note 34, at 1794.
44. Equitable Remedies, supra note 36, at 1208.
46. Equitable Remedies, supra note 36, at 1208–09.
47. Farrand, supra note 34, at 1794.
48. Id. at 1794–95; Mathews, supra note 45, at 1326. In other situations, the SEC would ask the court to appoint an independent director. Mathews, supra note 45, at 1326–28.
49. See Equitable Remedies, supra note 36, at 1196–99 (discussing past instances of SEC-mandated corporate policies).
approach to some degree.\textsuperscript{51} after 1984 monitorships received less attention until they enjoyed renewed popularity in the post-Enron era, in parallel with their adoption by the DOJ.\textsuperscript{52}

b. Department of Health and Human Services Office of Inspector General

Starting in the 1990s, the Department of Health and Human Services Office of Inspector General began using Corporate Integrity Agreements (CIAs) as a way to resolve claims related to False Claims Act investigations (e.g., overbilling the government’s Medicare program). What began as a loose copy of other self-disclosure programs (e.g., the Defense Industry Initiative)\textsuperscript{53} is now a formalized process with corporations agreeing to over 500 CIAs in the last few years.\textsuperscript{54} A CIA requires the corporation to implement improved internal controls and a compliance program, appoint a compliance officer, conduct employee training, and potentially fulfill other requirements as well.\textsuperscript{55} In addition, CIAs typically require an Independent Review Organization (IRO) to evaluate the compliance program. Companies compete for the IRO business. For example, PricewaterhouseCoopers claims to have served as an IRO for more than 50 companies.\textsuperscript{56}

c. Department of Justice

In addition to DPAs, corporate monitorships have been used as a term in a court-ordered probation after a criminal conviction or guilty plea. Although the idea of probation for organizations had existed for some time, the 1991 Organizational Sentencing Guidelines (the Guidelines) were the first governmental approval of probation for rehabilitation purposes (previously, probation was limited to ensuring corporations pay fines or restitution).\textsuperscript{57} Under the Guidelines, courts were required to


\textsuperscript{53} See infra notes 81–85 and accompanying text (describing the Defense Industry Initiative).


\textsuperscript{55} Corporate Integrity Agreements, supra note 54.

\textsuperscript{56} PWC ADVISORY PHARM. & LIFE SCIENCES INDUST. GROUP, HOW CAN PHARMACEUTICAL AND LIFE SCIENCES COMPANIES EFFECTIVELY MEET THE CHALLENGES OF NEGOTIATING AND IMPLEMENTING A CORPORATE INTEGRITY AGREEMENT (2008).

\textsuperscript{57} William S. Lofquist, Organisational Probation and the U.S. Sentencing Commission, 525 ANNALS
order probation if the organization had more than 50 employees and did not have an effective compliance program in place. As part of a probation order, courts were allowed to require corporations to report on the implementation of the program, and to have a special probation officer monitor compliance based on a records review or employee interviews. After the 2004 amendments, the Guidelines state that even if a corporation has a compliance program, a court “shall” order a term of probation “if such sentence is necessary to ensure that changes are made within the organization to reduce the likelihood of future criminal conduct....”

Commentators’ early criticisms and endorsements of corporate probation mirror the current debate about corporate monitorships. Critics questioned the ability of judges to effectively implement and monitor the requirements in a probation order. With respect to an early draft of the original sentencing guidelines, one commentator suggested that Senate confirmation hearings on federal judges must now assess those judges’ abilities to run major corporations, since that was what the guidelines would now require. Gruner, for example, argued instead for a probation system under which a corporation proposed a compliance program to the court, which upon approval became part of the probation terms, to be monitored by some form of probation officer. Gruner argued that this approach had several advantages, including shifting the burden to corporations, the ability to tailor the program to the corporation’s specific needs, greater legitimacy of the program within the corporation because it was internally developed and not externally imposed, encouraging innovation in compliance programs due to involvement of corporation personnel, and general buy-in by executives. Gruner’s arguments can easily be used to support the current use of corporate monitorships.

AM. ACAD. POL. & SOC. SCI. 157, 161 (1993) [hereinafter Lofquist, Organisational Probation] (describing the work of the U.S. Sentencing Commission); see also William S. Lofquist, Legislating Organisational Probation: State Capacity, Business Power, and Corporate Crime Control, 27 LAW & SOC’Y REV. 741, 749 (1993) (noting that the legislative history behind the Sentencing Reform Act of 1984—which provided for corporate probation—indicated that Congress rejected probation terms that were invasive and only approved noninvasive terms (e.g., fine collection and community service)).


59. Lofquist, Organisational Probation, supra note 57, at 162.

60. U.S. SENTENCING GUIDELINES MANUAL § 8D1.1(a)(5) (2004). In addition, the company may be required to develop an effective compliance and ethics program. Id. § 8D1.4(c)(1). The commentary states: “To assess the efficacy of a compliance and ethics program submitted by the organization, the court may employ appropriate experts who shall be afforded access to all material possessed by the organization that is necessary for a comprehensive assessment of the proposed program.” Id. § 8D1.4 cmt. 1. If the organization repeatedly violates the terms of probation, the Sentencing Guidelines specifically grant the court power to appoint a special master or trustee to ensure compliance with the court orders. Id. § 8B1.1 cmt. 1.

61. Richard Gruner, To Let the Punishment Fit the Organisation: Sanctioning Corporate Offenders Through Corporate Probation, 16 AM. J. CRIM. L. 1, 73–74 (1988) (questioning courts’ institutional competence to carry out such orders and comparing it to their ability, or lack thereof, to affect change in public bureaucracies).


64. Id. at 84.
One example of a probation order that employed a monitor involved Consolidated Edison (Con Ed). In 1994, Con Ed pled guilty to environmental law violations related to the failure to disclose a potential asbestos leak to the public, and the judge sentenced the company to the maximum fine and three years' probation with a corporate monitor. In sentencing the corporation, the judge specifically stated that Con Ed had a culture that discouraged reporting bad news, and that culture intimidated people who otherwise would have reported the presence of asbestos from making such a report. The monitor was charged with ensuring that Con Ed was adopting and implementing an effective compliance program. An initial report by the monitor stated that several months into the monitorship, Con Ed continued to use intimidation to prevent employees from reporting violations. The monitor also stated that even if the corporation sincerely attempted to implement its new proposed control system, it would have no effect unless the corporation also worked to reform its "insular" and "destructive" corporate culture. At the end of the three-year probation, however, the judge stated that Con Ed had made significant improvements in implementing a compliance program and the company credited the change to the guidance of the monitor. The monitor, however, had expressed some reservations just a few months before the probation ended, stating in a report that "[m]angers a rang or two below the officer level have expressed a fear of speaking up. Many employees said their fears will intensify once the probation ends." He turned out to be correct since, just a few months after the monitorship ended, the company again failed to notify the public in a timely manner of potential harm due to toxic chemicals, and was later placed under


66. Id. The judge stated:

One of the things I found disturbing here was the sense that there were people at Con Edison, who testified at the trial, who clearly knew and who should have been jumping up and down saying, there is asbestos here, we know it. It was obvious they didn't say it because they were intimidated from saying it, because they didn't think that was the corporate culture ... I do think there was a sense here, at certain levels within this company, that you had better not tell the bad news.

Id.

67. Id.


69. Id.


72. Kevin Flynn, Con Ed to Pay $2 Million to Recovers Exposed to PCBs at Fire, N.Y. TIMES, Nov. 20, 1999, at B2 (stating that the company agreed to pay approximately $2 million to firefighters and emergency workers exposed to toxic chemicals at the company's plant and reporting official claims that the company's delay in reporting the chemicals caused exposure to more people); David M. Herszenhorn, Con Edison Taken to Task Over PCBs, N.Y. TIMES, Sept. 20, 1998, at 45 (noting that the company delayed for over a week in notifying the fire department of possible exposure to toxic chemicals at a fire in one of its buildings).
the supervision of another monitor.  

III. HISTORY AND EVOLUTION OF CORPORATE ETHICS AND COMPLIANCE PROGRAMS

This brief historical overview suggests that, ultimately, monitorships are attempts to ensure that the organization has policies and procedures in place that will help prevent future misconduct. For corporations, those policies and procedures make up the organization’s ethics and compliance programs. The formalization of compliance programs and the development of compliance professionals evolved over a period of several decades, and today’s programs are characterized by an integrated and multi-factor approach to corporate compliance. This evolution is important because, as discussed in Parts IV and V below, corporate monitorships often seem to be operating on an older view of compliance—one that is focused on technical compliance as opposed to a more holistic, organizational culture-based approach.

A. A Brief History of Compliance Programs: From Controls to Corporate Culture

An early influence in the development and adoption of compliance programs were the antitrust criminal prosecutions in the heavy electrical equipment industry in the 1960s. During one prosecution, General Electric attempted to use its compliance program as a defense against the criminal charges. Although General Electric was unsuccessful, that attempt spurred widespread adoption of antitrust compliance programs. Eventually, regulators indicated they would take adoption of such programs into account when attempting to determine if a violation was “inadvertent” as opposed to intentional.

A second major catalyst for the development and adoption of compliance programs was the Foreign Corrupt Practices Act of 1977 (FCPA). In addition to prohibiting corporations from making corrupt payments to government officials, the FCPA requires corporations to implement accounting practices and internal controls that are designed to ensure that the company is not making corrupt payments. This spurred widespread adoption of codes of conduct and compliance programs by multinational corporations.

Third, in the 1980s, due to concerns about corruption in the defense industry, and based on the recommendations of a commission appointed by the President, the

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75. Id. at 1580–81.
76. Id. at 1581–82.
77. Id. at 1582.
79. Id. at 579–81.
80. Pitt & Groskaufmanis, supra note 74, at 1585–86.
81. Also in the 1980s, Congress passed the Insider Trading and Securities Fraud Enforcement Act of 1988, which required broker-dealers and investment advisors to adopt policies and procedures to prevent the misuse of material, nonpublic information. Id. at 1590–91.
Defense Industry Initiative (DII) was created.\(^82\) The DII was an attempt at self-regulation that encouraged defense contractors to adopt a code of ethics, to provide training on the code to all employees, and to create a "free and open atmosphere" within the organization for employees to report instances of fraud.\(^83\) Participation in the DII was voluntary, but the Department of Defense encouraged participation by indicating that it would consider a corporation's compliance program as a mitigating factor in any debarment decisions.\(^84\) To receive preferential treatment, corporations were expected to self-disclose the violation and cooperate with the Department of Defense in its investigation.\(^85\)

Finally, the most important influence occurred in 1991 when the United States Sentencing Commission followed the lead of the DII and amended the Federal Sentencing Guidelines to provide a mitigated sentence for corporations convicted of a crime if they were able to demonstrate that they had attempted to prevent the misconduct by having an "effective" compliance program in place.\(^86\) The Organizational Sentencing Guidelines established seven basic requirements for an effective program, including the adoption of standards and procedures to prevent criminal conduct, appropriate oversight of the program by high-level personnel, communication of the requirements to all employees, and monitoring and updating the program as needed.\(^87\)

The Guidelines pushed compliance programs out of the defense industry, beyond limited issues such as antitrust and the FCPA, and into the mainstream.\(^88\) This spurred the significantly increased use of Ethics and Compliance Officers, industry associations to support the work of compliance professionals, and education programs put on by such groups as the Practising Law Institute.\(^89\) The adoption of compliance programs consistent with the Guidelines continued to grow when in 1996, in the case of In re Caremark International Inc. Derivative Litigation, the Delaware Court of Chancery indicated that directors' fiduciary duties may require the board to take advantage of the potential for a mitigated sentence under the Guidelines by adopting a compliance program.\(^90\) Further incentives to adopt and improve compliance programs came in

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83. Kurland, supra note 82, at 138.

84. Pitt & Groskaufmanis, supra note 74, at 1595.


87. Id. at 703-04.


90. In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 961 (Del. Ch. 1996). The holding in Caremark was supported by the Delaware Supreme Court in Stone v. Ritter, 911 A.2d 362 (Del. 2006). For a
1999, when the DOJ officially stated that it would take into account the adequacy of a corporation’s compliance program when deciding whether to prosecute a corporation, as opposed to just prosecuting any individuals involved in the criminal activity.

Likewise, in 2001, the SEC issued what is commonly known as the Seaboard Report. The Seaboard Report indicated that it would be more lenient in its enforcement response for corporations that had effective compliance programs in place and cooperated with the SEC in its investigation.

During this time, academics and industry professionals worked at developing a better understanding of what makes a compliance program effective. One of the most influential insights was Harvard Business School Professor Lynn Sharp Paine’s distinction between compliance-based programs and integrity-based programs. Both

91 See Murphy, supra note 86, at 712 (noting that the Deputy Attorney General listed the existence and adequacy of a compliance program as a factor for prosecutors to consider when deciding whether to charge a corporation). This policy was found in the Memorandum from Eric H. Holder, Jr., Deputy Attorney Gen., U.S. Dep’t of Justice, to All Component Heads and U.S. Attorneys (June 16, 1999) [hereinafter Holder Memo], available at http://www.usdoj.gov/criminal/fraud/docs/reports/1999/chargingcorps.html. The Holder Memo was updated by Memorandum from Larry D. Thompson, Deputy Attorney Gen., U.S. Dep’t of Justice, to All Component Heads and U.S. Attorneys (Jan. 20, 2003) [hereinafter the Thompson Memo], available at http://www.usdoj.gov/opa/pr/2003/August/08-0008.html, and then by Memorandum from Paul J. McNulty, Deputy Attorney Gen., U.S. Dep’t of Justice, to All Component Heads and U.S. Attorneys (Dec. 12, 2006) [hereinafter McNulty Memo], available at http://www.usdoj.gov/opa/pr/2008/August/08-0875.html.

The major revisions relate mostly to changes in the consideration of waiver of attorney-client privilege, but also provide that “that prosecutors may not consider whether a corporation has sanctioned or retained culpable employees in evaluating whether to assign cooperation credit to the corporation.” Id. For purposes of this paper, we retain our original language of referring to these charging guidelines as the McNulty Memo, as the DOJ monitors we discuss in this paper almost all occurred under the Thompson or McNulty Memos.


Most recently, as of December 2007, companies that have contracts with the federal government that are over $5 million in value and have a duration of over 120 days are required to have a code of ethics and a compliance program. Sheri Qualters, Contractor Crackdown Gess Tougher, N.Y. L.J., Apr. 28, 2008, at 8.

93 Lynn Sharp Paine, Managing for Organizational Integrity, HARV. BUS. REV., Mar.–Apr. 1994, at 106, 110–11 (noting that compliance is “rooted in avoiding legal sanctions” but integrity is based on self-governance according to “guiding principles”).
applied to compliance programs, but Paine referred to a compliance-based approach as focusing primarily on deterrence through punishment for rule violations, while an integrity-based program focused on developing appropriate organizational values and empowering employees to act upon those values.94 Empirical studies show that the most effective compliance programs have elements of each approach, but that the integrity-based aspects must dominate.95

Implementing an integrity-based program requires understanding the organization's culture.96 The importance of managing an organization's culture to ensure the effectiveness of a compliance program gained significant traction when the Sentencing Commission formalized it as part of the Organizational Sentencing Guidelines in 2004. The amended Guidelines refer to a corporation's "compliance and ethics program" and describe an effective program as one designed to "prevent and detect criminal conduct" and to "promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law."97

B. The Development of Compliance Professionals

The increased importance of compliance programs has led to the development of compliance professionals. This development is supported by several nonprofit organizations and networks devoted to compliance professionals.98 The Society of Corporate Compliance and Ethics has recently started offering a one-day exam (and associated training programs) that allow an individual to become a certified compliance and ethics professional.99 Some universities are also starting to offer certificate programs in compliance.100

Despite the development of a compliance profession, there remains wide variation

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94. Id. For an overview and discussion of empirical studies showing the greater effectiveness of integrity-based approaches, see David Hess, A Business Ethics Perspective on Sarbanes-Oxley and the Organizational Sentencing Guidelines, 105 Mich. L. Rev. 1781, 1791–94 (2007) (stating that "whereas a compliance-based program focuses on teaching employees the laws and rules they must comply with, an integrity-based program focuses on integrating ethics into employees' decision making and inspiring them to live up to the company's ethical ideals").

