

2006

Does the Law Encourage Unethical Conduct in the Securities Industry?

Di Lorenzo Vincent

Follow this and additional works at: <https://ir.lawnet.fordham.edu/jcfl>



Part of the [Banking and Finance Law Commons](#), and the [Business Organizations Law Commons](#)

Recommended Citation

Di Lorenzo Vincent, *Does the Law Encourage Unethical Conduct in the Securities Industry?*, 11 Fordham J. Corp. & Fin. L. 765 (2006).

Available at: <https://ir.lawnet.fordham.edu/jcfl/vol11/iss4/3>

This Article is brought to you for free and open access by FLASH: The Fordham Law Archive of Scholarship and History. It has been accepted for inclusion in Fordham Journal of Corporate & Financial Law by an authorized editor of FLASH: The Fordham Law Archive of Scholarship and History. For more information, please contact tmelnick@law.fordham.edu.

DOES THE LAW ENCOURAGE UNETHICAL CONDUCT IN THE SECURITIES INDUSTRY?

*Vincent Di Lorenzo**

A 2002 Citigroup Inc. memo, released as part of a Florida lawsuit, shows that the bank's own analysts were reluctant to publish less-biased research over concerns of a backlash from its investment bankers.

John Hoffmann, the former head of equity research at Citigroup's Salomon Smith Barney unit, wrote in March 2002 that the firm's analysts were considering an increase in the number of "negative" ratings on stocks. In the same memo to Michael Carpenter, then head of Citigroup's corporate and investment bank, Hoffmann said doing so would threaten more than \$16 billion in fees and risk putting the firm at a disadvantage.

"Analysts have been told repeatedly that the primary goal of the firm is to get our equity underwriting market share ranking into the top three," Hoffmann wrote. "The equity research directors question the investment bank's ability to accept stricter rating standards at the expense of revenues."¹

INTRODUCTION

Are corporations committed to compliance with law? The *Principles of Corporate Governance*² demand a corporate commitment

* Professor of Law; Senior Fellow, Vincentian Center, St. John's University.

1. *Citigroup's Motives Rapped*, NEWSDAY, Sept. 9, 2005, at A55.

2. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE (1994) [hereinafter ALI]. The *Principles* were a fifteen year project of the American Law Institute. See also Richard B. Smith, *An Underview of the Principles of Corporate*

to compliance with law. The obligation exists even when corporate profits are not maximized. Cost-benefit evaluations in decisions on legal compliance are rejected. Do these *Principles* realistically reflect corporate activity in the market?

This article tests these views against recent evidence of corporate conduct. Two issues are explored: (a) whether law is determinative of corporate conduct falling within its scope, and (b) what role cost-benefit analysis plays in corporate decisions on legal compliance. Part One of the article explores the ethical obligation to comply with law that U.S. society has recognized for corporate actors. Two competing perspectives are examined. First, the viewpoint adopted in the *Principles of Corporate Governance* is presented. This viewpoint posits that law is determinative of corporate conduct. An absolute obligation to comply with the law's requirements is deemed to exist. This requires a commitment to legal compliance regardless of the impact on corporate profits. A second viewpoint is that found in complexity theory. Complexity theory contends that human behavior, and, in turn, corporate behavior, is influenced by many factors.³ Law is one influence, but it is not the sole influence and is not necessarily the determinative influence. This second perspective is not a normative perspective. Rather, it examines how corporate decisions are actually reached.

Part Two of this article tests these two viewpoints by examining evidence of actual market conduct. It explores whether corporate conduct demonstrates a commitment to legal compliance, including a commitment to the law's underlying purpose, even when corporate profits are not maximized. The key finding is that corporations are not committed to a broad ethical obligation to comply with the law including an obligation to serve the law's purpose. Legal mandates are narrowly construed and sought to be evaded. Underlying public policies are typically ignored. In sum, law is not serving as the determinant of corporate behavior.

Part Three of this article then examines the role cost-benefit evaluations play in influencing corporate behavior under various legal regimes. The influence of cost-benefit evaluations on corporate

Governance, 48 BUS. LAW. 1297 (1993).

