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Toward a New Model for Securities Law Enforcement

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TOWARD A NEW MODEL FOR SECURITIES LAW ENFORCEMENT

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TABLE OF CONTENTS

Introduction ........................................................................................................... 758
I. Corporate Governance and Deterrence-Based Response ......................... 762
   A. Scope Concerns ...................................................................................... 762
   B. Relying on Massive Deterrence .......................................................... 766
   C. Administrative Enforcement and Institutional Reform .................... 774
   D. The Unique Enforcement Environment ............................................. 777
II. Problems with the Framework for Cooperation ........................................... 783
   A. The SEC Framework for Cooperation ............................................... 784
   B. "Cynical Happy-Talk": The Problem with Credit-for-Compliance ......... 788
   C. The Problem with Credit-for-Cooperation ........................................ 792
III. Reform Undertakings as Enforcement Innovation ....................................... 797
   A. Comparative Advantages ................................................................. 802
IV. Next Steps and Missing Pieces ................................................................. 806
   A. The Intervention: Attributes of the Process ....................................... 806
   B. Profile of the Third Party ................................................................. 810
   C. The Need for a Center ........................................................................ 814
   D. Ramifying Back to the Enforcer ....................................................... 817
V. Toward a New Enforcement Model ............................................................... 819
   A. Structural Advantages ....................................................................... 820
   B. Embedding New Governance .......................................................... 821
   C. Remedial Agnosticism ......................................................................... 823
Postscript: A Different Kind of Governance .................................................... 827

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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

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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, 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

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7. See infra Part II.
settlement has been concluded. 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. 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. 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

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), available at http://www.fbi.gov/doorpressrel/pressrel04/10 accuse 12
1504.htm; Deferred Prosecution Agreement, United States v. Computer Assocs. Int’l, Inc.,
prosagreement.pdf; Press Release, Department of Justice, PNC ICLC Corp. Enters Into
Deferred Prosecution Agreement with the United States (June 2, 2003), available at
http://www.usdoj.gov/opa/pr/2003/June/03crm_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), 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.
chargingdocs/merrilllynchagreement.pdf; see also Off the Hook: Deferred Prosecution
crimereporter.com. While Deferred Prosecution Agreements work on a similar model and
deserve their own analysis, they are beyond the scope of this paper.

9. Christopher Cox was recently sworn in as the 28th Chairman of the SEC. Press
Release, SEC, Christopher Cox Sworn in as SEC Chairman (Aug. 3, 2005), available at

10. See Deborah Solomon & John D. McKinnon, Off the Beat: Donaldson Ends an
SEC Tenure Marked by Active Regulation, 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. 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, 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

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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.¹³ 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 sociolegal 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 remuneratory 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.\textsuperscript{19} WorldCom also adhered to "'checklists' of recommended 'best practices.'"\textsuperscript{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 	extit{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.\textsuperscript{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,\textsuperscript{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."\textsuperscript{23} These are the "worst actors."

\textsuperscript{19} See William C. Powers, Jr. et al., 	extit{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).


\textsuperscript{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, 	extit{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.


\textsuperscript{23} Christopher Stone, 	extit{The Place of Enterprise Liability in the Control of Corporate Conduct}, 90 \textit{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 underscorescrutinize 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, the Enron-related financial services firm settlements, the market timing and late trading mutual fund company settlements, or those with public companies such as Quest Communications, Royal Dutch Shell, and Bristol-Myers. The SEC billion penalty, satisfied post-bankruptcy at $750 million).


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."\textsuperscript{36}

Former SEC Director of Enforcement Stephen Cutler described the era’s approach as "an evolution, if not a revolution, in thinking."\textsuperscript{37} 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:

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

\[ \ldots \]

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

Moreover, entities have the ability to influence strongly the compliance orientation of their own employees. \ldots 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.\textsuperscript{38}
The claim that Enforcement can "effect change on an enormous scale" suggests a larger systemic role than Enforcement historically has claimed.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{42}

I do not disagree that the \textit{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.\textsuperscript{43} Recent sociolegal 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

\textsuperscript{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, \textit{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. \textit{But see infra} note 201 and accompanying text.