95. Hess, supra note 94, at 1792–94 (citing one study showing that integrity-based programs are more effective, and another finding that, when using both elements, the compliance aspect should not be overemphasized).

96. See id. at 1792 (noting that the program "focuses on integrating ethics into employees' decision-making and inspiring them to live up to the company's ethical ideals"); Paine, supra note 93, at 112 (listing company culture as a factor to consider).


99. See Society of Corporate Compliance and Ethics, supra note 98.

in corporations' general approach to their compliance programs. For example, there is no uniformity when it comes to whom the organization selects to be in charge of the compliance program. A recent survey found that the person with responsibility for the compliance program had the word "compliance" in their title (e.g., chief compliance officer) in only 40% of the companies that responded.\textsuperscript{101} Other corporate executives in charge of their companies' compliance programs include someone in the general counsel's office, the controller, or a vice president of internal audit.\textsuperscript{102} Accordingly, the background of the person in charge of the compliance program can also vary. A 2000 survey found that only 29% of compliance officers in the United States had a law degree.\textsuperscript{103} This reflects the evolution of the role, which seems to be moving away from being viewed as a field for simply "legal technicians."\textsuperscript{104} The approach to managing a compliance program can vary significantly between chief ethics and compliance officers (CECOs) who are lawyers by training and CECOs who come from a management background. For example, one survey found that legally trained CECOs believed that the most important root causes of misconduct were employee ignorance of legal requirements and corporate policies.\textsuperscript{105} CECOs from a management background, however, listed the most important causes as factors related to a corporation's culture, such as lack of leadership on ethics and management pressure to meet goals and performance expectations.\textsuperscript{106}

The individuals in charge of compliance programs typically report directly to the CEO or general counsel, but a smaller percentage report to the chief financial officer or the audit committee of the board of directors.\textsuperscript{107} Even though the individual in charge of the compliance program does not report directly to the board, under the Guidelines they should have access to the board if needed,\textsuperscript{108} and it appears that most do.\textsuperscript{109}

\textsuperscript{101} Melissa Klein Aguilar, \textit{CW Survey Shows Lack of CCO Standards}, \textit{Compliance Wk.}, June 2008, at 18-19. Larger companies are more likely to have a chief compliance officer. This survey was an online survey of the readership of \textit{Compliance Week} conducted during March 2008 with 284 usable respondents. The respondents were from corporations of a wide range of sizes and industries. The raw data is on file with the authors.

\textsuperscript{102} Id.


\textsuperscript{104} Caron Carlson, \textit{The Evolution of the Modern CCO}, \textit{Compliance Wk.}, Mar. 2008, at 1, 40 (quoting the comments of Scott Mitchell, the CEO of a nonprofit organization for compliance professionals).


\textsuperscript{106} Id.

\textsuperscript{107} Aguilar, supra note 101, at 19. The \textit{Compliance Week} survey found that 35% report to the CEO, 21% to the general counsel, and 13% to the board (or more likely, the audit committee of the board). Id. A 2007 survey by the Ethics and Compliance Officers Association found that 32% report to the CEO, 41% to the general counsel, and 7% to the board. Id. at 18. A third study, conducted by the Conference Board in 2005 with 225 respondents, found similar results, with 31% of executives in charge of compliance reporting to the CEO, and 37% to the general counsel. Ronald E. Berendelheim, \textit{Conference Board Research Report: Universal Conduct: An Ethics and Compliance Benchmarking Survey 10–11} (2006).


\textsuperscript{109} Berendelheim, supra note 107, at 11 (finding that for publicly traded U.S. corporations only five percent of executives in charge of compliance had no contact with the board, and that 46% communicate with the board in some manner on a quarterly basis).
Some, however, argue that this is not sufficient and that the board should have direct control over the compliance officer (e.g., hiring, compensating, terminating). These commentators argue that this control is necessary because ethics and compliance officers "do not have sufficient power, status [or] authority" to do their jobs appropriately, which is further harmed by an inherent conflict of interest resulting from the compliance officer being accountable only to top management. For example, one former chief compliance officer stated, "[a]s a chief compliance officer, the stances you have to take are sometimes in opposition to the direction the company may otherwise be inclined to go. That requires lots of intestinal fortitude." Others in the field claim that compliance officers have been forced out of their jobs when they refused orders from top management to stop an investigation, for example. Complaints that compliance officers face pressures to not start an investigation or to close it before completion appear to be fairly common.

C. Summary of Monitorships and Compliance Programs

Over the last few decades there has been tremendous growth in the importance of corporate compliance and ethics programs in criminal and civil liability. Although compliance programs started out focused on specific issues, best practices now suggest that a single program should encompass the near entirety of a firm's efforts at compliance with laws and regulations. This development has not been without controversy, however. Critics argue that corporations use compliance programs as "window dressing" to create merely the appearance of a commitment to compliance,

110. See W. Michael Hoffman & Mark Rowe, The Ethics Officer as Agent of the Board: Leveraging Ethical Governance Capability in the Post-Enron Corporation, 112 BUS. & SOC. REV. 553 (2007) (arguing that the ethics officer should be an agent of the board of directors); W. Michael Hoffman et al., An Investigation of Ethics Officer Independence, 78 J. BUS. ETHICS 87 (2008) (arguing ethics officers should be allowed greater independence from company management and instead report directly to the board of directors); see also Scott A. Roney et al., Leading Corporate Integrity: Defining the Role of the Chief Ethics and Compliance Officer (CECO) 20–21, 36 (2007), available at http://www.ethics.org/ceco (registration required) (stating that it is appropriate to have the CECO report to either the Board of Directors or the CEO, but that the Board should have authority over hiring and firing decisions).

111. Hoffman & Rowe, supra note 110, at 560.

112. Id. at 556–57.

113. Carlson, supra note 104, at 1, 40.

114. Id. at 41.

115. In a published interview, a well-known compliance consultant stated, "U[u]nfortunately and sadly, I'm aware of a number of cases where compliance officers seek to become the diligent, independent professionals they are supposed to be to protect the company from misconduct, and are told by senior management to cool it." Interview with Win Swenson, Partner, Integrity Interactive Corp., CORP. CRIME REP., Jan. 9, 2006, at 13.

Evidence from surveys is beginning to support this anecdotal evidence. One survey of compliance and ethics officers—with 127 respondents—found that 33% of Compliance and Ethics Officers had received pressure from corporate officers to not investigate alleged misconduct, and over half (51%) had received such pressure from other managers. Edwards & Reid, supra note 105, at 9. One in ten CECOs reported that they received such pressure from other managers frequently. Id. These compliance ethics officers also felt that their quality of investigations into wrongdoing suffered due to a general pressure to achieve the objective of closing cases quickly. Id. at 7–8.

which may still provide the corporation the benefits of a mitigated sentence if the need arises.\textsuperscript{117} These are "paper programs," where corporations adopt policies and procedures on paper but do not embed them into their actual operations.\textsuperscript{118} In response, and in recognition of the value of an integrity-based approach,\textsuperscript{119} current thinking expects compliance programs to consider an organization's culture as well, and enforcement agents look for evidence of a "compliance attitude" in corporations.\textsuperscript{120}

During the same time period, monitorships appeared in a variety of corporate and noncorporate settings. The overarching goal of a monitorship is to ensure that the organization in question has been "reformed," so that it would exhibit better legal compliance in the future. Thus, whether the monitor takes significant control over the organization or simply audits the changes management made, the goal is to improve the compliance program (using the term broadly) of the organization. As fully described in the next Part, monitorships in practice do not seem to be keeping up with the evolution of the compliance profession. This is in large part explained by the background of the monitors selected. Perhaps drawing from the experience of trustees in the union RICO suits, monitors are primarily former prosecutors and attorneys with similar training, who may not have the right skills and approach for the task at hand.\textsuperscript{121} Exacerbating the problem are additional factors, which were also behind the inconsistent success rate of trustees in union RICO suits,\textsuperscript{122} such as lack of information sharing between monitors and the failure of the government to conduct systematic performance evaluations for the purpose of improving future monitorships.\textsuperscript{123} The SEC, which started on a different monitorship trajectory, now appears to be developing practices consistent with the DOJ, and in fact often conducts joint monitorships with the DOJ. The next Part the DOJ and SEC monitorships' current path. Following this path was not necessarily a conscious choice, but a result of various decisions along the way that create a significant gap between the potential of monitorships in theory and monitorships in practice.

IV. UNDERSTANDING CORPORATE MONITORSHIPS

Breaking monitorships down into a process involving a series of discrete decision stages helps us to think about how they function in practice. The first stage in the


\textsuperscript{118} Interview with Win Swenson, Partner, Compliance Systems Legal Group, Warwick, Rhode Island, CORP. CRIME REP., Apr. 26, 2004, at 10, 16 [hereinafter Win Swenson Interview I].

\textsuperscript{119} See supra note 94 and accompanying text (describing an integrity-based approach).

\textsuperscript{120} Raishkover, supra note 92, at 539.

\textsuperscript{121} See infra Part IV.B.2 (noting that the personal qualities of monitors ultimately determines the success of the monitorship).

\textsuperscript{122} JACOBS, supra note 21, at 246–47.

\textsuperscript{123} See infra Part IV.D.
process is negotiating the terms of the monitorship, which also includes the decision by the government to agree to a settlement. During this process, the parties determine whether or not a monitor is required and, if so, the duties and powers of the monitor. Second, the parties select the monitor through the process defined in the agreement. Third, the monitor begins his work, including developing a work plan, analyzing the needs of the organization, overseeing the implementation of a compliance program, and evaluating the effectiveness of that program. Finally, the monitorship comes to an end with a determination by the monitor and the government that the company has satisfactorily completed the terms of the agreement.

Decisions by the parties at each stage in this process have a significant impact on the subsequent stages and ultimately determine whether or not the monitorship is successful in terms of improving corporate compliance and preventing future violations of law. In order to better see these relationships, this Part presents our analysis of the interview data through the stages of this process. This analysis is based principally on interviews with individuals directly involved in the monitorship process. To collect our primary data, we conducted 20 telephone interviews in the summer of 2008. Almost half of our interviews were with individuals who have served as corporate monitors for the DOJ and/or the SEC. The rest of the interviews were with monitors in some of the noncorporate contexts described above, compliance consultants, and regulators in both the United States and Canada. We spoke with interviewees not only about their direct experience, but also their broader views on monitorships, and those broader views are also reflected here. Our secondary data includes public statements made by monitors, compliance officers at companies that underwent a monitorship, public officials, and attorneys involved in the negotiation of settlement agreements. Our analysis also includes a review of the settlement agreements and the few cases in which monitorship reports were made publicly available.

Our study is limited by the fact that we were only able to speak to a subset of monitors and regulators, and not to any corporate officials directly involved in a monitorship. Although these monitors and regulators described a range of different experiences in many ways, our findings could still be unrepresentative if those choosing to participate in our study had significantly different experiences from those that chose not to participate. We have also put aside some important differences between the civil and criminal contexts in order to keep the scope of this paper focused on monitorships as a whole. While this limits the specificity of our findings, it allows

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124. These public statements include articles these individuals have written, their public presentations at conferences and in "webinars," and interviews with them conducted by others that were published.

125. As discussed below, monitor reports are typically not made public. Multiple Freedom of Information Act requests, to the SEC in 2006 and 2008, to obtain copies of monitorship reports and other relevant documents were declined, generally on the basis that disclosure would interfere with ongoing enforcement activities.

126. Our sample was selected by contacting all individuals who have served as monitors of whom we were aware, as well as corporations involved in monitorships, representatives of nonprofit organizations dedicated to corporate compliance, and representatives of several United States and Canadian civil and criminal regulators. In addition, although we were able to interview a number of regulators, officials from certain key government bodies were unwilling to contribute to our study. Our observations about the policies and motivations of these specific organizations had to be drawn from publicly available policy documents and interviews with external individuals.
us to focus on significant and otherwise underappreciated commonalities between these models. Even with these limitations, however, we believe our insights and points of caution are instructive for the use of corporate monitorships in all situations. These findings point to potential problems that should be examined by any government agency that uses monitorships, and should be further investigated and tested by future researchers.

A. Negotiating the Terms of the Settlement Agreement

The settlement agreement establishes the terms of the monitorship. The monitors we interviewed all placed great importance on conducting their monitorships within the bounds of the agreement. Thus, clearly defining the goals of the monitorship and establishing the duties of the monitor are highly important for ensuring that the monitorship is successful and that success can ultimately be determined by some objective standard. Although flexibility in the implementation of monitorships is one of their virtues as a policy tool, there is a difference between flexibility—which can be carefully designed—and vagueness, which is a failure to specify key components or terms. If the terms of the monitorship are too vague, different monitors may interpret similar terms quite differently based on their background and approach to monitorships. In this section, we first look at the foundational issue of why the government might enter into settlement agreements. The policy goals behind that decision should be reflected in the stated goals of the monitorship agreement. In this section we also discuss the factors that go into decisions about the duties and independence of the monitor.

1. Settle or Prosecute? Policy Debates Behind Settlement Agreements

In the criminal context, the first decision a prosecutor must make is whether to indict the corporation, agree to a settlement (with or without a monitor), or prosecute only individuals and not seek punishment for the corporation. Of course, there will be times when imposing sanctions on genuinely “bad apple” individuals is all that is needed. The SEC’s Framework for Cooperation and the McNulty Memo factors also suggest that there may be times when a corporation’s cooperation is so complete that no enforcement action needs to be taken, even where a violation existed. The recent increase in the use of settlement agreements has not been without controversy, and also has reinvigorated the familiar debate about whether a corporation should be held criminally liable for the actions of its employees in any circumstance.

This paper’s specific concern is whether, assuming that some action against a

127. McNulty Memo, supra note 91.

128. For those using the rise of settlement agreements to argue against broad corporate criminal liability standards, see, e.g., John S. Baker Jr., Reforming Corporations Through Threats of Federal Prosecution, 89 CORNELL L. REV. 310, 337 (2004) (stating that vastly increasing the number of federal crimes does not address corporate reform); Preet Bharara, Corporations Cry Uncle and Their Employees Cry Foul: Rethinking Prosecutorial Pressure on Corporate Defendants, 44 AM. CRIM. L. REV. 53, 56 (2007) (citing the potential for government excess in prosecution of corporate entities); Richard A. Epstein, The Deferred Prosecution Racket, WALL ST. J., Nov. 28, 2006, at A14 (arguing that the Deferred Prosecution Agreements do not serve the public interest).
corporation is called for, settlement agreements with monitorships provide sufficient benefits to justify their use. As stated earlier, some view these settlement agreements as a "stroke of genius," as the "government is able to get everything out of a deferred prosecution agreement that it can get out of an actual trial."129 The government can save the costs of an investigation and trial by having the corporation admit wrongdoing (for DOJ settlements, but usually not for SEC settlements). In addition, the corporation agrees to terms that are equivalent to corporate probation.130 While some celebrate this trend, some of our interviewees worried about the "swords of Damocles" that hang over the corporation's head in the criminal context, even when the company enters into a DPA. On the other side of the debate, some argue that these settlements are letting corporations escape accountability131 and perhaps even encouraging corporations to engage in riskier behavior and push the limits of the law.132

Not all cases are appropriate for settlement agreements with monitorships.133 One civil-side regulator interviewee told us that only a small portion of the enforcement cases it pursues every year result in monitorships. Trying to determine the cases that are appropriate is the challenge faced by prosecutors and other government regulators. On the criminal side, the McNulty Memo provides guidance on the factors prosecutors should consider when conducting an investigation and deciding whether to charge a corporation.134 With respect to nonprosecution agreements, the Memo only specifically mentions the factor of voluntary cooperation.135 However, the factors related to the prosecution decision clearly impact the settlement decision as well. On that front, the Memo identifies key factors such as "the pervasiveness of the wrongdoing" and the "corporation's history of similar conduct."136 The Memo does not tell the prosecutor how to weigh those different factors against each other, though it does state that in some cases one factor, such as the nature and seriousness of the offense, may "warrant prosecution regardless of the other factors."137

For some of the regulators we interviewed, the presence of these factors related to widespread wrongdoing within the organization were what made a case appropriate for a monitorship. For example, one regulator stated that monitorships were most appropriate where:

[An organization] has engaged in violative conduct. That violative conduct has not been corrected, or we don't have enough assurance that it's been corrected, so the conduct or the problem might be ongoing. . . . The source of

129. Interview with Jan Handzik, supra note 4, at 12–13.
130. Id.
131. Crime Without Conviction, supra note 5, at 3–10 (referring to DPAs as resulting in "crime without conviction").
133. In this section, we consider settlement agreements with and without monitorships together. Below, we consider the issue of whether or not a monitor is needed as part of a settlement agreement.
134. McNulty Memo, supra note 91, at 4 (stating that the factors listed in the memo should be used by prosecutors when "conducting an investigation, determining whether to bring charges, and negotiating plea agreements").
135. Id. at 7–8.
136. Id. at 4.
137. Id. at 5. In addition, the Memo cautions that the nine factors it lists are "not a complete or exhaustive list." Id.
the problem is at the firm level, it’s not just an isolated bad apple.\textsuperscript{138}

Thus, although many monitorships involve cases of intentional wrongdoing for which individuals, including senior corporate officers, are often sanctioned, it is important to recognize that individual wrongdoing is often difficult to separate from organizational wrongdoing. Likewise, it is difficult to conceive of many situations that call for a monitorship, but for no individual responsibility. At some point, however, the organization must be deemed too rotten to be entitled to a DPA monitorship and must face prosecution. As one regulator interviewee suggested:

If we came to the conclusion that they were rotten to the core, you need to indict. That’s still the correct result for the worst of the worst. Monitors for those middle cases persuade prosecutors that there have been lapses but that they are committed to rectifying these wrongs, including terminating responsible people and instituting new control mechanisms.