3. See, e.g., GREGOIRE NICOLIS & ILYA PRIGOGINE, EXPLORING COMPLEXITIES: AN INTRODUCTION 8 (W.H. Freeman & Company 1989) (explaining the required components for complexity to arise in dynamic systems).

behavior has been cast aside and, therefore, ignored under the *Principles of Corporate Governance*. However, the evidence strongly suggests that corporations are not ignoring cost-benefit evaluations when making decisions on legal compliance. In reaching this conclusion, the role of behavioral tendencies and decision making heuristics are explored to ascertain their influence on corporate cost-benefit evaluations. The conclusion drawn is that they cause corporate actors to view noncompliance with legal mandates as a reasonable decision. As a result they do not induce a strong commitment to legal compliance. Part Three of this article then offers an alternative approach to prevailing legal regimes — an alternative that accepts and embraces cost-benefit evaluations. It is an alternative that relies on market-based sanctions to alter cost-benefit evaluations so as to allow the law to exert greater influence on corporate decisions.

PART ONE – PERSPECTIVES ON THE INFLUENCE OF LAW ON BUSINESS
CONDUCT

A. The Principles of Corporate Governance: Law as a Determinative
Factor

The American Law Institute's *Principles of Corporate Governance*, released in 1994, summarized, among other things, the expectations regarding corporate compliance with law.⁴ The *Principles* reflect the "common understanding of the key legal relationships in the corporations . . ." ⁵ Section 2.01 of the *Principles of Corporate Governance* begins with the view that a corporation's primary objective is to enhance corporate profit and shareholder gain.⁶ However, the corporation is obliged to act within the boundaries set by law, even if corporate profit and shareholder gain are not enhanced.⁷

A minimalist view of the ethical obligations of corporate actors is that they must comply with the requirements of law, but this means only adherence to its literal requirements. Even this narrow view of ethical

4. ALI, *supra* note 2.

5. *Id.* (Director's Forward).

6. *Id.* § 2.01.

7. *Id.* § 2.01(b)(1).

obligation, however, requires compliance when profits are not maximized. This article explores whether corporations are committed to this minimalist ethical standard. It also explores commitment to a broader ethical standard. A broader view of ethical obligations is one based upon requirements of law but not limited to the narrow view of commitment to literal compliance. Instead, it asks corporations to commit themselves to conduct that not only meets the literal requirements of governing law but also serves its underlying purpose.⁸ The American Law Institute embraced the position that the obligation to comply with law is not a limited duty of literal compliance but should take into consideration the purposes behind the laws in question. It explained:

The corporation, like all other citizens, is under an obligation to act within the boundaries set by law. In determining these boundaries the corporation should not rest simply on past precedents or an unduly literal reading of statutes and regulations, but should give weight to all the considerations that the courts would deem proper to take into account in their determinations, including relevant principles, policies, and legislative purposes.⁹

The determinative role assumed to be played by the law and demanded in the *Principles of Corporate Governance* is contrasted with their view of the role of cost-benefit analysis in corporate decisions regarding compliance with law. The American Law Institute went out of its way to consider and reject the view that the duty to comply with law depends on the costs of noncompliance as compared with the economic benefits captured. It noted:

It is sometimes maintained that whether a corporation should adhere to a given legal rule may properly depend on a kind of cost-benefit analysis, in which probable corporate gains are weighed against either probable social costs, measured by the dollar liability imposed for engaging in such conduct, or probable corporate losses, measured by potential dollar liability discounted for likelihood of detection.

8. This article limits its exploration of corporate ethical obligations to the obligation to comply with the law and to demonstrate a commitment to the law's purpose. Positive law as equivalent to ethical conduct in a commercial setting is discussed in Bruce D. Fisher, *Positive Law as an Ethic: Illustrations of the Ascent of Positive Law to Ethical Status in the Commercial Sector*, 25 J. BUS. ETHICS 115 (2000).

9. ALI, *supra* note 2, at 60.

Section 2.01 does not adopt this position. With few exceptions, dollar liability is not a “price” that can properly be paid for the privilege of engaging in legally wrongful conduct. Cost-benefit analysis may have a place in the state’s determination whether a given type of conduct should be deemed legally wrongful. Once that determination has been made, however, the resulting legal rule normally represents a community decision that the conduct is wrongful as such, so that cost-benefit analysis whether to obey the rule is out of place. . . . Section 2.01(b)(1) is based on the moral norm of obedience to law.¹⁰

This is an ethical viewpoint that rejects very narrow interpretations of legal requirements and, therefore, rejects attempts to evade legal requirements. In cases of uncertainty, conduct consistent with the law’s purpose is the proper standard against which to judge ethical conduct.