\textsuperscript{40} \textit{See} Oliver Wendell Holmes, \textit{The Path of the Law}, 10 HARV. L. REV. 457 (1897).

\textsuperscript{41} \textit{See} Steven Shavell, \textit{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).

\textsuperscript{42} \textit{See infra} notes 106-18 and accompanying text.

\textsuperscript{43} \textit{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. \textit{See}, e.g., \textit{SALLY S. SIMPSON, CORPORATE CRIME, LAW, AND SOCIAL CONTROL} 40 (2002); \textit{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. Consider that the enforcement of law, like law itself, serves an expressive purpose. 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. 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. 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.

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

44. Making the same point in the broader criminal context based on psychological studies is Tom R. Tyler, Why People Obey the Law (1990).


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

50. See John T. Scholz, Enforcement Policy and Corporate Misconduct: The Changing Perspective of Deterrence Theory, 60 LAW & CONTEMP. PROBS. 253, 261-65 (1997). According to Scholz, the belief that others are complying with mutually advantageous rules correlates more closely with individual firm compliance than do other factors, such as the size of the penalty for violation, which would be more important under a pure deterrence model. Id. Enforcement action can bolster incentives to cooperate voluntarily. Scholz argues that the support function of public enforcement is enhanced where criminal sanctions are limited to egregious cases, enforcement procedures are perceived to be fair, substantive rules are perceived to be adequate and legitimate, Enforcement targets "bad apples" and gives greater deference to compliant firms, and where Enforcement strengthens and encourages private enforcement systems (e.g., trade associations). For "tit-for-tat" literature, see ROBERT AXELROD, THE EVOLUTION OF COOPERATION (1984); AYRES & BRAITHWAITE, supra note 21, at 20-27.

51. See AYRES & BRAITHWAITE, supra note 21, at 39 (comparing models of enforcement regulation).

52. See infra Part V.
seeking legitimacy may choose to be only facially compliant. This may be so because of conflicting internal commitments, because of internal blindness to causal factors, or because they resist the substantive content of those compliance rules.

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-massive-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 \textsc{Christopher Stone}, \textit{Where the Law Ends} 121 (1975); see also Stone, \textit{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., \textit{Understanding Enron: “It’s About the Gatekeepers, Stupid,”} 57 \textsc{Bus. Law.} 1403 (2002); John C. Coffee, Jr., \textit{What Caused Enron? A Capsule Social and Economic History of the 1990s}, 89 \textsc{Cornell L. Rev.} 269 (2004); Ronald Gilson & Reinier Kraakman, \textit{The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias}, 28 \textsc{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, \textit{supra} note 26.


\textsuperscript{60} See Stephen M. Cutler, Remarks at the Second Annual General Counsel Roundtable: Tone at the Top: Getting it Right (Dec. 3, 2004) [hereinafter Cutler Speech] (“Cultivating a culture of compliance requires a sustainable effort. A one-time push is not enough... don’t fall victim to a checklist mentality.”), \textit{available at} \url{http://www.sec.gov/news/speech/spch120304sml.htm}; Stephen M. Cutler, Remarks before the 2004 Investment Company Institute Securities Law Developments Conference (Dec. 6, 2004) (describing the “three Ps” as the places, people, and processes required to avoid another round of scandals), \textit{available at} \url{http://www.sec.gov/news/speech/spch120604smc.htm}.

\textsuperscript{61} \textit{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. 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.

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NEW MODEL FOR SECURITIES LAW ENFORCEMENT

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 Lumpining, 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,\textsuperscript{66} and health care.\textsuperscript{67} 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{68}

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}


\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{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, \textit{Experimentalist Equal Protection}, 22 YALE L. & POL'Y REV. 261 (2004); Dorf, \textit{Legal Indeterminacy}, supra note 68; Cristie L. Ford, \textit{In Search of the Qualitative Clear Majority: Democratic Experimentalism and the Quebec Secession Reference}, 39 ALBERTA L. REV. 511 (2001); JEAN L. COHEN, \textit{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. 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.