These comments are basically consistent with our prior arguments that “worst actor” (but not utterly corrupt) corporations are those whose conduct was most appropriate for a monitorship.\textsuperscript{139} For those who would argue that corporations with widespread wrongdoing cannot be reformed and therefore indictment is necessary, some of the union trusteeships may suggest that even deeply corrupt organizations can be reformed through monitorships (bearing in mind that the scope of the successful union trusteeships seems to be beyond the intended scope of most current corporate monitorships).\textsuperscript{140} The challenge facing prosecutors is identifying appropriate cases for monitorships. The prosecutor must be able to distinguish between truly egregious conduct that calls for prosecution; those “middle cases” where the conduct was sufficiently wrongful and pervasive to justify the costs and intrusions of a monitor; and the lesser cases where such costs are not justified.

Another factor from the McNulty Memo that may outweigh the others and tip the scales in favor of a settlement relates to “collateral consequences,” or harm to the stakeholders of the corporation.\textsuperscript{141} The fall of Arthur Andersen is regularly cited as a spectacularly bad outcome that demonstrates the need for settlement agreements to protect innocent employees and shareholders and to keep viable business entities functioning.\textsuperscript{142} Siemens is a corporation that could potentially benefit from this

\textsuperscript{138} Un cited quotations in this Article come from our confidential interviews with monitors and others.

\textsuperscript{139} Ford, supra note 52, at 764 (defining “worst actors” as firms/corporations facing serious allegations of intentional wrongdoing, where the degree of harm is significant; firms/corporations that are potentially recidivists and for whom there is reason to believe that pervasive cultural or ethical problems persist, but not firms/corporations that are utterly criminal enterprises); David Hess & Cristie Ford, Corporate Corruption and Reform Undertakings: A New Approach to an Old Problem, 41 CORNELL INT’L L.J. 307, 333–35 (2008) (providing examples of companies that may classify as worst actors); see also Christopher Stone, The Place of Enterprise Liability in the Control of Corporate Conduct, 90 YALE L.J. 1, 28 (1980) (describing “that group of firms, impossible to identify in advance, whose behavior in the face of realistically achievable penalty levels will remain inadequately modified”).

\textsuperscript{140} See supra text accompanying note 31.

\textsuperscript{141} McNulty Memo, supra note 91, at 4.

\textsuperscript{142} See Lichtblau, supra note 132, at 1 (noting that the indictment of Arthur Andersen—as opposed to reaching a settlement—resulted in the company being shut down and forced 28,000 employees out of work).
reasoning.⑭ Siemens, a German company that is also listed on the New York Stock Exchange,⑮ appears to have engaged in egregious violations of the FCPA; and such corrupt payments seem to have been deeply ingrained into that organization's business practices.⑯ One compliance consultant we interviewed suggested that Siemens would be the "perfect case" for a monitorship on the basis that, even though this was clearly an organization that needed significant help in reforming itself, an indictment that forced it out of business would have a tremendous and negative impact. In spite of the importance of this factor, however, it is clear that concerns about collateral consequences are not the only rationale behind monitorships.⑰ Indeed, monitorships are regularly imposed on midsize corporations and firms, and there is precedent for imposing a monitorship on small, family owned businesses as well.⑱ The government's reasons for imposing a monitorship on a small firm—including one with a tight relationship between ownership and control—could be many: the cost of litigation and the possibility that litigation might fail, the hope that more concentrated oversight and education could help the firm become compliant, or simply the desire not to destroy the firm if other options are still available.⑲

⑭ Since the original drafting of this Article, Siemens reached a plea agreement with the DOJ in which it admitted to violating the FCPA and agreed to pay the largest fines recorded for FCPA violations. Eric Lichtblau & Carter Dougherty, Bribery Case Will Cost Siemens $1.6 Billion, N.Y. TIMES, Dec. 16, 2008, at B8. Under the agreement, Siemens was allowed to continue to bid for U.S. government contracts, id., and accepted a monitor for a period of four years. Press Release, Dept. of Justice, Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations and Agree to Pay $450 Million in Combined Criminal Fines (Dec. 15, 2008), available at http://www.usdoj.gov/opa/pr/2008/December/08-crm-1105.html.

⑮ William J. Holstein, A Few Bad Apples, and Everybody's Sauce, N.Y. TIMES, May 1, 2006, § 3, at 10.

⑯ Carter Dougherty, Ex-Manager Tells of Bribery at Siemens, N.Y. TIMES, May 27, 2008, at C4 (reporting the testimony of a former manager describing the "intricate system of slush funds and bribery at the company" and noting that internal investigators have identified over $2 billion in suspicious payments).

⑰ In fact, in announcing the settlement agreement with Siemens, the DOJ did not mention collateral consequences as a reason for not seeking an indictment that would bar the company from bidding for government contracts, but only Siemens' extensive cooperation in bringing to light the FCPA violations and efforts to reform itself. Press Release, Dept. of Justice, Transcript of Press Conference Announcing Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations (Dec. 15, 2008), available at http://www.usdoj.gov/opa/pr/2008/December/08-opa-1112.html.


⑲ For these organizations, the line between individual and corporation starts to blur. Several monitors we spoke with believed that a monitorship would not be successful in that situation, because the individual wrongdoers could not be extricated from their positions without effectively destroying the firm as well, and reform was not possible with the wrongdoers still in leadership positions. In contrast, we posit that these small firms may be especially good forums for monitorships.

In another context, Darren Sinclair and Neil Cunningham have pointed out that many small and medium-sized enterprises operate at the margins of profitability and cannot afford to devote many resources to such issues as compliance. Also, they often lack expertise and awareness, and in the absence of an acute enforcement event they may not integrate compliance priorities into their business processes. Neil Cunningham & Darren Sinclair, Leaders & Laggards: Next-Generation Environmental Regulation 13-40 (2002). These small and medium-sized enterprises may in fact be exactly the right candidates for some form of monitorship (perhaps modified to accommodate their humbler resources), because these may be the firms that can benefit the most from some assistance and education at a crucial
If any overarching generalization is possible about what cases are appropriate for settlement agreements involving monitorships, it would be that some sort of balancing test is called for. The misconduct in question should have a systemic, organization-wide component, but the misconduct cannot be so pervasive that the corporation is an utterly criminal organization. Problems should be serious enough to justify the cost of a monitorship, but the corporation cannot be irredeemable. The subject firm or corporation can be "too big to fail," or small enough to learn and reform itself, or somewhere in between. Because monitorships can be a viable option in such a range of situations, they can become a convenient middle-of-the-road choice (or nonchoice) for a prosecutor. In fact, one monitor we interviewed thought that monitorships were becoming a "fall-back position" for prosecutors. That is, monitorships are being imposed on corporations without clear thought by the prosecutor as to whether or not they are appropriate for the case at hand. The perception that monitorships are being used in a "one size fits all" manner may adversely affect their perceived legitimacy and therefore their chances of long-term success.

2. Power and Participation in the Negotiation Process

Once the government has decided to enter a settlement agreement, the parties must negotiate the exact terms of the agreement. Many have noted that prosecutors have significant power over corporations in this context. The government has a bargaining advantage because it has the option of pursuing criminal charges, and a criminal conviction can have a significant negative effect on a company (some even refer to it as a "death sentence"). In addition, if an executive has already pled guilty, then the corporation knows it has little to no defense. Some argue that prosecutors have abused this power. Professor Epstein goes so far as to argue that "DPAs no longer serve the public interest. The agreements often read like the confessions of a Stalinist purge trial, as battered corporations recant their past sins and submit to punishments wildly in excess of any underlying offense." Complaints receiving significant media attention include settlement terms not directly related to the underlying offense, and conflicts of interest within the DOJ relating to the monitor selection process.

149. In general, there is room to negotiate the terms of the settlement agreement. However, at least one regulator we interviewed periodically imposes monitorship terms, using a boilerplate agreement, for smaller matters in lieu of conducting a formal investigation. The regulator also uses monitorships, the terms of which can be negotiated, in settlement of formal investigations.


151. Interview with David Pinto of, Partner, Goodwin Proctor LLP, New York, New York, CORP. CRIME REP., Nov. 28, 2005, at 46 [hereinafter Interview with David Pinto].

152. Epstein, supra note 128.

153. For example, the Bristol-Myers Squibb agreement included the requirement that the company endow a chair in ethics at the Seton Hall Law School. Joan McPhee, Deferred Prosecution Agreements: Ray of Hope or Guilty Plea by Another Name?, 30 CHAMPION 12, 14 (2006) (providing examples of settlement terms that are not directly related to the underlying offense).

154. Lichtblau, supra note 132 (describing the controversy surrounding a U.S. attorney's selection of former Attorney General John Ashcroft to serve as a monitor in a case that could earn Ashcroft's consulting firm over $50 million).
response, there have been calls for greater legislative and court control over monitorships.155

This public criticism has created some changes that attempt to restrict U.S. Attorneys' discretion. In May 2008, the DOJ issued guidelines that prohibit a settlement agreement from requiring a corporation to make payments to any organization that was not a victim of the criminal activity.156 In March 2008, the DOJ issued guidelines for the selection of monitors.157 To reduce the potential for conflicts of interest in the selection of the monitor, the guidelines require the use of committees to make selection decisions, and require final approval by the Office of the Deputy Attorney General.158

Although public criticism has affected some aspects of monitorship negotiations, the parties at the bargaining table have not changed. Noticeably absent are any parties other than the government and the corporation, including investors, employees, or community representatives.159 Khanna and Dickinson observe that corporate monitorships share features with proposals by others that would require corporations to include on their boards professional, independent directors elected by institutional investors.160 This suggests that the shareholders of the corporation may have an interest in having a say in the terms of the agreement or the selection of the monitor.161 One corporate defense attorney and former prosecutor stated, "I think part of the frustration of people who question the government's use of deferred prosecution agreements is that the process does not include parties that may take a contrary view."162 Also frustrating to these other parties is the fact that an unknown number of deferred and nonprosecution agreements are not made public. This prevents these stakeholders from having a more complete understanding of how the DOJ is handling corporate crime.

Only one of our interviewees told us that the prosecutors negotiating the terms of the monitorship had considered involving a major shareholder in the process. The decision was ultimately made not to involve that shareholder, apparently out of concerns that the shareholder was more interested in finding fault than reforming the

158. Id. at 3.
159. Interview with David Pitosky, supra note 151.
161. See id. at 1742 (stating that "[p]erhaps institutional investors could have some greater, explicit voice in this process by, for example, being consulted by the government agency before appointing a monitor").
162. Interview with David Pitosky, supra note 151.
corporation. The concern mirrors a parallel concern discussed further below about making monitors’ final reports to the U.S. Attorney available to the public. In both situations, the advantages of opening the process to a wider group of stakeholders may be outweighed by the potential chilling effect on the corporation’s complete participation in the negotiations and the monitorship process.

Overall, there is considerable inequality of bargaining power at the negotiating table. Not only do corporations not have a better alternative to settlement that would give them a credible threat of leaving the negotiation table, but corporations may even be afraid to push back against government demands for fear of being perceived as not genuinely contrite or willing to correct their problems. While many corporations surely enter into monitorships with a sincere desire to fix problems and regain their ethical footing, their immediate goal is to mitigate: to resolve the matter without a criminal indictment and at the least possible cost.

3. Corporate Rehabilitation and the Duties of Corporate Monitors

By contrast to the corporation’s immediate goal, the government’s priorities may be wide-ranging, and can include providing appropriate restitution where necessary, administering a level of deterrence that is deemed appropriate in the circumstances, and putting the corporation on the path to reform. The 2006 McNulty Memo states that the decision of whether to prosecute a company or settle should ensure that the goals of criminal law—including punishment, deterrence, and rehabilitation—are sufficiently satisfied. The 2008 Morford Memo states that monitorships should not be used “to further punitive goals.” Taken together, this means that monitorships can serve as a reform measure and as a deterrent. As discussed earlier, several commentators challenge the idea that monitorships are effective specific or general deterrents. One compliance consultant we interviewed, however, suggested that monitorships could be a truly “scary deterrent” because, although shareholders may not be too concerned with fines, the presence of a monitor can create a troubling level of uncertainty that lasts throughout the monitorship. Many of our interviewees also observed that “nobody wants a monitor,” effectively because of the disruption they represent to business operations.

In this paper, our primary concern is with the potential for corporate rehabilitation under a monitorship. The desire to spur meaningful reform is implicated at every stage of the settlement process. The factors behind a prosecutor’s decision to enter into a settlement agreement reflect the same concerns, and also should have an impact on the terms of the settlement agreement and the scope of the monitorship.

A key factor in the settlement determination under the McNulty Memo is the “the existence and adequacy of the corporation’s . . . compliance program.” In at least one case, the government has turned to compliance consultants to help evaluate this factor. The U.S. Attorney in Western Pennsylvania hired Compliance Systems Legal

163. See infra Part IV.C.4.
164. McNulty Memo, supra note 91, at 5.
166. See Crime Without Conviction, supra note 5.
Group to investigate Mellon Bank's compliance program as part of the U.S. Attorney's consideration of the McNulty Memo factors. Although Mellon Bank avoided criminal prosecution for the destruction of tax documents, the DOJ found its compliance program to be deficient, and its settlement agreement required the company to improve its compliance and ethics program and pay for a monitor to oversee the implementation of the program. In a different case, prosecutors found a clearly inadequate compliance program. Faro Technologies, which admitted in its settlement agreement to violating the FCPA, did not even address issues related to the FCPA in its compliance program or training even though it regularly conducted business in China, which put it at high risk for making corrupt payments. In both cases, the settlement agreement addressed these compliance-program inadequacies and required improvement.

In addition to the compliance program, prosecutors are also instructed to consider a "company's compliance attitude" or, in other words, the corporation's culture. The McNulty Memo requires prosecutors to look for a "corporate culture that encouraged, or at least condoned, such conduct, regardless of any compliance programs." Likewise, in securities enforcement, the Seaboard Report tells enforcement lawyers to ask: "How did the misconduct arise? Is it the result of pressure placed on employees to achieve specific results, or a tone of lawlessness set by those in control of the company?" Through these inquiries, the government is trying to determine if a small group of rogue employees ("bad apples") who went against the grain of the rest of the corporation committed the wrongful acts, or if corporate leadership had created a culture that rewarded and encouraged the wrongful acts in spite of having a compliance program that purported to prohibit such behavior (a "bad barrel"). If the investigation shows that a root cause of the problem is a "bad barrel," then any settlement agreement sought by prosecutors should seek to address that problem. Accordingly, a monitor's duties should typically serve those ends.

Focusing specifically on the DOJ, according to the recent Morford Memo, monitorships are typically used to ensure the company has "effectively implemented ethics and compliance programs to address and reduce the risk of recurrence of the corporation's misconduct." Most monitorships in place as of the publication of the Morford Memo in March 2008 are consistent with the guidelines set out in that memo.