B. Organizational Theory: Complexity and Corporate Decisions

Complexity theory, sometimes referred to as chaos theory, presents a different view of the determinants of human behavior, including corporate conduct. It is not a normative viewpoint but one that examines actual conduct in the market. The starting point in complexity theory as applied to human behavior is that actions are influenced by many factors. Complexity recognizes that an effect is often not the product of one constant cause. Rather, it results from the interaction of many forces.¹¹ In corporate decision making, this includes cost projections, risk projections, legal mandates, industry norms, societal norms, as well as other influences (e.g., the personality and viewpoint of the CEO). The strength of the influence of each factor (e.g., risk projections) varies over time and within different factual contexts. The outcome (decision) is a result of the interaction of all of the relevant influences and the synergy produced from such interaction. In other words, there is not a linear relationship between a particular influence and resultant outcomes.¹²

10. *Id.* comment g.

11. NICOLIS & PRIGOGINE, *supra* note 3, at 6.

12. In linear systems, there is a proportionate relationship between cause and effect, and the mathematical relationship between variables is stable. In nonlinear systems, the cause-effect relationship is not proportionate and relationships between

Organizational theorists have embraced complexity theory and applied it to decision making in business organizations.¹³ Thus, the theory has been applied to analyze how information is processed in organizations.¹⁴ It has also been applied to characterize successful organizations as organizations that embrace and respond to principles recognized in complexity theory, such as nonlinear feedback and chaotic equilibrium.¹⁵ Organizational behavior as seen through the lens of complexity theory is summarized in the following study's findings regarding corporate environmental performance:

Corporate environmental behavior and motivation are extremely complex. They involve the interaction of numerous variables, difficult to measure. It is harder still to assign an appropriate weight to each variable, or to perform a reliable quantitative multivariate regression analysis. . . . Nevertheless, . . . [b]oth our quantitative and qualitative analysis leave us convinced that theories of corporate environmental behavior that focus on a single variable – whether legal, economic, or attitudinal – are almost always doomed to be incomplete and inadequate.¹⁶

Given the complexity that characterizes corporate decision making, the best evidence of the influence of various factors on corporate decisions is to study outcomes under varying legal regimes. Actual market conduct reflects the interaction of various variables, including law.

Earlier studies have found that various influences play a role in corporate decisions regarding corporate compliance with law — influences in addition to the legal mandate or the sanction imposed for

variables are dynamic, rather than stable. JAMES GLEICK, *CHAOS: MAKING A NEW SCIENCE* 23-25 (1987).

13. See Robert Kagan, Neil Cunningham & Dorothy Thornton, *Explaining Corporate Environmental Performance: How Does Regulation Matter?* 37 *LAW & SOC'Y REV.* 51, 76-78 (2003).

14. SIEGFRIED STREUFERT & ROBERT W. SWEZEY, *COMPLEXITY, MANAGERS AND ORGANIZATIONS* 2 (1986).

15. RALPH D. STACEY, *MANAGING THE UNKNOWABLE: STRATEGIC BOUNDARIES BETWEEN ORDER AND CHAOS IN ORGANIZATIONS* chs. 3, 4 (1992). The concept of equilibrium points within an outer boundary set by a strange attractor is discussed *infra* notes 110-11 and accompanying text.

16. Kagan, Cunningham & Thornton, *supra* note 13, at 76.

violation.¹⁷ The studies have called into question the influence of the severity of sanctions on legal compliance,¹⁸ and whether the perceived obligation to comply with a legal mandate is the most important factor determining corporate conduct.¹⁹

Recognition that non-legal factors play an important role in influencing corporate decisions, combined with complexity theory's concept of nonlinear relationship between various influences and a particular outcome, has led some commentators to conclude that law is unnecessary to induce ethical business conduct.²⁰ However, the

17. Peter J. May, *Compliance Motivations: Affirmative and Negative Bases*, 38 LAW & SOC'Y REV. 41 (2004) (summarizing prior studies regarding the influence of various factors such as inspection frequency and consistency, perceived legitimacy of regulations, reputation, and ability to comply, including costs and competitive effects); Kagan, Gunningham & Thornton, *supra* note 13, at 67-69 (finding firm-level economic differences and community pressures as having significant effects on companies' environmental performance); BRENT FISSE & JOHN BRAITHWAITE, *THE IMPACT OF PUBLICITY ON CORPORATE OFFENDERS* 227, 233, 243 (1983) (showing studies of adverse publicity and corporate reaction to it, finding many of the companies studied introduced substantial reforms in the wake of their adverse publicity crisis which, although perhaps in only a small way, would reduce the probability of recurrence of the offense or wrongdoing. In many cases thorough ongoing reform was forsaken for piecemeal changes).