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).
important part of a regulatory system—has not been dislodged.\textsuperscript{81}

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.\textsuperscript{82} 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.\textsuperscript{83} 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.\textsuperscript{84}

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

\begin{itemize}

\item \textsuperscript{82} I am not speaking of that exceedingly rare firm that is so “rotten” that the only course must be to shut it down. \textit{See infra} notes 213-16 and accompanying text.

\item \textsuperscript{83} \textit{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).

\item \textsuperscript{84} \textit{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).
\end{itemize}
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. 85 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, 2005) (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

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.

86. Michael Schroeder & Greg Ip, Imperfect Guardian: SEC Faces Hurdles Beyond

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
(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" 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.

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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
sorting 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
involving business organizations), available at http://www.usdoj.gov/dag/cft0/corporate
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,” and “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 discussion99 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?100

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?101

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/spch586.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?

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?

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

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.\(^\text{(104)}\)

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

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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[ Yamaha]” 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. U. 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. § 7201-7266 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.\textsuperscript{109} Relying on shallow tests for board independence, then, fails to account for the undoubtedly nuanced relationship between board independence and good corporate citizenship.\textsuperscript{110} 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.\textsuperscript{111} 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 un fettered 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

\textit{Structural Board Independence from Management}, 43 \textit{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).


\textsuperscript{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, \textit{Social Influence and the Triple Tumor Structure of Organizational Dishonesty}, in \textit{CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS} 44 (David M. Messick & Ann E. Tenbrunsel eds., 1996).

\textsuperscript{111} \textit{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. 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. 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. 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.") 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. It would not be in a firm's interest to


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).

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

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.

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. 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.

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.

Controls, 93 YALE L.J. 857, 859-62 (1984) (asserting that employee indemnification agreements tend to limit the degree to which blame-shifting to employees actually results in pecuniary savings for the firm); cf. Stone, 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(b)(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, 510-16 (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). In
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

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HeinOnline -- 57 Admin. L. Rev. 793 2005
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.\footnote{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.\footnote{128} The incentive toward what William Laufer calls “reverse whistleblowing” would theoretically be strongest in those companies with the most to hide.\footnote{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.\footnote{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.\footnote{131} Whether or not individual Enforcement staff and counsel are fair and capable—as no doubt they are—as a structural matter, no enforcement

\footnote{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.}

\footnote{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.}

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

\footnote{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, 2078-01 (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 Laufer, 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., \textsc{David Weisbrud, Stanton Wheeler $\&$ Nancy Bode}, 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, 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, administratively ordered, or incorporated into settlement agreements between

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/ir17588.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/ir17866.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\footnote{137} 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.138

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.139 Reform Undertakings also appear in settlement documents, sometimes jointly reached with other government bodies, such as the United States Attorney’s Office.140 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.
The 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, investment advisors, specialist firms, and self-regulatory organizations (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. The only information available online with respect to the scope of these settlements is that 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 the firm’s 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(h) 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.pdf. 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) (relaying 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

that it retain an independent Third Party consultant was an “outrageous” and punitive measure.

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.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.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

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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 In re Monsanto Co., supra note 141, the firm retains the Third Party for three years.

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/cdrh/leveraging/03c.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. Dep't 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.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.159

158. Simon, supra note 81, at 25-28; Sabel & Simon, supra note 62, at 1054. But see Dallas, 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, supra note 62, at 1020; see also Bradley C. Karkkainen, Information-Forcing Environmental Regulation: Penalty Defaults, Destabilization Rights, and Environmental Governance, in NEW GOVERNANCE AND CONSTITUTIONALISM IN EUROPE AND THE U.S., 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, 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.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.161

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), available at http://www.sec.gov/news/press/2004-174.htm. For a thoughtful discussion of New Governance environmental regulation and SMEs, see NEIL GUNNINGHAM & DARREN SINCLAIR, LEADERS & LAGGARDS: NEXT-GENERATION ENVIRONMENTAL REGULATION 13-40 (2002).