171. Rashkover, supra note 92, at 539.
The large majority of the monitors are charged with ensuring compliance with the settlement agreement, reviewing the compliance program related to the offence, recommending changes to existing compliance processes, and then reviewing the effectiveness of the implementation of those changes. In addition, in slightly under half the agreements, the monitor is charged with monitoring the company's compliance with applicable federal laws. Interestingly, however, almost without exception, McNulty Memo-style language about a corporation's compliance "attitude" or "culture" does not appear in the agreements.

In the nine months since the Morford Memo, as of this writing, three additional monitorships have been imposed on companies through settlement agreements with the DOJ for violations of the FCPA. All three cases were handled by the DOJ's Fraud Section and they use almost identical language for establishing the procedures for selecting the monitor and the duties of the monitor. With respect to compliance programs, the monitors are required to oversee the implementation of a compliance program, ensure that the program is "appropriately designed," and conduct annual follow-up reviews of the program. The agreements also state that the monitor should take "such steps as are necessary to develop an understanding of the facts and circumstances surrounding any violation that may have occurred." That broad language allows for significant interpretation, which may or may not include matters related to a corporation's culture. Two of these agreements, however, qualify that language in that they specifically state that the monitors should not conduct their own investigations into past FCPA violations at these companies (and therefore may have to rely only on information provided to them by the corporation). There is no indication why these monitorships (all agreed to within a few weeks of each other) were treated differently.

Although the agreements (either pre- or post-Morford) do not address the issue of

175. Faro Technologies, supra note 170, app. C, ¶ 5; Deferred Prosecution Agreement, United States v. AGA Med. Corp., No. C88-172JMR, Attachment D, ¶ 6 (D. Minn. June 2, 2008) [hereinafter AGA Medical] (on file with author); Deferred Prosecution Agreement, United States v. Willbros Group, Inc., Crim. No. H-08-287 (S.D. Tex. May 14, 2008) [hereinafter Willbros] (on file with author). In addition, in all three cases, before the monitor conducts a review, the Monitor is required to develop a written work plan and make that plan available to the company and the U.S. Attorney's Office for comment.

176. Faro Technologies, supra note 170, app. C, ¶ 6(e)(i); AGA Medical, supra note 175, at Attachment D, ¶ 6(e)(ii); Willbros, supra note 175, Attachment D, ¶ 7(e)(i).

177. The agreements state that "the parties do not intend that the monitor will conduct his or her own inquiry into those historical events." AGA Medical, supra note 175, at Attachment D, ¶ 6(e)(i); Willbros, supra note 175, Attachment D, ¶ 7(e)(i). This language apparently comes from the Morford Memo, where it states that the "monitor's mandate is not to investigate historical misconduct." Morford Memo, supra note 157, at 6. However, the memo goes on to state that such knowledge may be necessary to "inform a monitor's evaluation of the effectiveness of the corporation's compliance with the agreement." Id.

178. Clearly, the monitor's role is to ensure the company has an effective compliance program going forward and not to attempt to discover undisclosed wrongdoing that had occurred. Gaining an understanding of why and how the wrongdoing occurred, however, would in most cases seem to be essential information in diagnosing what went wrong and then ensuring that the corporation implements an appropriate compliance program.

It is unclear how (if at all) the qualifying language would impact a monitor's ability to conduct those activities or the monitor's perceptions of his or her powers. As discussed below, there is a need for collecting data on how such terms impact the monitorship, and a need for greater explanation of the expected role of the monitor, which would also help explain the inclusion or exclusion of such terms in the agreement.
corporate culture in so many words, in some cases the government appears to view certain negotiated terms as addressing those issues. For example, in Bristol-Myers Squibb's DPA, the U.S. Attorney who negotiated the agreement specifically stated that Bristol-Myers Squibb's culture "greatly contributed to the criminal conduct." Employees in the company regularly used fraudulent means to hit aggressive sales and earnings targets between 2000 and 2001. The company engaged in similar conduct in the early 1990s and implemented controls to reduce that behavior, but corporate culture overrode those controls and the wrongful behavior reached new heights. In an attempt to correct these cultural problems, the U.S. Attorney did not specifically charge the monitor with investigating the culture issues and making recommendations—though the monitor did have the power to "to take any steps he believe[d] [were] necessary to comply with the terms of this Agreement"—but included certain structural reforms in the DPA. For example, the DPA required quarterly meetings between senior managers and the independent auditors, to help foster a culture of disclosure. In addition, the DPA required the CEO and CFO to make certain reports on transactions to the board, the monitor, and the company's chief compliance officer. Finally, the DPA required the company to implement a training program. In explaining the need for these requirements, the U.S. Attorney who negotiated the DPA stated: "[m]any of the remedial measures in the deferred prosecution agreement—the top-level structural and governance changes, the reporting by senior management, and the training and education programs for key financial and legal personnel—are designed to spread knowledge and responsibility for doing the right thing throughout the Bristol-Myers organization." These kinds of comments demonstrate a desire on the part of the U.S. Attorney to change the organization's culture. Leaving aside, for now, questions about whether these negotiated terms are sufficient on their own to effect positive change to corporate ethical culture, the initial problem is that although the monitor is charged with overseeing the implementation and effectiveness of required compliance measures, the monitor's exact role in this process is unclear. The terms of the agreement could

180. Id.
181. Id. at 1057–58.
182. Id. at 1050–51.
183. Id. at 1057–58.
185. Id. ("A top-down commitment to honor and integrity, coupled with an educated and empowered workforce, undoubtedly will help Bristol-Myers demonstrate its commitment to exemplary corporate conduct during and after the two-year term of the deferred prosecution agreement.").
186. It may be that the retention contract between the corporation and the monitor, or some other documents that are not publicly available, contain more specific expectations than that contained in the settlement agreement. We are not aware of any case in which a contract has been entered into between the monitor and the government, or of any other particular documents that might govern the situation, so the corporation-monitor contract would be the logical place for any additional detail. The monitor contract in the University of Medicine and Dentistry of New Jersey was made publicly available. If this contract is representative of other corporation-monitor contracts, then these contracts do not
allow the monitor to take on only an auditor role and simply check what the company has done, or the monitor could become a team member pushing and assisting with cultural change. 187

4. The Scope of the Monitorship

Along with variation in the duties of monitors, there has been variation in the scope of monitorships. These issues are clearly intertwined with the duties of monitors discussed in the previous section, but in this section we try to add some clarity to the variations—both intentional and unintentional—around what role the monitor is expected to play.

The Morford Memo recognizes that the monitor’s role must be appropriately designed and states:

Neither the corporation nor the public benefits from employing a monitor whose role is too narrowly defined (and, therefore, prevents the monitor from effectively evaluating the reforms intended by the parties) or too broadly defined (and, therefore, results in the monitor engaging in activities that fail to facilitate the corporation’s implementation of the reforms intended by the parties). 188

The monitor’s role should vary based on the circumstances and should be designed to allow the monitor to carry out her duties appropriately, without being overly intrusive. Based on the settlement agreements (including SEC agreements), we place the monitorships along a spectrum using four general categories, which from smallest scope to largest scope are: Advisor, Auditor, Associate, and Autocrat.

In its most modest version, the monitor may simply serve an Advisor role. For example, although the DOJ listed Aaron Marcu as a monitor for Aurora Foods in its letter to the House Judiciary Committee, 189 the settlement agreement appears to give the monitor very limited powers. According to the agreement, the monitor is referred to as an “outside consultant” that is to be hired “to advise Aurora regarding an appropriate compliance program.” 190 The company is also required to “implement[] the recommendations made by that outside consultant.” 191 The agreement further specifies that certain individuals must oversee the implementation of the compliance program, including an individual appointed as a compliance officer and a newly appointed

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187. See infra notes 189–202 and accompanying text (setting out different possible roles for the monitor).
188. Morford Memo, supra note 157.
189. Letter from Brian A. Benczowski, Principal Deputy Assistant Gen., to John Conyers Jr., Chairman, House Comm. on the Judiciary (May 15, 2008) (copy on file with authors).
191. Id.
independent director to serve on the audit committee. 192

At the other extreme—the Autocrat—monitors are given significant powers. The primary example is the appointment of Richard Breeden as the monitor for WorldCom following an SEC request for ancillary relief from the court. Initially, Mr. Breeden was appointed to ensure that the company did not destroy evidence, and to review compensation payments to ensure that the company was not using excessive officer compensation as a form of “looting.” 193 In a later consent decree, the monitor’s powers were expanded to include reviewing and making recommendations on the company’s entire corporate governance structure, including its compliance program. 194 This resulted in Mr. Breeden issuing a 147-page report that included far-reaching recommendations on such controversial matters as shareholder nomination of directors, and a ban on the use of stock options for compensating corporate officers. 195 Mr. Breeden also played a role in selecting and removing certain members of the board of directors, and determining to which potential acquirer the company should be sold. 196

Another example of the Autocrat Monitor is the DPA for the University of Medicine and Dentistry of New Jersey (UMDNJ). In that agreement, the monitor had full access to all documents and information held by UMDNJ and at the monitor’s “discretion” could investigate any allegation of wrongdoing. 197 In addition to reviewing and making recommendations on UMDNJ’s compliance program, the monitor had the “authority to require UMDNJ to take any steps he or she believe[d] [were] necessary for UMDNJ to comply with the terms of this [a]greement” and was required to “[e]nsure UMDNJ’s compliance with applicable federal and state laws.” 198 During the course of the monitorship, the monitor, Herbert J. Stern, a former federal prosecutor and judge, filed reports alleging wrongdoing by various doctors and a dean, which led to employment terminations. 199 The monitor employed various law and auditing firms to assist in his work, and after six months on the job submitted a bill for $5.8 million, which drew criticism because that figure was higher than the amount that UMDNJ had allegedly overbilled Medicaid. 200

In the middle are the Auditor and Associate roles. The Auditor assumes a role of assuring the DOJ that the corporation is doing what it says it is doing in terms of implementing internal controls and a new compliance program. The Auditor also may

192. Id.
194. Id. at 98.
195. Id. at 99.
196. Id. at 101–02.
198. Id. at 3. In addition, the monitor was required to select the candidates for the board to consider for the positions of General Counsel and Chief Compliance Officer. Id. at 4.
make recommendations for improvements where necessary. The Associate, on the other hand, conducts the work of an Auditor, but also functions more fully as a partner with the compliance officer, board of directors, or other relevant corporate officials. For each of these roles, the settlement agreement typically states that the monitor will evaluate the company’s compliance with the settlement agreement, review the company’s compliance program and make recommendations for improvement, oversee implementation of the recommended changes, conduct follow-up evaluations of the compliance program (e.g., annually for the next two years), and file reports with the company and the DOJ on the company’s progress. As discussed below, the monitor’s adoption of either the Auditor or Associate role has less to do with the written terms of the agreement and more to do with the monitor’s chosen approach.

5. Monitor Independence

Although the Morford Memo states that a monitor is “by definition” independent of the company and the government, sometimes the decision is made that a fully independent monitor is not necessary. Our research indicates that both civil and criminal-side regulators are willing to consider monitorship structures of varying degrees of independence, depending on the perceived needs of the case, with less independent monitors typically serving an “advising” role. One civil-side regulator we spoke with described a spectrum, with certification by a firm’s in-house counsel or internal audit department on one end, review by a firm’s outside counsel in the middle of the spectrum, and a fully independent review by a third party at the far end. According to this regulator, certifications or internal compliance audits are generally considered to be adequate where the conduct in question is less serious and/or the review can be fairly easily verified on objective bases.

Where the conduct is especially serious, the judgments required are subjective, and the regulator is not satisfied with the steps the firm has taken so far, the regulator is more likely to insist on retaining a wholly independent monitor. This regulatory


202. See infra Part V.A.


205. See supra notes 189–92 and accompanying text (describing the Advisor role).

206. This regulator stated, in part:

It depends on the seriousness of the conduct and the scope of harm. So, sometimes you might have what I’d call an "easy fix," and in this case we might just require the firm’s in-house compliance department to conduct a review or audit, and then to certify that changes have been made. . . . Maybe we would have the firm’s outside counsel do it instead sometimes. At the other end of the spectrum is the "big fix," where we might require the firm to hire an independent consultant. As a term of the settlement, that independent consultant would be precluded from
staffer pointed out that the first thing a firm often does when it gets into trouble with a regulator is to retain outside counsel or an accountant to conduct an internal review. Where credible outside counsel has already done substantial work on the problem, it can be burdensome and largely pointless to require the firm, as a term of a settlement, to bring another party in to redo the same work. For example, as soon as the DOJ started investigating Bristol-Myers Squibb, the company hired Frederick Lacey, a former U.S. Attorney and federal judge, to review the company’s compliance program and internal controls as an independent advisor.\footnote{Christie & Hanna, supra note 179, at 1054.} A year later, in a settlement agreement with the SEC, the company agreed to retain Lacey as an independent advisor.\footnote{News Release, Bristol-Myers Squibb, Bristol-Myers Squibb Statement on SEC Settlement (Aug. 4, 2004), available at http://investor.bms.com/phoenix.zhtml?c=106664&p=irol-newsArticle&ID=600607&highlight=.} The following year Lacey became an independent monitor for the company under the DPA with the DOJ.\footnote{Stephanie Saul, A Corporate Nanny Turns Assertive, N.Y. TIMES, Sept. 19, 2006, at C1.} Although Lacey had earlier been retained by the company, this apparently did not affect his independence since he later recommended that the company terminate the employment of the CEO that had hired him.\footnote{We discuss independence below. See infra notes 216–18 and accompanying text.}

A civil-side regulator interviewee also told us that staffers recognize that a multiyear ban on subsequent business relationships between monitor and firm can be a burdensome requirement for all involved—the consultant as well as the firm. As a result, that regulator no longer automatically requires this as a condition of every monitorship. There may be other factors that constrain independence—for example, if the decision is made that the monitor must have extensive experience in the industry, or must have specialized expertise, there may be a limited number of potential monitors that are qualified and willing to take on the engagement. In those situations, a monitor’s prior business relationships with a subject firm may not necessarily be a disqualifier. The appropriate question is whether the level of independence is sufficient, not whether it is complete. As one regulator we interviewed described it:

There were enough questions about the management and the firm that we weren’t just going to rely on their representations. We wanted somebody independent of the firm to verify. So we wanted a more formal auditor relationship and the sufficient independence of that was satisfied. Basically if you’re independent enough to be their financial auditor then that was sufficient for this engagement. It didn’t have to be somebody brand new. . . .

The context with their industry experience was an important factor for us.

For those involved in the process, the degree of independence was not a central concern. Both regulators and monitors told us that, ultimately, monitors’ own professional reputation and integrity were what made them behave responsibly in the role and avoid being captured.\footnote{Christie & Hanna, supra note 179, at 1054.}
B. Selecting the Monitor

1. Selection Process

Monitors are selected through a variety of methods. In most cases the DOJ selects the monitor, often after "consultation" with the company,\(^\text{212}\) or the DOJ and the company select a monitor who is "mutually agreed upon."\(^\text{213}\) In other situations, the company selects a monitor and the government retains a veto right.\(^\text{214}\) In at least one case the court chose the monitor from a selection of three candidates agreed to by the corporation and the government.\(^\text{215}\) The monitors we spoke to were selected through several of these options.

The Morford Memo approves of the use of any of these methods, though—reflecting the memo's origins in the scandal surrounding John Ashcroft's appointment as a monitor by a U.S. Attorney's office—the government's final selection cannot be made solely by the U.S. Attorney, but must be through an ad hoc committee, and final approval must be given by the Deputy Attorney General.\(^\text{216}\) In the three cases since that memo, however, the DOJ has used the veto method of selection.\(^\text{217}\) The debate about monitor selection methods has even reached Congress, as one proposed bill seeks to require the DOJ to use an open competition for monitorships.\(^\text{218}\)

Significantly, the monitor is typically selected after the settlement agreement has been negotiated and signed. This takes the identity of the monitor out of the initial settlement negotiations. It puts the company in the interesting position of agreeing to a contract, one essential element of which remains undetermined.