18. May, *supra* note 17, at 55-56 (showing that studies are mixed with respect to findings concerning the effect of the level of sanctions for compelling compliance, and this study finds that fear of sanctions and fear of legal liability has little effect); John Braithwaite & Toni Makkai, *Testing an Expected Utility Model of Corporate Deterrence*, 25 LAW & SOC'Y REV. 7, 8, 24 (1991) (discussing that studies have shown very little support for an effect of the perceived severity of sanctions on compliance, and this study confirms this conclusion for organizations). *Contra* Steven Klepper & Daniel Nagin, *Tax Compliance and Perceptions of the Risks of Detection and Criminal Prosecution*, 23 LAW & SOC'Y REV. 209 (1989), and Harold G. Grasmick & George J. Bryjack, *The Deterrent Effect of Perceived Severity of Punishment*, 59 SOC. FORCES 471 (1980) (explaining how risk of criminal prosecution and perceived severity of sanction affects conduct).

19. May, *supra* note 17, at 55 (finding that the duty to comply with legal requirements was cited as an important motivation by respondents but less important than reputation as a motivation for compliance and almost equally important to marketplace demands as a motivation).

20. See Greg Ip, *A Less-Visible Role For the Fed Chief: Freeing Up Markets*, WALL ST. J., Nov. 19, 2004, at A8 (quoting a view articulated in the 1960s by Alan Greenspan that it is in the self-interest of every business to maintain its reputation — a reputation for honest dealings and a quality product — and regulation undermines this

deficiency in this conclusion is that it is an untested conclusion. This article explores this issue as well.

Theoretically, legal mandates can control outcomes if corporations are committed to compliance with law. In such a scenario, the legal mandate would override all other influences on corporate behavior. This is the assumption in the *Principles of Corporate Governance*. This article examines recent corporate conduct to further explore the influence of law on corporate decisions, more specifically whether or when it is a determinative influence. It also explores whether market based sanctions can exert a greater influence on corporate decision making.

PART TWO – A STUDY OF CORPORATE CONDUCT – THE SECURITIES INDUSTRY

There are many unethical business practices that have come to light in the securities industry in recent years. These include illegal allocation of shares in initial public offerings,²¹ trading abuses by mutual fund companies,²² lack of due diligence by underwriters leading to defrauding of investors,²³ illegal practices in sales of variable annuities including

superlatively moral system). *E.g.*, Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. LEGAL STUD. 295 (1988); Ronald J. Gilson & Reinier Kraakman, *The Mechanics of Market Efficiency*, 70 VA. L. REV. 549 (1984) (arguing that reputation provides a sufficient incentive for auditors to detect fraud and imposing is unnecessary).

21. *J.P. Morgan Agrees to \$25 Million Penalty in Settling SEC Allegations of IPO Abuses*, 35 Sec. Reg. & L. Rep. (BNA), at 1642 (Oct. 6, 2003) (showing settlements between SEC and J.P. Morgan Chase, FleetBoston, and Credit Suisse First Boston).

22. David M. Walker, Comptroller General of the United States, *Assessment of Regulatory Reforms to Improve the Management and Sale of Mutual Funds*, GAO-04-533T, at 2, 6 (Mar. 10, 2004) (finding that as of March 1, 2004, the SEC had formally announced seven enforcement actions involving broker-dealers and other firms involved in late trading schemes, and twelve cases involving market timing activities, including five that also involved late trading); Christopher Oster, *Settlements in Wake of Scandal Include Payments That Extend Beyond Refund of Tainted Profits*, WALL ST. J., June 29, 2004, at D1 (noting that mutual fund companies have agreed to settlements totaling more than \$2 billion, and this is sure to grow substantially as ten mutual fund companies have yet to settle).

23. *E.g.*, Mitchell Pacelle, *Citigroup Will Pay \$2.65 Billion to Settle WorldCom Investor Suit*, WALL ST. J., May 11, 2004, at A1 (displaying a settlement with investors in suit against 17 underwriters, including Citigroup, J.P. Morgan Chase, Deutsche Bank

market timing, violation of suitability rules, and inadequate disclosure,²⁴ and sex discrimination.²⁵ This article focuses on misleading reports issued by securities analysts. It presents a case study of industry cost-benefit evaluations that lead the corporate actor to evade or, at times, ignore the law.