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. 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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{165} Transparent reasoning helps preclude decision-making based on pure exchange, bias, or scapegoating. Decision-making is disciplined by its openness to outsiders' scrutiny.\textsuperscript{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.\textsuperscript{167}


\textsuperscript{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.}

\textsuperscript{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").}

\textsuperscript{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.\textsuperscript{167} 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).\textsuperscript{168}

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.\textsuperscript{169} 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.\textsuperscript{170} By contrast, the expert-centric WorldCom model leaves little room for the firm to do its own learning during the Undertaking time

\textsuperscript{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. \textit{Id.}

\textsuperscript{168} Cutler Speech, supra note 60; see also Diane Vaughan, \textit{Rational Choice, Situated Action, and the Social Control of Organizations}, 32 \textit{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”).

\textsuperscript{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”).

\textsuperscript{170} In a similar vein, see Sturm, supra note 62, at 1390-96. 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, \textit{The Promise of Participation}, 78 \textit{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.\textsuperscript{171} 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.\textsuperscript{172}

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.\textsuperscript{173} This is no small point. Through this sort of participatory work, the True Reform Undertaking grows

\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{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. 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? 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. 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

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.

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 C1.

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. 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. 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 currying the firm’s favor. The Third Party should also be able to rely on outside support from the

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 reapplication of the SEC's enforcement stick.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

\textsuperscript{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, \textit{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.

\textsuperscript{181} \textit{In re Monsanto Co.}, \textit{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, \textit{Citing Pullback, Antigraft Team Quits Teamsters}, \textit{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. \textit{See Note, Mastering Intervention in Prisons}, \textit{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 normally 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.

\textsuperscript{182} \textit{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 satisficing 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

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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. ENVT. 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.\textsuperscript{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.\textsuperscript{190} Because the

\textsuperscript{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.

\textsuperscript{190} DiMaggio & Powell, supra note 55, at 66-67, 69-70.
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.\footnote{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 satisfice for facial compliance.\footnote{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.\footnote{193} The Office is an overarching body, not situated within Enforcement.\footnote{194} The Office has internal risk teams which work according

\footnote{191. See, e.g., Lauren Edelman, 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).

\footnote{192. See Dorf & Sabel, supra note 64, at 354-56 (describing “rolling best practices rulemaking”); Sabel & Simon, 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, supra note 20. This observation only reinforces the need for a meaningful clearinghouse function.

\footnote{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/tsll11803whd.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: 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. SEC Strategic Plan, supra note 87, at 25.

\footnote{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. 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. 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.

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. 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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Enforcement in data-gathering reintroduces inefficiencies. It also raises the risk that Enforcement will assume command-and-control style management of the processes or will be unduly influenced by its own self interest in seeing the Reform Undertaking method work relative to other non-Enforcement initiatives.


196. See Donaldson, supra note 193.

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-discern 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).
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. 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. The same standards of credibility and transparency that characterize the True Reform Undertaking process should characterize problem-solving at Enforcement.

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. 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. Sparrow, supra note 75, at 103-08.


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. SEC Strategic Plan, supra note 87, at 26-27. The SEC should include credit for innovative solutions that circumvent organizational limitations in performance metrics. 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, 

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 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. 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.\textsuperscript{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 reformative 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 reformative 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 reformative 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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{208} Relative to

\begin{footnotes}
\item[205] See supra note 79. Criminal prosecutors have made similar advances. See supra notes 6, 11.
\item[206] It is a harder project to ramify the learning all the way back to Congress, which also promulgates broad prophylactic requirements.
\item[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).
\item[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
\end{footnotes}
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. 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.

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, 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. Significantly, this is a stick of a different kind than that
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. 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. 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. 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. In practical terms, this means that SEC Enforcement retains the right and the means to destroy or shut down the noncompliant firm. 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.

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.

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 overlook 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:

[T]here 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.