During a selection process where the company is afforded some significant voice in the process, it is not uncommon for potential monitors to make a presentation to the

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214. Faro Technologies, supra note 170, app. C, ¶ 2 (stating that the "Department retains the right, in its sole discretion, to accept or reject any Monitor proposed by FARO pursuant to the Agreement").
216. Morford Memo, supra note 157, at 3.
217. Faro Technologies, supra note 170, app. C, ¶ 2; AGA Medical, supra note 175, attachment D, ¶ 2; Willbros, supra note 175, attachment D, ¶ 3. One of our interviewees suggested that the DOJ had been moving away from the veto approach toward language that requires a "mutually acceptable" monitor, because the "mutually acceptable" language gives the Department more control over the selection. These three cases go against the trend the interviewee identified, but they are all from the Fraud Section. Thus, it is difficult to say if future DPAs from outside the Fraud Section will follow the lead of the Fraud Section or the trend our interviewee identified.
218. The Accountability in Deferred Prosecution Act of 2008, H.R. 6492, 110th Cong. § 5 (2008), available at http://thomas.loc.gov/cgi-bin/query/D?c110:1;temp=c110ZYIF:. This Bill would require the Attorney General to establish a national list of potential monitors and establish rules for their selection that further the goal of creating "an open, public, and competitive process for the selection of such monitors." Id. § 5(c).
company. This interview process gives the company the opportunity to determine whether a particular monitor has the personality, skills, and experience necessary to provide value to the company, as well as to achieve the government's objectives. Our research does not answer the question of whether the DOJ also interviews potential candidates, although none of our interviewees told us that they had been so interviewed. However, at least one monitor we spoke with was aware of instances in which the government had exercised its "veto" power and rejected a company's choice of monitor, either because of a perceived conflict of interest or because the proposed monitor was not thought to have the necessary qualifications. The next section turns to the qualifications of those monitors.

2. Monitors' Background and Experience

There are several common traits among monitors. One common trait, especially on the criminal side, is the lack of experience in conducting a monitorship. Many monitors seem to have been retained for only a single engagement. If the government continues its use of monitorships, then experienced monitors may become more common. For example, Timothy Dickinson served as the monitor for Monsanto and was recently selected as the "independent consultant" for Delta & Pine in a settlement with the SEC. George Stamboulis served as the monitor for Merrill Lynch and Bank of New York. In addition, he serves as a "private monitor" for other companies, which presumably also gives him valuable experience as a monitor. He estimates that he spends 70% of his day as a monitor in some form. On the civil side, for a fairly small community of lawyers, SEC or FINRA monitorships and corporate internal investigations more generally form a substantial part of their practice.

On the other hand, some fear that the selection process will often not favor experienced monitors. For example, one observer had the following perception of the selection process (though others we spoke to disagreed):

Typically an Assistant U.S. Attorney or an Assistant District Attorney will leave to go into private practice; a case will come up in the office where they'll decide to do a deferred prosecution agreement. Somebody will call the guy who's left and say "Hey Charlie would you like to do this?" And he says "Sure." Looking for business, it's sort of like being a prosecutor again, sounds interesting and so he does it. That's how he gets appointed; somebody knows him, he's a friend. And that may be the only one he does for his entire


A second common trait is that monitors are typically former prosecutors or other
government employees. From the list of 40 monitors submitted by the DOJ to the
House Judiciary Committee on May 15, 2008, 30 were former government employees,
including 23 former prosecutors. A separate review of 25 monitorships found that
"at least 17 were ex-federal prosecutors," and others included former federal judges, "a
former SEC Chairman and an ex-SEC general counsel." The monitors we
interviewed viewed their backgrounds as a positive and highlighted their prosecutorial
experience and their presumed professional judgment as the most likely reasons for
their selection. A number of them also thought that their experience on "both sides"—
i.e., as prosecutors and also representing companies on white collar crime matters—
equipped them to be monitors. One monitor stated, "I used my professional experience
and training as a prosecutor and also as a defense attorney. You have to wear both hats,
see things from different perspectives." Another described key skills as "[l]earning
how to investigate and quote-unquote prosecute, tempering that with an understanding
gained as a defense lawyer about the mitigating and absolute defenses against certain
conduct, and overlaying that, appreciating that you have competing interests."

Several people we interviewed raised concerns about the government selecting ex-
prosecutors as monitors. However, the typical case may not be the selection of a former
superior, as in the selection of John Ashcroft, or some other conflict of interest, but the
DOJ selecting someone they know, trust, and are comfortable working with. This may
result in a prosecutor selecting a former colleague to be a monitor, as suggested in the
quote above. In addition, the company itself may select an ex-prosecutor in an attempt
to win the trust of the government and signal their willingness to comply with the
settlement agreement. One monitor stated:

I think the reason that you see so many people who do this who have recently
been in the government is really because they have a credibility component
and an independence component from the perspective of the regulator who
has to approve them.... [I]f you are the company looking to retain
somebody, you want to have somebody the regulator is going to view as a
credible force.... [Y]ou sort of only have one shot at it and you want a
household name about whose integrity no one is going to call in to
question....

Another monitor said:

I think the comfort level that the government might have in the monitor is
important not only to the government but the more credibility the monitor
has with the government the better off the company can be too because if the
company has a monitor who has done an effective job and has made
recommendations that are going to be received and accepted by the
government, that's good for all concerned.

In addition to their prosecutorial or regulatory experience, monitors commonly

221. Eric Lichtblau & Kitty Bennett, 30 Former Officials Become Corporate Monitors, N.Y. TIMES,
222. Sue Reisinger, Someone to Watch over Me, CORP. COUNS., Oct. 2007, at 100, 103–04.
assumed that they were selected for their knowledge of the substantive law related to the wrongdoing in question, and their experience in that industry or with similar corporations. When asked whether compliance program professionals could be effective monitors, many of the monitors we interviewed were skeptical. The primary basis of that skepticism was the view that compliance management professionals do not have the necessary "legal expertise." In general, the monitors were not concerned that they themselves did not have experience in corporate compliance or similar managerial positions. As one monitor pointed out:

[Lawyers do this type of work all the time, they're used to bringing in the necessary experts to assist their role, so if the monitor needs a compensation specialist they can always bring one in. Lawyers know how to bring in people to augment their work.]

Not surprisingly, compliance consultants we interviewed raised concerns about the heavy use of ex-prosecutors and similar attorneys as monitors. Their primary concerns related to these monitors' lack of experience in implementing and evaluating compliance programs in a way that takes into account how those programs are embedded in the corporation's culture. Although a lawyer experienced with the FCPA, for example, can provide necessary expertise on policies the company needs to adopt to avoid violating the law (e.g., what risks to be aware of, what types of payments are not defensible), that expertise may be insufficient to ensure that the corporation's employees actually comply with those policies. This is where issues related to a corporation's culture (e.g., incentives, social norms) are important for understanding future compliance. Thus, the changes implemented may not be sufficient to have a long-term impact on the corporation.

To illustrate these concerns, one consultant brought up the old joke of a person dropping her keys in the middle of the street but looking for the lost keys at the side of the road by a street lamp. When asked why she was looking there, she responds, "Because that's where the light is." As applied here, it means that monitors without experience in establishing compliance programs will rely on what they do know or, as discussed further below, will rely on indicators that are easy to measure but may be misleading.

Although monitors may bring in teams of professionals with the skills and experience that the monitor lacks, this may not reassure all compliance consultants. First, the monitor may not understand the relevant professional experience he or she lacks. In a published interview, a member of the original commission that worked on the 1991 Organizational Sentencing Guidelines criticized high-profile monitors, stating that they "lack background or, frankly, interest in understanding the substantial body of compliance best practices." Second, as one compliance consultant pointed out, the

223. See supra Part III B (describing compliance professionals).
224. See supra notes 105–06 and accompanying text (describing the difference between compliance officers with management backgrounds and legal backgrounds in their beliefs on the root cause of organizational misconduct).
225. See infra notes 236–37 and accompanying text (discussing how lack of knowledge about company culture can cause a misleading interpretation of data).
226. Win Swenson Interview II, supra note 118, at 10, 16.
corporation must pay the bill to bring in these other parties even though it has little or no control over who the monitor hires and how many billable hours they can charge. To the extent that the monitor must learn on the job and bring in outsiders as part of this learning process, corporate officers may come to resent the process. This can impact the monitorship's legitimacy and its chances for long-term success. This is perhaps especially true if a monitor is selected simply for his or her name recognition, which is done presumably to add credibility.

If, as the Morford Memo states, one of the key roles of the monitor is to ensure that the company adopts an effective compliance program, then experience with compliance programs from a managerial perspective would seem to be an essential qualification for most monitorships. As a former prosecutor interviewee stated:

One of the reasons why the deferred prosecution agreements require a monitor to be put in place is that the prosecutor's office has no experience or skills to analyze whether a company is reforming its internal governance practices. That's just not something that prosecutors do. Instead, they need to find someone who does understand corporate forms and operations, and has the time and resources to monitor the company's progress.

This statement, which is uncontroversial, seems inconsistent with the decision to consistently choose individuals with only prosecutorial or technical legal expertise with respect to compliance programs.

C. Conducting the Monitorship

In the course of a monitorship, the monitor develops a work plan, conducts his investigation, advises the organization as to what changes are required, evaluates the implementation and effectiveness of those changes, and produces a report containing his evaluation and recommendations. Over the next two years or so, the monitor is often required to conduct annual follow-up evaluations with formal written reports. In this section, we take a closer look at how monitors conduct these activities.

1. Developing and Implementing a Work Plan

A monitorship typically begins with the development of a work plan. The work plan sets out who the monitor will interview, what documents she will review, and the other work of the monitor and her team. Significantly, in many cases the work plan is developed after the settlement agreement has been finalized and the monitor appointed, often by the monitor herself on a rolling basis. In other cases the work plan is negotiated with the company and the government. One interviewee had the impression that negotiated work plans, developed in advance of the start of the monitorship, were becoming more commonplace.

The negotiation of a work plan has occurred both formally and informally. The settlement agreement itself can require the joint development of the plan. For example, in the Baker Hughes DPA, the agreement specified a process under which the monitor submitted a work plan to both the company and the DOJ for their comments before the

project began. 228 All three of the monitorships entered into since the Morford Memo have required that the monitor submit a work plan to both the company and the DOJ for comment. 229 In other cases, monitors reported taking the initiative and calling a meeting with the company and DOJ to ensure everyone had a clear understanding of expectations. Finally, the company may take the initiative. One monitor stated that as part of his presentation to the company during the company’s selection process, he described the work plan he would implement.

In developing a work plan, the monitors we spoke to told us they generally used the settlement agreement to establish the bounds of their investigation, and stated they would not take on tasks that would go outside their duties as stated in the agreement. The terms of the agreement, however, may contain substantial room for interpretation by the monitor.

One area open to interpretation is whether and how to investigate the corporation’s culture. As stated earlier, settlement agreements do not contain language explicitly charging the monitor to provide recommendations on managing a corporation’s culture, but some monitors recognize the importance of corporate culture and assume responsibility for making recommendations on those issues. For example, the monitor in the AOL case, James Robinson, and two colleagues who worked on the monitorship with him, published an article describing their views on how a monitor should conduct his work. 230 In the article, they state that the AOL DPA tasked the monitor with a “mandate to review and monitor a compliance culture as it relates to business practices and revenue recognition.” 231 The paragraph cited by Robinson as giving the monitor this mandate states that the monitor shall review “the effectiveness” of AOL’s “internal control measures,” “training related to these internal control measures,” AOL’s “sign-off and approval procedures,” and the “corporate code of conduct.”232 One of our interviewees (a monitor operating under a comparable mandate) expressed a similar view, and perceived a similar link between compliance program policies and procedures and the corporation’s culture:

I wasn’t appointed to change the corporate culture at [the company]. That said, the broad topics that I was there to examine and report on went deeply into the culture and required me to sort of make observations about the culture and about how it influenced the compliance of the company, and as a consequence, at least, my perception was dealing on almost a daily basis with questions of corporate culture.

Although it is unclear from Robinson’s article what these monitors did to examine or review their company’s “compliance culture,” their direct discussion of culture suggests a distinctly different approach from some other monitors. For example, when

229. Faro Technologies, supra note 170, app. C, ¶ 5(e); AGA Medical, supra note 175, attachment D, ¶ 6(e); Willbros, supra note 175, attachment D, ¶ 7(e).
231. Id. at 337. The authors contrast the America Online DPA mandate with that of the Monsanto DPA, which was focused on a compliance program related to the Foreign Corrupt Practices Act. Id. at 336–37.
232. America Online, supra note 213, at 6, ¶ 13.
one monitor we interviewed was asked about reviewing the company’s culture, the
monitor told us, in effect, that it was hard to even know what the term meant. The
monitor observed that he could objectively look at processes and procedures, but that if
he wanted to be able to measure results it would be difficult to even determine how to
measure corporate culture. That monitor speculated that some other monitorships might
be concerned with corporate culture, but that his monitorship was intended to be
limited. Interestingly, the settlement agreement that monitor was working under
charged the monitor with essentially the same duties as the AOL monitor, focused
around reviewing new internal controls.

Even among those monitors who consider themselves to be engaging with issues
of corporate culture, it is unclear whether their use of the term matches the use of the
term by compliance professionals. In his article, the AOL monitor used the phrase
“compliance culture” but he did not specifically discuss how, if at all, his team
attempted to measure the corporation’s culture. That monitor’s approach may or may
not be consistent with current best practices from the perspective of compliance
professionals. For example, a common term in settlement agreements requires the
company to implement some form of anonymous hotline to allow employees to report
wrongdoing. If the monitor views her task very narrowly, then she will simply
ensure that the hotline has been implemented, that it is being monitored (perhaps by
someone who reports to the audit committee), and that employees are made aware of
the hotline through training. Although reviewing policies and procedures can ensure
the hotline has been implemented, it tells the company very little about its
effectiveness. For example, many employees refuse to report significant wrongdoing
to hotlines due to a belief that the organization will do nothing to correct the problem and
a fear of retaliation, even if the hotline is anonymous. Unless the monitor has a
sense of the organization’s culture and the pressures and social norms related to
reporting wrongdoing, the monitor will not know whether the hotline is an effective
tool.

Likewise, reflecting the comment made earlier about looking for keys under the
lamp post because that is where the light is, a monitor who is not a compliance
professional may misconstrue information coming in about the corporation’s culture.
For example, in a published interview, one attorney who later served as a monitor
stated that the fact that a company’s hotline was rarely used by employees—and when
it was used it was for minor, personal matters—provided evidence of a positive
compliance culture. Compliance consultants we interviewed, however, seem
universally to agree that the use of a hotline is not a good indicator of a corporation’s
compliance culture or measure of the level of wrongdoing within the organization.
Instead, to get a sense of the corporation’s culture, they would recommend using
surveys, focus groups, and other similar measures.

233. STRYKER ORTHOPEDICS NONPROSECUTION AGREEMENT, supra note 212, ¶ 40.
235. See supra Part IV.B.2.
236. Interview with F. Joseph Warin, Partner, Gibson, Dunn & Crutcher, Washington, D.C., CORP.
CRIME REP., Mar. 6, 2006, at 11, 14.
237. See Emily Layzer Sherwood, Measuring the Effectiveness of Ethics/Compliance Programs,
ETHIKOS & CORP. CONDUCT Q., Jan.–Feb. 2007, at 7, 8. Sherwood states: “The tools most commonly used to
Overall, we found significant variation in how monitors conducted their work. All seemed to review documents related to policies and procedures. All monitors also conducted interviews, but some stated that it was unnecessary to talk to employees below upper management. Those latter monitors focused solely on the "[ethical] tone at the top," which can create a biased view of the organization. 238 With respect to lower level employees, those monitors seemed to focus simply on removing the wrongdoers. Other monitors, however, conducted one-on-one interviews with employees at various levels of the company on the view that people were more likely to be candid in that environment, and even engaged in "surprise" visits to branch offices to interview employees before management had a chance to prepare for them. 239 In addition, some did not rely solely on interviews to understand the company, but sat in on meetings where decisions were made. Some intervened in corporate decisions early, while others tried to remain more in the background, on the belief that:

[What you want to do . . . is to allow the business and compliance and legal people to tackle it and to observe how they tackle it. And then to intervene if and only if they're not handling it properly, and then, finally, report to the government on it, how it all went, rather than run to the government when an issue first arises and seek government intervention or seek yourself to impose the solution, because then you're not teaching the company anything.

In sum, how monitors view their obligations under the terms of the settlement

measure ethics and compliance programs include: document reviews; surveys; one-on-one interviews; focus groups; and 'deep dives.' A "deep dive" "does not include compliance audits which tend to be prescribed, fill-in-the-box procedures," but is a flexible process using the tools listed above to get a complete picture of the organization. Id. at 8, 10.