A. The Challenge

Securities analysts evaluate securities and estimate their value as investments for potential investors. They collect and review information about the corporations that they are evaluating, including information found in company documents filed with the SEC, materials sent to shareholders, trade publications, and information obtained in interviews with company officers and employees and visits to company sites.²⁶ So called “sell-side analysts” are generally employed by brokerage firms and produce reports and buy-sell recommendations for the firm’s

and Bank of America); Kurt Eichenwald, *Jury Convicts 5 Involved In Enron Deal With Merrill*, N.Y. TIMES, Nov. 4, 2004, at C1 (noting that a jury found that five defendants, including four former executives of Merrill Lynch, had conspired to help Enron report bogus profits. The convicted defendants include the former head of global investment banking at Merrill Lynch, and the former head of the firm’s project and lease finance group).

24. *Annuities Deal Criticized*, NEWSDAY, June 10, 2004, at A53 (finding that in the past two years the NASD had taken more than 80 disciplinary actions against brokers and investment firms, including Prudential and American Express, for abuses in sales of variable annuities); National Association of Securities Dealers, NASD Fines Prudential \$2 million; Orders \$9.5 Million to Customers for Annuity Sales in Violation of NY Insurance Regs, New Release (Jan. 29, 2004), available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002856 (involving Prudential Equity Group, formerly known as Prudential Securities, and Prudential Investment Management Services).

25. Patrick McGeehan, *Morgan Stanley Settles Bias Suit With \$54 Million*, N.Y. TIMES, July 13, 2004, at A1 (discussing a settlement reached with Morgan Stanley; earlier settlements with Merrill Lynch and Smith Barney resulted in more than \$200 million in payments); Patrick McGeehan, *Merrill Lynch Ordered to Pay For Sexual Bias*, N.Y. TIMES, Apr. 21, 2004, at A1.

26. The role of securities analysts is summarized in Jill E. Fisch & Hillary A. Sale, *The Securities Analyst As Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1040-42 (2003); John L. Orcutt, *Investor Skepticism v. Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors*, 81 DENV. U. L. REV. 1, 7-9 (2003).

customers and other investors. The reports include predictions of future earnings.²⁷

The investors that might rely on the reports and recommendations are not typically sophisticated investment entities that regularly trade in securities, such as mutual funds, hedge funds, insurance companies or retirement funds. Rather, such entities employ their own, so-called "buy-side analysts" who generate reports solely for their employers and not for the general public.²⁸ In recent decades more and more individuals have embraced the securities market as a vehicle for channeling their savings and other financial assets.²⁹ Thus, individual investors and, in many cases, unsophisticated individual investors are increasingly the recipients of analysts' reports and recommendations.

Analysts face conflicts of interest on several fronts. First, they are employed by securities firms, and analysts' recommendations generate brokerage commission revenues for their employers.³⁰ In a related vein, the securities firms typically engage in the investment banking business as well. Securities analysts help to develop and maintain relationships with investment banking clients of the firm, and, therefore, generate investment banking fees for their employers.³¹ Examples of the conflict

27. Fisch & Sale, *supra* note 26, at 1042; Orcutt, *supra* note 26, at 8 (research reports are typically made available only to clients of the brokerage firm, although in recent years many firms have begun to distribute reports to non-clients).

28. Orcutt, *supra* note 26, at 8-9 (although buy-side analysts do use sell-side research as a source of information).

29. Overall individual investor participation in the stock market has risen from 30.2 million U.S. shareowners in 1980 to 84.3 million in 2002. Securities Industry Association, Key Trends in the Securities Industry, *available at* http://www.sia.com/research/html/key_industry_trends_.html (last visited Nov. 8, 2004). This includes individual stock ownership, both inside and outside employer-sponsored retirement plans, and ownership stock of mutual funds. Individual stock ownership outside employer-sponsored retirement plans extended to 31.5 million shareowners in 2002. INVESTMENT COMPANY INSTITUTE AND SECURITIES INDUSTRY ASSOCIATION, EQUITY OWNERSHIP IN AMERICA 17 (2002).

30. Orcutt, *supra* note 26, at 14-15 (stating that research shows that analyst recommendations can have a substantial impact on both stock prices and trading volumes, and buy ratings are more likely to encourage trading volumes); Fisch & Sale, *supra* note 26, at 1045-46 (noting that in today's world research departments do not earn revenue; other departments support them).