238. "[Ethical] tone at the top" is a phrase used to describe the CEO and other senior officers roles in setting the right tone for the corporation's culture. Linds Klebe Trevitho, Out of Touch: The CEO's Role in Corporate Misbehavior, 70 BROOK. L. REV. 1195, 1208-09 (2005). Trevitho's comments based on her empirical research show why focusing only on senior managers will likely lead to misunderstandings about the effectiveness of a compliance program in practice. She states:

Because of their inclination to identify closely with the organization and its image, top managers have a "rosier" view of their organization's ethical climate than do lower-level employees. Further, due to fear and futility concerns, employees are unlikely to report ethical problems up the chain. As a result, CEOs are unlikely to know about ethical problems in their organizations. Finally, because most CEOs interact primarily with others of high status, they are likely to be out of touch with the daily realities of their own organizations and employees, including the ethical climate.

Id. at 1208.

239. One monitorship agreement even required the monitor to conduct interviews throughout the organization. SCHNITZER STEEL INDUSTRIES DEFERRED PROSECUTION AGREEMENT, supra note 14, ¶ 15, which states:

Schnitzer shall require the Compliance Consultant to formulate conclusions based on sufficient evidence obtained through, among other things, (i) inspection of documents, including all of Schnitzer's policies and procedures relating to Schnitzer's anti-bribery compliance program; (ii) onsite observation of FCPA systems and procedures, including Schnitzer's internal controls, recordkeeping and internal audit procedures; (iii) meetings with and interviews of Schnitzer employees, officers, directors and any other relevant persons; and (iv) analyses, studies and testing of Schnitzer's anti-bribery compliance program.
agreement will influence how they establish a work plan, which will influence the information they collect, who they interview, and what aspects of the organization’s operations they investigate. A monitor’s view of these obligations shapes the entire nature of the monitorship (and in some cases the choice between what we identified earlier as the Auditor and Associate roles), and ultimately what recommendations they make and how they report their findings. These decisions seem to be based more on the background and experience of the monitor than on the terms of the settlement agreement or the negotiations leading up to the settlement agreement.

In making these decisions, monitors learn by trial and error (at the company’s expense) and without the benefit of other monitors’ experience. The monitors we interviewed typically were not able to supplement their knowledge by consulting with other monitors—except rarely and on an ad hoc or informal basis—before developing work plans and starting monitorships of their own. Nor could they rely on other monitor reports as guidelines, as most were nonpublic. Several monitors expressed a strong desire for a forum in which to share their insights and learn from the experiences of other monitors. Without efforts by the government to attempt to capture the lessons of monitorships, however, it seems unlikely to occur on its own. Government intervention may be needed because some monitors may only conduct one monitorship and have little incentive to participate, while others that may seek additional monitorships in the future may view such information as proprietary.\textsuperscript{240} For example, one monitor stated:

I think there’s also the dynamic that people are competing with one another . . . . It’s kind of like in your world, you know the other people who are in your space. Sometimes you collaborate with them, sometimes you don’t.

2. Impacting the Organization

The mere presence of a monitor has the potential to create significant change in how the corporation approaches its internal controls and compliance and ethics program. First, it forces the company to direct attention and resources to compliance and ethics.\textsuperscript{241} For some corporations, compliance programs are simply a cost that they try to minimize. The company seeks to “buy” just enough of a compliance program that it has some protection in the event that internal wrongdoing comes to light.\textsuperscript{242} The settlement agreement and presence of a monitor forces such corporations to direct more resources to this function and in some cases even to hire an officer for a new position of chief ethics and compliance officer, or develop a compliance committee on the

\textsuperscript{240} See Jacobs et al., supra note 25, at 433–34 (making the same observation in the union trustee context).

\textsuperscript{241} For example, the U.S. Attorney in the Bristol-Myers Squibb case stated that: “Independent monitors are visible, on-site reminders that compliance with the terms of a deferred prosecution agreement is mandatory, not optional.” Christie & Hanna, supra note 179, at 1055.

\textsuperscript{242} Laufer, Corporate Liability, supra note 117, at 1382–1402 (discussing how corporations intentionally fail to meaningfully implement a compliance program but then still claim to have an effective compliance program when negotiating with prosecutors).
board of directors.\footnote{243}

Second, the monitor can grant legitimacy and power to the CECO. As noted earlier, the CECO may sometimes be pressured to end investigations or otherwise not live up to the job's requirements.\footnote{244} The monitor gives the CECO more clout to resist that pressure. For example, one CECO reported using the monitor to ensure that management and the board would support what the CECO wanted to do. By putting the CECO's recommendations in the monitor's report, the monitor essentially forced management and the board to agree to a plan they might have otherwise resisted.\footnote{245}

Likewise, one interviewee stated:

There will be competing views within the corporation. The lawyers in the corporation may not have the standing that they ought to, and they may take one position, the business people may take another, and the [monitor] is in a position where he can, forgive the whole phrase, speak softly, but carry a big stick.

Third, the presence of a monitor can be a sufficiently disruptive force to cause the company to conduct a meaningful re-evaluation of its practices. One monitor noted that because there was a "cop on the beat" at the corporation, employees started to act as they ought to under the compliance program. Eventually, the monitor hoped, appropriate social norms would develop and, due also to the other reforms, officers and employees within the corporation would continue to act that way after the monitor was gone.\footnote{246}

Although the presence of the monitor can have an immediate impact, to sustain this impact over the long term the corporation must be committed to the underlying reform goals behind the monitorship process, or at least the idea of adopting a meaningful compliance program. To do this, the monitors agreed that there must be some degree of buy-in from the corporation and trust between the monitor and corporation. As mentioned earlier, there is always the potential for corporate resentment to the monitor's presence and the costs they are imposing on the corporation. To get the necessary buy-in, some monitors commented on the need to have a meaningful dialogue with the company, as opposed to simply lecturing the company.\footnote{247} Some monitors believe (and many compliance professionals agree) that if reforms are to have a lasting impact, they need to be the product of an endogenous learning process at the company, and not imposed in a top-down manner.\footnote{248} This approach appears to be in significant contrast with the approach used by Richard

\footnotetext{243}{For a settlement agreement with these requirements, see Computer Associates, supra note 201, ¶ 12-14 (discussing the addition of independent directors to CA's board of directors and the development of an ethics and compliance program).}

\footnotetext{244}{See supra note 115 and accompanying text (recounting an interview with a compliance consultant who claimed an awareness of a number of cases where a compliance officer was pressured to back off compliance efforts).}


\footnotetext{246}{Id.}

\footnotetext{247}{See, e.g., id. These comments echo those made by Richard Gruner 20 years ago with respect to the potential benefits of corporate probation. See supra notes 63–64 and accompanying text.}

\footnotetext{248}{LRN.com, supra note 245.}
Breeden at WorldCom. Mr. Breeden’s *Restoring Trust* report seemed to consist of his own views as to what that corporation needed to do, as opposed to working with the management team to develop solutions with them that made the most sense for that company. Of course, one could argue that WorldCom was so pervasively corrupt that a monitor’s only hope for success would be to adopt an Autocrat role. Yet, at least one monitor we spoke with described a decision to define the assignment in direct distinction to the Breeden model:

Well, I don’t know that much about how Mr. Breeden went about his job, but reading his report led me to think that he may have a different view of how you handle this than I did. That is to say, I think, and maybe it was a function of the company he was in, or the circumstances, I don’t mean to second guess him, but my impression was that he was much more coming up with solutions and imposing them on management than doing the sort of advocacy that I advocate . . . . I would say that I set that paradigm, if you will, and worked against it. Whether it’s a fair description of Mr. Breeden or not, I sort of created that image of how one might do the monitorship and then I worked against it, because I didn’t think it was—as I got into my job—I didn’t think it was the right way to handle things . . . . But I hasten to add . . . that there are times when you’ve got to say, this is the way it’s going to be. When there’s a serious problem, or something that really requires immediate attention, or raises very clear ethical issues. Plainly, under those circumstances, you don’t wait around or allow the company to take anything less than the completely ethical position on a given issue.

### 3. Accountability and Role Conflict

In addition to advising the corporation on its compliance program, the monitor is also charged with monitoring the corporation’s compliance with the settlement agreement, and may be under an obligation to disclose or investigate other relevant instances of wrongdoing. Thus, the role contains inherent tensions.

The majority of our monitor interviewees agreed that there was some tension built into their role, but they thought it had a minimal impact on their work. Some monitors pointed out that their role did not contain any more conflicts than the kinds of roles they were accustomed to as lawyers and prosecutors. Others told us that the conflict was minimal, either because everyone understood the monitor’s position as an independent and credible third party, or because all parties ultimately wanted the same thing: for the company to adopt an effective compliance program and for the monitor to be able to verify that such a program was in fact adopted. As discussed further below, this smoothing over of the inherent tensions in the role may create other problems.

In terms of accountability, the Morford Memo’s second principle states: “A monitor is an independent third party, not an employee or agent of the corporation or of

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249. See *supra* Part IV.A.3 (discussing the duties of corporate monitors and the functions they serve).
250. The same observation was made three decades ago in the context of special masters in prisons. See Note, “Mastering” Intervention in Prisons, 88 Yale L.J. 1062 (1979).
the government.\textsuperscript{251} The monitors we spoke with generally endorsed that position. While DPAs are filed with the court, the monitors we spoke with did not report having a significant relationship with the court. Some monitors suggested that they were generally accountable to the relevant regulator or prosecutor, in the sense of writing their report for that audience. Among the monitors we spoke to, however, many had concluded that in their final analysis they were answerable only to themselves, and that their actions were constrained by the desire to maintain their own professional reputation. This raised concerns for others: "(M)onitors aren't infallible, they can run amok, they can miss things, they can overcharge, they can create more problems than they solve, and they've got to be answerable to somebody."

4. Reports and Follow-Up

At the completion of the initial investigation and during various other stages of the monitorship, the monitor is required to draft a written report and present it to the company and the government. Some monitors sought input from the company in drafting the report. One monitor stated:

Sure, the monitor wants to write a good report that makes useful recommendations; so if they show a draft to the company, the company can say maybe you just got this one wrong, and we can show you information that you made the wrong decision, and they will be able to persuade the monitor or not. Not letting them talk is like a doctor giving a pain reliever and not asking if it's working.

In another case, the settlement agreement prohibited the monitor from sharing the report with the company until a preliminary version had been submitted to the government.\textsuperscript{252} Any concerns the company had with the report were to be submitted in writing to the government and the monitor, and the monitor could then respond to the comments as he saw fit.\textsuperscript{253}

During their investigation and drafting of the report, the monitors had a variety of experiences with respect to their interactions with the government. Although some monitors indicated an ongoing dialogue with the government independent of the company, others reached out to the government only if they reached an impasse within the company. Still others indicated that their only contact with the government was the submission of reports. In general, structured input from the government during the monitor's investigation and development of the report did not seem to be the norm. Instead, the government simply reviewed the report as submitted. The general impression was that these reports were read closely and the government would have questions for the monitor. However, as discussed below, no structured institutional mechanism exists for deploying or leveraging the learning beyond that reading for that particular case. In one case—Bristol-Myers Squibb—the settlement agreement required

\textsuperscript{251} Morford Memo, supra note 157, at 4.


\textsuperscript{253} Id. It should be noted that that agreement also provided for significant direct interaction between the monitor, the corporation, and the U.S. Attorney's office. See infra text accompanying note 254.
that the company, including the CEO and general counsel, meet each quarter with the U.S. Attorney's Office and the monitor in conjunction with the filing of the monitor's reports.\textsuperscript{254} Such a formal meeting process seemed to be unique, however.

With few exceptions,\textsuperscript{255} monitors' reports are not made public. There are several arguments in favor of making the reports public. First, the reports would allow monitors to learn from each others' experience. Second, it would provide the greater compliance community with additional information on what the government is looking for with respect to being able to demonstrate that a compliance program is effective. Third, it provides greater accountability to the public, since interested parties would be able to determine if corporations were in fact rehabilitated, or if they "got off easy" for their wrongful behavior.

On the other hand, most monitors thought that a nonpublic report provided significant benefits to the monitorship process. The primary benefit was providing an environment for open communication, as stated by one monitor:

[The chances of identifying and observing... important issues and corporate behavior go way up if your report isn't going to be on the front page of the business section of The New York Times. You know, people are going to be much more willing to even seek you out, or at least answer your questions. I've found that there were people hungry to talk to me when I did my job.]

5. Cause for Concern in Conducting the Monitorship

The combination of settlement agreement language that is open to interpretation and the selection of monitors without a background in compliance and ethics programs can lead to a monitorship that follows a simple Advisor or Auditor model regardless of what the situation calls for. Under this model, the monitor looks for technical compliance and the presence of the appropriate policies and procedures, but does not go deeper into the workings of the organization to determine if those policies and procedures are supported by an organizational culture that will ensure they are effective over the long term. Although the Auditor model may be appropriate in some situations,\textsuperscript{255} for organizations with a history of significant wrongdoing it does not ensure against the possibility that the corporation only adopts a "paper program."

This problem can be somewhat alleviated through a work plan, developed jointly and in advance, which clarifies all parties' expectations of the monitorship. It is unclear if the joint, ex ante development of work plans is becoming standard practice. The work plan, however, may still not force a monitor from an Auditor role to an Associate role. The DOJ hires the monitor for his or her expertise in these areas. The prosecutors

\textsuperscript{254} Bristol-Myers Squibb, supra note 252, ¶ 13.


\textsuperscript{256} See supra Part IV.A.4 (discussing the four general categories—Advisor, Auditor, Associate, and Autocrat—of the monitorship continuum).
involved may not know the right questions to ask or what is required for a successful work plan that ensures the monitor adequately studies the organization's culture. The corporation, which wants to ensure it receives positive reports from the monitor and completes the monitorship with minimal disruption and cost, may push for an Auditor role. In addition, the selection of the monitor may not be providing the type of expertise needed, and therefore the monitor is also not pushing for a deeper investigation. Thus, although the settlement agreement may be drafted to ensure the corporation adopts an effective compliance and ethics program, no one present during a work plan negotiation may be pushing for what it would actually take to develop, implement, and test a compliance program, based on best practices from compliance experts. This is not to say that something akin to the Auditor model is never appropriate, but in situations where there is widespread wrongdoing and significant reform is needed, the current choices seem to work against the more comprehensive Associate model being adopted when it would be the most valuable model to use.

Furthermore, a corporation may argue that an expensive and lengthy monitorship potentially required by the Associate model harms current shareholders. This would mirror the criticisms of Sarbanes-Oxley section 404 to the effect that the mandatory procedures are expensive and provide little benefit. Instead of an expensive monitorship, corporations can argue that they will agree to adopt and improve their compliance programs, but that a monitor will not add much value beyond what they would get from hiring a compliance consultant, for example. If a monitor is imposed, the company will use those arguments to push for a more limited Auditor or Advisor role. Multiplying these effects is the possibility that financial industry regulators will share these concerns, along with a desire to move the case forward, close the file, and return the corporation “to the fold.” This may partially explain the difference between the corporate regulatory monitorships and those in the noncorporate (and especially RICO) context. Corporations, unlike mob-ridden unions, attract a certain presumptive support from professional regulators. They are not utterly “broken,” there is no public appetite for government to “run” public corporations, and they serve important public and private functions, so one should tread lightly.

D. Termination and Post-Monitorship

Although settlement agreements commonly allow for the monitorship period to be extended if needed or for the agreement to be terminated upon breach by the corporation, thereby releasing the government from its obligations, monitorships seem to end when the originally stated time expires. As one example, Bristol-Myers Squibb’s monitorship ended at the expiration of its term, even though additional wrongdoing had been discovered and the CEO was forced out due to involvement in

257. Of course, part of the monitor’s job should be to show the corporation how an effective compliance program adds value to the corporation and reduces liability risks.
258. See generally Robert Prentice, Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404, 29 CARDOZO L. REV. 703 (2007) (reviewing the criticisms related to the costs SOX section 404 imposes on corporations and then reviewing empirical evidence that Prentice argues shows that those criticisms are overblown).
that wrongdoing.\textsuperscript{259} The monitor's report, however, praised the company for its "reformation of the company's corporate culture into one that embraces and endorses a commitment to compliance, ethics, integrity and excellence, and encourages open and participatory communication throughout the organization."\textsuperscript{260} The monitor also praised the company's "outstanding global compliance program, whose policies, processes and procedures are designed to ensure a culture of integrity and ethics that enables Bristol-Meyers Squibb (BMS) to conduct its business worldwide in compliance with all applicable laws, regulations and other governing policies."\textsuperscript{261} Strikingly, only a few months later, the company reached another settlement with the DOJ and paid over $300 million for wrongdoing related to fraudulent pricing and marketing practices.\textsuperscript{262} As part of the new agreement, Bristol-Myers Squibb entered a Corporate Integrity Agreement (CIA) with the Office of Inspector General of the Department of Health and Human Services, which required the company to adopt numerous compliance program features.\textsuperscript{263} Although some of the wrongful conduct giving rise to this settlement occurred during the time the monitorship was in effect, the U.S. Attorney agreed to the settlement based in part on the monitor's account of how the company had improved its compliance program.\textsuperscript{264}

Once a monitorship ends, ideally, as indicated by Jacobs in relation to union trusteeships, a debriefing process should take place.\textsuperscript{265} This is a necessary process to build a foundation of knowledge on what practices have worked and what have not, and how the process can be improved. This is not being done, however, either through a community of monitors or by the government.

The absence of meaningful follow-up means it is difficult to vouch for the accountability or success of monitorships. As one of our interviewees memorably put it:

> Maybe it turned out okay, maybe it didn't, maybe nobody knows, because there's nobody out there evaluating these things. And unless a company gets caught doing something improper again nobody may find out whether the deferred prosecution agreement worked or didn't work.

Although our analysis has generally discussed criminal-side and civil-side monitorships together, there are significant differences in the contexts in which the

\begin{itemize}
\item \textsuperscript{259} Stephanie Saul, \textit{Drug Maker Fires Chief of 3 Years}, \textit{N.Y. Times}, Sept. 13, 2006, at C1.
\item \textsuperscript{261} Id.
\item \textsuperscript{264} Bristol-Meyers Press Release, supra note 262, at 3.
\item \textsuperscript{265} JACOBS, supra note 21, at 246-47.
\end{itemize}
monitorships are enacted that should be taken into account. Most important, unlike a
regulator, a criminal prosecutor does not have the institutional structure for following
up on a monitor’s report. Several of the civil-side regulators we spoke to told us that
their organizations’ practice was to pass monitors’ reports onto their
compliance/examinations departments, which would use the reports as blueprints for
subsequent compliance examinations and audits. This means that individuals with
expertise in at least auditing firms for compliance have regular opportunities to
evaluate the firm’s or company’s progress past the end of the monitorship. Prosecutors’
offices have no such built-in structure.

That said, even within the regulatory context, there is a clear distinction between
regulated entities and public companies, in terms of the kind of follow-up and
oversight they can expect. Broker-dealer firms and other regulated entities operate in a
highly regulated environment and are required to be in contact with their regulators
through a number of prescribed mechanisms. Nothing similar is required of public
companies as a condition of listing—and most people would probably agree that
nothing similar should be required.266 Given that public companies are not going to be
closely regulated, monitorships may need to provide more explicitly for meaningful
follow up, including perhaps longer terms for the monitorships themselves. Without
such follow up, it is difficult to determine if a monitorship had any long-term impact
short of evidence to the contrary from a similar compliance problem emerging at the
same company.

V. TOWARD MORE MEANINGFUL MONITORSHIPS

A. Monitorships in Theory and in Practice

Earlier we placed monitorships on a continuum with four general categories—
Advisor, Auditor, Associate, and Autocrat—showing the range of possibilities from the
least ambitious monitorship to the most ambitious.267 Typically, it appears that the
government does not intend for the monitor to serve an Autocrat role, and with a few
exceptions monitors have not taken on such a role. At the other extreme, an Advisor
role may be appropriate where the government is comfortable that the wrongdoing is
not widespread throughout the organization or being intentionally (or unintentionally)
encouraged by the organization’s culture. Thus, an investigation may show that the
wrongdoing was in fact due to just a few rogue employees, and an Advisor is necessary
to help the corporation modify its compliance program and internal controls
appropriately, as well as to ensure that appropriate resources are directed to the
compliance program. In such a case, only technical adjustments to a company’s
policies or procedures are deemed necessary. Perhaps such a case should not even be
termed a “monitorship,” as independence may not be necessary.268

266. As an exception, see James Fanto, Paternalistic Regulation of Public Company Management:
Lessons from Bank Regulation, 58 Fla. L. Rev. 859, 862–63 (2006), for an argument for the SEC to
“appoint a corporate governance monitor for certain public firms who would have a role like that of an
examiner of a large bank or financial holding company,” but also recognizing that his proposal is unlikely to
be adopted.
268. See supra Part IV.A.5.
The Auditor role is one step above the Advisor, and may be called for in substantially similar situations but where the government (1) has less confidence in the corporation's ability or desire to make the needed changes or (2) has been impressed by observed compliance program changes made by the corporation during the course of the investigation leading up to the settlement.\(^{269}\) In cases where the wrongdoing spreads beyond a small number of individuals or there is evidence that organizational pressures or social norms were key contributing factors to the wrongdoing, then the Associate model may be needed. Under this model, the monitor investigates the root causes of wrongdoing—including all facets of the organizational culture—and collaborates with the corporation in a discursive, open-ended investigative project. There appear to be some cases where this is occurring.\(^{270}\)

In the appropriate situations, the Associate model is the kind of monitorship that, in theory,\(^{271}\) offers the greatest possibility of long-term, meaningful reform of corporate operations, as compared to the other models and the simple use of sanctions and other deterrence-based fines. Unlike financial sanctions, monitorships cannot be dismissed as just a "cost of doing business." Instead, monitorships should work toward institutionalizing a self-reflective process within corporations that will address underlying causes of misconduct in the organization and implement, and then continually revise, an effective compliance program that is embedded within the organization’s culture. What makes monitorships so promising in theory is that they are an institutionalized, structured mechanism for disrupting other, problematic institutions and structures. Disrupting existing ways of doing things also can help to reform a corporation, because sweeping away or rejecting the status quo can open up a space for reconsidering fundamental assumptions.\(^{272}\) Without the monitorships, this process of change is unlikely to occur in many corporations.\(^{273}\) For example, as one of our interviewees stated:

The greatest problem to effect change is the inevitable loss of momentum

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\(^{269}\) During the course of an investigation—which can last many months—the corporation will terminate wrongdoers and improve its compliance program in the hopes of obtaining credit for cooperation. One monitor raised the issue of whether there are cases where the government should end its investigation early and start a monitorship as soon as possible, thereby having the monitor directly involved in the changes the company is undertaking (as well as potentially saving the corporation significant costs related to defense attorneys and duplicated efforts). In some ways this occurred at Bristol-Myers Squibb, when the independent advisor the company hired to review their compliance program during the investigation stage was later hired as their monitor. See supra notes 207–10 and accompanying text. A full consideration of the issues raised by this proposal is beyond the scope of this paper.

\(^{270}\) The public statements of the CECO and monitor in the Computer Associates case seem to suggest that this was a successful monitorship based on what we term the Associate model. LRN.com, supra note 245. However, virtually all top management at Computer Associates was replaced as part of the process. A much harder case is one in which top management stays.

\(^{271}\) See generally Ford, supra note 52 (discussing reform undertakings—which focused on civil-side monitorships—as a form of New Governance regulation).

\(^{272}\) This is one of the key points made by Sabel & Simon, supra note 19, at 1073–82. See also Ford, supra note 52, at 805 (affirming that reform is a "wake up call" to firms to change).

\(^{273}\) See Vikas Anand et al., Business as Usual: The Acceptance and Perpetuation of Corruption in Organizations, 19 ACAD. MGMT. EXEC. 9, 20–21 (2005) (arguing that an external change agent is often needed to reverse corrupt organizational cultures); see also supra notes 241–46 and accompanying text (describing the potential benefits from simply a monitor’s presence in an organization).
that occurs inside an entity once the crisis has passed. Just the everyday pressures that exist to do whatever business it is, to deal with whatever crisis there is, gets in the way of actually completing whatever it is people agree is the right thing to do. So having an independent consultant involved in the process puts a framework around it, just like program management does to cause ordinary change to take place. You need the discipline of someone outside the organization who’s got a timeline, who’s got to report to somebody. You have to have an end date. When you have those things, then you’ve managed to meet all the milestones and get it done.

Monitorships require the corporation to pay direct attention to the reasons for its past compliance failures and, with the prodding of a capable monitor, rehabilitate itself. This process should separate the reform effort from the enforcement action and allow a deep and demanding, but flexible and open-ended reform process to evolve as needed over a period of time.274 By separating enforcement and reform, corporations are expected to take a less adversarial stance and engage in less calculated cooperation,275 and instead engage in a more open and discursive process that has a better chance of gaining company buy-in to the process. In the background, the “big stick” of enforcement should help ensure the corporation is taking the process seriously.276

In practice, however, monitorships that have the goal of reforming corporations are at risk of falling short. They rarely appear to be doing what compliance consultants would say is necessary to ensure the corporation’s compliance program is effective and will result in reforming a corporation’s culture over the long term. They also seem to be failing at generating the necessary self-reflective process. Even in cases where there is widespread wrongdoing within the organization, it seems the monitor is typically assuming the narrower Auditor role over the more in-depth Associate role. In this section, based on the evidence we have,277 we explain why this may be occurring. This is not to say that successful monitorships do not and cannot happen where the Associate model is required, but that those successes seem to be due to self-motivated individual efforts and not due to an effective system that produces consistent results.

A key potential cause is that the incentives and motivations of the three actors involved in the monitorships (the company, the government, and the monitor) can come together in such a way that the monitorship process settles for a significantly lower level of operation and ambition than we would hope for. Although the parties’ interests may be aligned in the ways described above,278 they may not be aligned with

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274. Ford, supra note 52, at 822.
275. Hess & Ford, supra note 139, at 330 (using the term “calculated cooperation” to describe how the government granting corporations benefits for cooperation with the investigation creates incentives for “corporations to scapegoat certain employees to end the governmental inquiry without adequate examination of the organizational causes of the wrongful act”).
277. The limitations of this study are identified above. Supra note 126 and accompanying text. As stated earlier, we hope that this report will be a springboard for additional study into the actual operation of monitorships, including more in-depth studies undertaken not only by academics housed in business and law schools, but also by other organizations with an interest and stake in corporate governance, ethics, and regulation.
278. See supra Part IV.C.5.
the long-term best interests of shareholders or the public. Specifically, the corporation wants a monitorship that is just rigorous enough to allow the monitor to write a report that can satisfy the government; it does not want a monitorship that is broader in scope or more expensive than it has to be. The monitor wants to conduct an investigation that will enhance or at least not adversely affect her professional reputation and oversee a compliance program implementation that allows her to write a credible report for the government. Interestingly, if the use of monitorships continues to increase, some monitors seek to obtain future monitorship appointments, and the company has some meaningful say in the selection of the monitor, then monitors may actually come to operate in a more company-friendly manner. According to compliance consultants we interviewed, because the monitor has an eye to her next appointment, she may be careful about implementing too onerous a monitorship. Even if a monitor is not seeking additional monitorships, she may still conduct a company-friendly monitorship because of the natural tendency to view the corporation as a client, and the desire to “add value” for that client.

The government also may not push the monitor and the company to go beyond a basic Advisor or Auditor model of monitorships. The prosecutor wants to close his file in a way that is reasonably calculated to ensure that the subject corporation has at least decent, industry-standard compliance processes in place (at least on paper), and then move on to the next case. The prosecutor does not want similar problems to recur at the same firm in short order, but separate fines and sanctions against individuals can go some distance here too. On the other hand, mindful of criticisms about monitors running amok, the prosecutor does not want to be unreasonable or to force the company, or more specifically its shareholders, to incur costs that are more burdensome than they have to be.

The end results of these factors can be relatively conservative monitorships focused on technical compliance with policy and procedure requirements. There is

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279. As one observer told us:

You put the rabbit in the hat. I mean you started with the assumption that everybody wants the same thing and if that’s true then it makes your job very easy because what you need to do is to provide guidance and to document the cultural changes that have taken place in the organization, so it makes it very easy if that’s the case. But it’s not necessarily true. A deferred prosecution agreement may be put in place because that’s the easiest way to bring a criminal case to a conclusion and the people who are running the company feel that they are getting off lightly . . . . . . It’s the culture that determines how people are going to behave in the organization, not any particular individual. Unless you bring about cultural reform you’re probably destined to repeat some form of misconduct at some point in the future as soon as the pressure is off.

280. The three monitorships since the Merford Memo, and at the time this research was conducted, have all allowed the corporation to pick the monitor with the government retaining a veto power. Faro Technologies, supra note 170, at app. C, ¶¶ 1–2; Willbros, supra note 175, at Attachment D, ¶¶ 1, 3; AGA Medical, supra note 175, at Attachment D, ¶¶ 1–2.

281. Clearly, an effective compliance program can and should add value to a company, and even compliance consultants market themselves as claiming to add value to the company. There will be situations, however—especially here, in the enforcement context—where appropriate implementation of a compliance program requires some tradeoffs between at least short-term value and accountability. Monitors must ensure that they are considering not just company value and company concerns, but ensuring accountability to the government and the public more generally.
little interest in a drawn-out, discursive process and no one seems to have an incentive to attempt a "deep dive" into issues of corporate culture. Even if the corporation itself may be motivated to do so, it may rationally choose not to deal with such issues with a corporate monitor who is not in an attorney-client privileged relationship with the corporation. Thus, despite any initial aspirations, the pressure on the monitorship structure is downward—toward the Advisor or Auditor model.

A second major cause of low-ambition monitorships—which also impacts the motivation of monitors discussed above—is the type of monitor that is being selected. As indicated earlier, the corporation wants to pick a monitor that has credibility with the government, and the government wants a monitor it can trust. The end result is the selection of a monitor that closely resembles a prosecutor's profile (and commonly is an ex-prosecutor), which deeply affects the subsequent path the monitorship takes. The monitorship becomes a process designed by prosecutors, run by former prosecutors, and for ultimate consumption by prosecutors. As one monitor pointed out to us, the corporation only has "one shot at it," and the stakes are high. It is not a time to take risks when a consensus is emerging about what constitutes an acceptable monitorship. The risk of a future problem emerging because underlying cultural issues have not been addressed feels remote in the middle of an acute incident, and people tend to discount future risks in favor of present needs in any event. In addition, without a system for tracking, aggregating, and sharing experiential and outcome data between companies or between U.S. Attorney's offices, the actors create the features of each monitorship in an environment of uncertainty and are likely to simply follow the lead of those who came before. In the end, with each subsequent monitorship, the conservative, technical compliance-oriented model is reproduced through a process similar to what organizational sociologists call mimetic isomorphism.

B. Reform Recommendations

The shift toward the Advisor and Auditor end of the spectrum is not necessarily an intentional choice, but the result of choices along the way in a process that is influenced by the various motivations and incentives of the actors involved. Returning to our simplified four-stage monitorship model, we can identify decisions at each stage that affect the subsequent possibilities and generally push toward a less ambitious monitorship. These problems suggest various reforms to better structure a monitorship to meet the needs of the case at hand and to develop systems to help ensure monitorships improve over time.

At the negotiation stage, the terms of the agreement are drafted in a way that leaves significant interpretation to the monitor. Although flexibility is one of the key virtues of monitorships, their effectiveness calls for more careful and context-specific


283. See Paul J. DiMaggio & Walter W. Powell, The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields, 48 Am. Soc. Rev. 147, 151–52 (1983) (developing the idea of mimetic isomorphism, which involves organizations copying each other in the face of uncertainty due to the legitimacy established by the prior actor and not due to their fitness for the environment).
thought upfront about the monitor's exact role and the scope of monitorship. Second, parties are selecting monitors with a prosecutor's mindset and skill set, as opposed to someone more closely identified as a compliance professional. Third, during the course of the monitorship and as a function of the two choices made above, monitorships tend to focus on technical compliance and easily measurable outcomes. Although we have been unable to review monitor reports in the for-profit corporation setting, our estimation based on our interviews is that "corporate culture" is used more as a buzzword than as a meaningful construct. Finally, at the post-monitorship stage, efforts to capture learning from monitorships and apply it to other ones are virtually nonexistent. Instead, patterns are reproduced from one monitorship to the next based on precedent, rather than clear thought as to whether they are appropriate to the new situation.