31. Fisch & Sale, *supra* note 26, at 1046-47 (finding that analysts have been used in marketing activities aimed at prospective purchases of new issues of securities); Orcutt, *supra* note 26, at 19-21 (showing that after a company is taken public,

of interest faced by research analysts are provided by the New York State and SEC investigations of industry practices. At Merrill Lynch, the head of equity research solicited information from analysts on their involvement in investment banking so that their compensation could be calculated. He said:

We are once again surveying your contributions to investment banking during the year . . . please complete details on your involvement in the transaction, paying particular attention to the degree your research coverage played a role in origination, execution and follow-up. Please note as well, your involvement in advisory work on mergers or acquisitions, especially where your coverage played a role in securing the assignment and you made follow up marketing calls to clients. Please indicate where your research coverage was pivotal in securing participation in high yield offerings.³²

Similarly, at Morgan Stanley, research analysts were compensated, in part, based on the degree to which they helped generate investment banking business for the firm. In their annual performance evaluation, analysts were asked to submit self-evaluations that often included their involvement in investment banking, including a description of specific transactions and the fees generated.³³ One analyst's evaluation stated "Bottom line, my highest and best use is to help [Morgan Stanley] win the best Internet IPO mandates . . ."³⁴

Second, in the past, analysts were paid by their employers based, in large part, on their ability to generate investment banking business, as well as on their reputation among investors, as reflected in annual

investment banks compete for additional stock and debt offerings and for financial advisory work, and sell-side analysts can play an important role in securing fees generated from their activities).

32. United States Senate Committee on Commerce, Science and Technology, *Hearing on Corporate Governance, Before the Subcomm. on Consumer Affairs, Foreign Commerce and Tourism of the Senate Comm. on Commerce, Science and Technology*, 106th Congress (2002) (testimony of New York State Attorney General Eliot Spitzer), available at <http://www.oag.state.ny.us/press/2002/jun/testimony7.pdf>.

33. SEC v. Morgan Stanley & Co. Inc., Exchange Act Litigation Release No. 18117, Apr. 28, 2003, available at <http://www.sec.gov/litigation/litreleases/lr18117.htm>.

34. *Id.* (emphasis in original).

Institutional Investor rankings.³⁵ Curiously, stock picking and earnings forecast ratings of analysts did not weigh heavily in these rankings.³⁶

Third, analysts, their employers, and other employees of the firm commonly had ownership interests in the companies that the analysts were covering.³⁷ Thus, given these conflicts of interest, the challenge is to issue fair, accurate research reports and recommendations. From the standpoint of assessing ethical behavior, in some cases inaccurate reports and recommendations can violate legal prohibitions aimed at protecting investors against fraudulent practices.

B. The Legal Environment

As described below, members of the securities industry have settled charges of violations of state antifraud statutes, rules of the New York Stock Exchange (NYSE) and National Association of Securities Dealers (NASD), as well as violations of the federal securities laws. This article examines the federal securities law as the governing legal regime. The regime consists of a vague statutory standard. In that sense, the legal regime is not different in form than state law³⁸ and the rules of NASD

35. Orcutt, *supra* note 26, at 21-22 (stating that analysts receive a base salary plus a discretionary year-end bonus that typically can be fifty percent or more of the analyst's base salary); Laura S. Unger, Acting Chair, U.S. Securities and Exchange Commission, *Testimony Concerning Conflict of Interest Faced by Brokerage Firms and Their Research Analysts, Before the Subcommittee on Capital Markets, Insurance and Governmental Sponsored Enterprises, Committee on Financial Services, United States House of Representatives*, July 31, 2001, available at <http://www.sec.gov/news/testimony/073101ortslu.htm>. The SEC's on-site examinations of nine full service brokerage firms discovered that, in seven of the nine firms inspected, investment banking had input into analysts' bonuses and the analyst hiring process. *Id.* The staff inspections also reported, "[i]nterviews with former analysts revealed that it was well understood by all of these analysts that they were not permitted to issue negative opinions about investment banking clients." *Id.*

36. Orcutt, *supra* note 26, at 22.

37. *Id.* at 22-25; Fisch & Sale, *supra* note 26, at 1043-44. The SEC's on-site inspections of nine full service brokerage firms found that about one quarter of the analysts inspected own securities in the companies they cover. Testimony of Laura S. Unger, *supra* note 35.