In the remainder of this Article we provide recommendations for reform at each of these stages. We should note that our conclusions are limited in that we have had virtually no access to monitor reports and we have only had contact with a small sample of actors involved in monitorships. That said, even if more monitorships have been deeper and more consistent with compliance industry knowledge than we surmised, the systematic problems we identify are real in some number of cases and could easily become the norm if they are not monitored and managed appropriately. In addition, these reforms will not lessen the effectiveness of already successful monitorship models, but will only work to strengthen them and improve the chances for success for all monitorships.

1. Crafting Monitorships for the Case at Hand

Once the government decides to agree to a monitorship, it needs to clearly articulate the reasons that it came to that conclusion. In addition, and flowing from that original rationale for the monitorship, the agreement should be more specific on what role the monitor is expected to adopt. The challenge in many situations, however, is determining the corporation's reform needs before the monitor has started her work.

Currently, the government relies on its own investigation, which in turn relies heavily on the company's internal investigation. Many corporations conduct proactive internal reviews when internal wrongdoing comes to light. An important policy reason for granting corporations "credit for cooperation" is that it allows the government to essentially outsource its investigations. As one interviewee stated, "The good thing about it is that it leverages the government's resources. I mean, with a handful of prosecutors you can be running many huge investigations of big companies, which if you had to staff it with your own people you'd never be able to do." These investigations can be a valuable source of information. For example, they may demonstrate that a corporation's compliance program is clearly inadequate.

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284. See supra note 126 and accompanying text.

285. Of course this outsourcing has been controversial, especially with respect to the perception that the government routinely requires corporations to waive attorney-client privilege in order to be considered cooperative—a concern that the revised charging guidelines for corporations addresses. See supra note 91.

286. See, for example, Faro Technologies, supra note 170, ¶ 22, whose compliance program did not include training employees on the requirements of the Foreign Corrupt Practices Act and did not appoint
However, internal investigations are not equivalent to a monitor's investigation and their context must be taken into account. For our purposes, a central concern is that internal investigators are motivated to identify individual "bad apples," and away from identifying deep problems of corporate culture. Thus, the government should not automatically assume, based on an internal investigation, that there is no need for a more ambitious, Associate-style mentorship.

One possible solution is to follow the lead of the U.S. Attorney in the Mellon Bank case, who hired compliance consultants to investigate the company before she agreed to a DPA. Although there are of course significant limits on the ability of such consultants to determine the state of compliance at the time of the offense (which typically includes acts that have occurred months or years ago), the consultants can investigate the current state of compliance to make a recommendation as to whether they believe the company is at risk of engaging in similar activity in the future. This recommendation can then be used by the parties as they negotiate the terms of the settlement, including the role of the monitor.

Next, to ensure the monitor conducts an appropriate investigation and follows the desired mentorship model, the basic structure of a work plan should be incorporated into the settlement agreement. This ensures that, where a complete and thorough investigation of the company's ethics and compliance program and organizational culture is called for, this is actually what the monitor does. It also should help weed out potential monitors who do not have the skills and experience to conduct this type of investigation. In addition, it may be useful to have some form of the final work plan made available to the public (in a redacted form if necessary to protect any legitimate privacy concerns of the corporation) for purposes of accountability and information sharing for future mentorships. This more direct guidance upfront still allows the mentorship to develop and evolve in a manner that meets the needs of the situation, but (along with other necessary reforms) helps ensure that the monitor does not move to a lower ambition mentorship, such as an Advisor or Auditor role, where the needs of the situation do not justify that move.

2. Selecting the Monitor: Competency Versus Credibility

One thing we heard from several monitors is that, ultimately, the success of the mentorship comes down to the personal qualities of the monitor chosen. Several monitors emphasized the importance of professional judgment. At its starkest, we heard that it may be "impossible for mentorships to be institutionalized" because "[t]he kind of self-restraint, the kind of self-critical analysis, the kind of self-discipline that you need to be a monitor is very, very, very unusual and there's nothing that really prepares you for it." This observer told us about the "intellectual and emotional discipline" required to do the job:

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anyone to monitor the company's compliance with anti-corruption laws.

287. Ford, supra note 52, at 792-96; see also Lauf, Corporate Prosecution, supra note 117, at 648 (describing a problem he calls "reverse whistle blowing," which "occurs when an organization, typically through the acts of senior management, identifies culpable employees and offers evidence against them in a trade with prosecutors for corporate leniency or possible amnesty").

288. See supra notes 164-69 and accompanying text.
You[‘ve] got to be prepared to pull the plug and quit, or you[‘ve] got to be prepared to turn on the people that you[‘ve] come to like and feel are supportive, or you[‘ve] got to be prepared to defend people that you don’t like depending on the circumstances that you find yourself in. And you[‘ve] got to do it in a way where every time you make a judgment, every time you express yourself you can back up your conclusions with overwhelming evidence that you’re correct and you can’t afford to make a mistake, it’s a zero defect kind of a role.

Accepting the difficulties of the job and the inherent tensions in it, there are still steps that can be taken to increase the possibility of an effective monitorship. Of primary importance is finding the monitor with the right skills for the monitorship at hand. The Morford Memo is correct in stating that the corporation should maintain responsibility for designing its compliance and ethics program because only corporate managers, and not the monitor, have duties to shareholders. 289 The point is not to have monitors take over corporations and their compliance programs, because there can be more than one way to implement a compliance program and each can be equally correct and effective. It should be the corporation’s choice on which approach to take, as long as its choice is reasonable and it can convince the monitor of the likely effectiveness of the proposed approach.

To determine this effectiveness, the monitor must have sufficient experience with the workings of ethics and compliance programs in practice. This does not mean simply technical compliance with legal requirements, but an understanding of how matters that affect a corporation’s culture, such as rewards systems, impact the effectiveness of a compliance program that looks complete on paper. These issues go to the heart of the monitor’s effectiveness. Overall, as one compliance consultant told us, there is a reason why the compliance profession has developed, and it is that lawyers focused on technical compliance were not getting the job done. 290 Because the monitor’s primary duty is to ensure the corporation has an effective compliance program, then those individuals with the experience and skills to serve as a chief ethics and compliance officer should be the first people considered for the position.

The current dominant use of ex-prosecutors and similar attorneys as monitors was not a conscious choice resulting from a consensus that corporate compliance problems will be addressed most effectively by using such monitors. The terms of the monitorship agreements we reviewed do not specify this preference, and, indeed, the Morford Memo explicitly states that nonlawyers can do this work. 291 To address the

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289. Morford Memo, supra note 157, at 5. Principle 3 states: "A monitor is not responsible to the corporation’s shareholders. Therefore, from a corporate governance standpoint, responsibility for designing an ethics and compliance program that will prevent misconduct should remain with the corporation, subject to the monitor’s input, evaluation and recommendations." Id.

290. We are not saying that monitors whose primary experience is having been a prosecutor or white-collar defense attorney cannot get the job done (and there seems to be evidence that they can). What we are saying is that the prosecutorial model of lawyering seems to be under-equipped to do this job in many cases, especially those we have deemed appropriate for an Associate model of monitorship, see supra notes 269–70 and accompanying text, and should not on its own be considered either a necessary or a sufficient requirement for selection as a monitor.

ossification of this model, the government must be involved in the selection process and implement policies on the skills and experience a monitor should have, related to the growing body of knowledge from compliance professionals.

In selecting the monitor, there also must be some balance between the government selecting the monitor and the corporation selecting the monitor with the government only retaining a veto power. If the corporation has too much control over the process, then it may attempt to select monitors that are company-friendly. In addition, there is the potential for the monitor to begin to view the company as her client, especially if the monitor underwent an interview in which she had to convince the corporation to hire her. If the government has too much control, then it may select monitors through a process that raises legitimacy concerns (i.e., selected based on personal connections rather than merit) or that will not work well with the company. As stated earlier, corporate buy-in and trust of the monitor are key factors for a successful monitorship. Monitors should be selected through a process in which the parties select a mutually acceptable monitor. In addition, during the post-monitorship review (we suggest reforms in this area below\(^\text{292}\)), the government should collect data on the performance of the monitors and ensure that information is available to those government officials involved in the selection process.

Government involvement in the selection process—and greater contact with the monitor throughout the monitorship—also should help ensure monitor accountability and independence. The Morford Memo and most (but not all) DPAs place great importance on structural independence (meaning a monitor who has no prior business relationship with a firm, and who is precluded from taking one for a period of years after the monitorship). This does not, however, ensure independence of mind. At a subconscious level if not a conscious one, the fact that the company is paying the monitor may motivate the monitor to try to convince the company that he or she is “adding value” in much the same way that these same attorneys want their clients to see the value of the services they provide in the rest of their practice. Especially where the monitor is working on a close and daily basis at the company, with little contact with the government, the (conscious or subconscious) desire to have positive interpersonal interactions with key players can become significant. Thus, structural independence must be supplemented with other aspects of the monitoring process, such as greater contact and involvement with the government during the process. The government should be in regular contact with the monitor and provide written feedback with its assessment of the strengths and weaknesses of the monitor’s investigations and reports.\(^\text{293}\)

3. Compliance for the Long Term

The goal of a monitorship is to ensure that the corporation implements an effective ethics and compliance program. Although monitorships are typically 24 to 36 months in duration, they are expected to have an impact that lasts significantly longer.

\(^{292}\) See infra Part V.B.4

The first step in accomplishing this is designing a monitorship that can assist the corporation in uncovering root causes of misconduct, identifying persistent organizational culture hurdles standing in the way of adopting an effective ethics and compliance program, and assisting in identifying and implementing effective measures in light of these factors.294

To ensure lasting change, the next step must be to entrench the changes made during the monitorship into the operations and structure of the corporation. Susan Sturm has described, in a different context, how the "architecture" of an organization needs to be reconfigured to prevent backsliding at the end of an acute intervention like a monitorship.295 Con Ed’s monitorship appears to be an example of exactly that problem.296 In the context of forcing compliance reform on a corporation, a leading example is the use of Corporate Integrity Agreements that require certain structural changes.297 DPAs often require similar changes, such as the appointment of a chief ethics and compliance officer or the selection of independent directors to serve on the board committee with supervision duties over the compliance program.298

Thus, to help ensure that changes remain once the pressure is off,299 settlement agreements where the Associate mentorship model is required should likely include the following requirements. First, if the position does not already exist, the corporation should appoint a CECO and make that person part of the company’s high-level management. Second, the CECO should be an agent of the board of directors, at least as far as incentive compensation and termination decisions are concerned.300 Third, the corporation’s board should be required to adopt a compliance committee, and the CECO should have reporting responsibilities to that committee.301 During the course of the mentorship, the monitor should ensure that the CECO and compliance committee are performing their duties competently. In addition, and as discussed further below, information should be systematically collected on when and why such requirements are used, and this information should be combined with data collected by the monitor on how well these structural changes have worked.

296. See supra notes 65–66 and accompanying text (describing the Con Ed story).
297. See supra notes 54–55 and accompanying text (describing the use of Corporate Integrity Agreements).
298. See Aurora Foods, supra note 190, at 4 (requiring both the appointment of a compliance officer and two independent directors to serve on the audit committee; Baker Hughes, supra note 213, ¶ 7.b.iii (requiring the assignment of a corporate official to be in charge of the compliance program and requiring that person to report directly to the board’s Audit/Ethics Committee).
299. See supra note 279 (quoting an interviewee as stating, “Unless you bring about cultural reform you’re probably destined to repeat some form of misconduct at some point in the future as soon as the pressure is off”).
300. See supra notes 110–15 and accompanying text (describing the arguments for making the CECO an agent of the board of directors).
301. See Hess, supra note 94, at 1809 (arguing in favor of a compliance committee with authority over the CECO).
4. Post-Monitorship: Institutionalize Learning

One of the regulators we spoke with indicated that, with respect to the degree of independence they required of the monitor, the regulator organization had developed an informal policy to help ensure that burdensome independence requirements were not imposed where they were not necessary.\textsuperscript{302} This policy was apparently based, at least in part, on a review of its past monitorships. However, this same regulator did not see a reason to analyze the content of the monitors' recommendations in the same overarching manner to see, for example, if insights could be generated for handling the most common compliance failures, or if best practices in resolving common problems were starting to emerge. Many of our interviewees had not contemplated that much valuable information would come from this kind of exercise, especially considering the amount of work involved.

We believe that the absence of systematic methods for capturing the lessons of past monitorships is a major failing. As indicated above, the government must play some role in this process.\textsuperscript{303} Although monitors seek to have this information, they are reluctant to provide it to others either because they view it as proprietary information or they appropriately do not want to disclose confidential information about the corporation.

There are several reasons why there is a need to develop mechanisms to capture the learning from monitorships.\textsuperscript{304} First, costs are reduced by new monitors not having to reinvent the wheel for their monitorships. Monitors reported having no models to rely upon for developing a work plan or even drafting their report, and corporations are therefore required to pay the bill for their learning on the job. Second, to improve the effectiveness of monitorships, an effort must be made to capture best practices and review their evolution over time due to increased experience. Third, capturing these lessons also allows the government (including U.S. Attorneys without any experience with monitorships) to become more knowledgeable and therefore a more productive participant in the monitorships along the lines suggested above, including negotiating the settlement agreements, selecting monitors based on their skills and experience, and reviewing the monitor's work during the monitorship. This allows the four stages of a monitorship we identified above to function as a cycle, where the lessons from past monitorships feed into the next round of monitorships.

The lessons the government should attempt to capture include not just best practices on the monitorship process, but also indicators on the final performance of monitorships over time. This is vital information for determining if monitorships are

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\item[302.] See supra notes 205–06 and accompanying text.
\item[303.] See supra note 240 and accompanying text (providing arguments for the necessity of government intervention).
\item[304.] More generally, a number of New Governance scholars have emphasized the need for a "central data clearinghouse" or other similar structure to permit collective learning and disseminate best practices. See, e.g., Michael C. Dorf & Charles F. Sabel, A Constitution of Democratic Experimentalism, 98 COLUM. L. REV. 267, 345–56 (1998) (calling for agencies to engage in benchmarking, or "comparative evaluations" of one another, in order to ultimately achieve best practices); Sturm, supra note 295, at 410–22 (describing institutional intermediaries); see also MALCOLM SPARROW, THE REGULATORY CRAFT: CONTROLLING RISKS, SOLVING PROBLEMS, AND MANAGING COMPLIANCE 167–68 (2000) (expressing a desire for agencies to "organize the lessons they learn and to make the accumulated knowledge readily available").
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even working as a policy alternative. Overall, without an effort to analyze the experiences of monitorships and an attempt to distill the lessons to be learned, certain ineffective practices may become the standard without appropriate thought and evaluation.

VI. CONCLUSION

Like others, we are concerned with the development of corporate monitorships. Our concerns, however, have less to do with fears of unaccountable monitors running roughshod over corporations and more to do with monitors not conducting deep dives into the corporation's culture. As stated by the Ethics Resource Center—a leading nonprofit conducting research on organizational ethics—"Ethical culture is the single biggest factor determining the amount of misconduct in [an] organization."\textsuperscript{305} Likewise, to obtain the benefits of a mitigated sentence under the Organizational Sentencing Guidelines, a corporation must "promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law."\textsuperscript{306} In some cases, monitors are dealing with these issues to at least some degree, but in others they are not. Not delving into these issues may be the right decision in certain limited situations. In practice, however, this determination has less to do with a well-thought-out strategy to match the monitorship to the case at hand and more to do with flaws in the monitorship process. In cases where wrongdoing is widespread within the organization and social pressures toward corruption are great, the monitor must investigate a corporation's culture and force the corporation to address these issues if monitorships are expected to have a reliable impact on corporate behavior over the long term. We are not saying that technical, compliance-based monitorships are never useful. Having in place appropriate processes and procedures is important to corporate compliance and is the foundation of an ethical corporate culture. Thus, all monitors serve an important function in making sure that firms are structurally equipped to prevent and detect internal wrongdoing. What we advocate, though, is a monitorship process that incorporates some of the learning that has emerged from compliance professionals about the importance of organizational culture. The reforms suggested here—including rethinking who is qualified to serve as a monitor and capturing the lessons from experience—are simple steps toward creating more ambitious and more consistently successful monitorships.