38. New York's Martin Act prohibits any "fraud, deception, concealment," any "promise or representation . . . which is beyond reasonable expectation or unwarranted by existing circumstances" and any false representation or statement made to induce or promote the sale of securities. N.Y. GEN. BUS. LAW § 352c (1996).

and NYSE³⁹ that are alleged to be violated and that are also vague legal standards.

The governing statutory standard is found in the antifraud provisions of the federal securities law. The settlements reached were based on section 15(c) of the Securities and Exchange Act of 1934 because the particular securities in question were traded over-the-counter.⁴⁰ However, section 10(b) of the Act could have been invoked for securities other than those traded over-the-counter.⁴¹ These statutes prohibit “any manipulative, deceptive or other fraudulent device or contrivance” to induce or attempt to induce the purchase or sale of any security.⁴²

The purpose behind these antifraud provisions is to protect the average investor against overreaching. As one leading commentator has explained:

39. *E.g.*, NASDAQ Inc., Rule 2210(d)(1)(A), available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000480 (stating “Standard Applicable to All Communications with the Public: All member communications with the public shall be based on principles of fair dealing and good faith . . . [and should] provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading.”). *See* NASDAQ Inc., Rule 2210(d)(1)(B) (prohibiting members from making “[e]xaggerated, unwarranted or misleading statements or claims” in all public communications and stating that “no member shall, directly or indirectly, publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.”). *Id.* *See also* NYSE Rule 472, available at http://rules.nyse.com/NYSE/NYSE_Rules/ (follow “Communications with the Public” hyperlink) (providing that “[n]o members or member organization shall utilize any communication which contains (i) any untrue statement or omission of a material fact or is otherwise false or misleading; or (ii) promises of specific results, exaggerated or unwarranted claims; or (iii) opinions for which there is no reasonable basis; or (iv) projections or forecasts of future events which are not clearly labeled as forecasts.”).

40. *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION at 904-07, 1060-61 (2004) (broker dealers are subject to section 17a of the 1933 Act, Rule 10b-5, and over-the-counter broker dealers are additionally subject to 15c of the 1934 Act).

41. *See id.*

42. 15 U.S.C. § 78o(c)(1A-C)(2005). *See also* 15 U.S.C. § 78j(b)(2000).

The antifraud provisions are part of a statutory scheme that resulted from a finding that securities are "intricate merchandise" and a congressional determination that the public interest demanded legislation that would recognize the gross inequality of bargaining power between the professional securities firm and the average investor. "The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do."⁴³

In a similar vein, the courts have explained that "[a] fundamental purpose, common to these [federal securities] statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."⁴⁴

Thus, the ethical obligation to act in accordance with the purpose behind the governing law would require a commitment on the part of securities firms to insure fair, accurate reports and recommendations on the part of securities analysts. Did the securities industry's actions reflect commitment to compliance with the law, including its underlying purpose?

C. The Industry Response

Through the late 1990s and thereafter, the industry's response was to ignore the proscription against deceptive statements and practices and, instead, boost investment banking and brokerage earnings by overstating predictions of corporate earnings,⁴⁵ and maintaining strong "buy" recommendations⁴⁶ for stocks despite analysts' privately held views that the recommendations were not justified. Also, the response was

43. LOUIS LOSS & JOEL SELIGMAN, 7 SEC. REG. 3418-9 (1989) (citations omitted).

44. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

45. Orcutt, *supra* note 26, at 50 (noting that while academic studies have confirmed that analysts consistently overestimated earnings forecasts, these studies did not isolate the cause of the overestimates).

46. *Id.* at 11-13 (finding that studies have confirmed over-optimism in buy recommendations). See also Fisch & Sale, *supra* note 26, at 1045-46 (concluding that analysts' recommendations are consistent with their employer's incentives but not those of the investing public). Also, independent analysts' behavior differs substantially from that of analysts employed by securities firms. *Id.* at 1051. These studies do not document the cause of the over-optimism.

frequently to boost personal fortunes by issuing rosy forecasts for stocks in which the analyst, the analyst's employer, or other employees had an equity stake that they could sell after a lock-up period.⁴⁷

Charges alleging such activities have been brought and have been settled against twelve securities firms.⁴⁸ The practices uncovered have been characterized as widespread and continuing for many years as an industry practice.⁴⁹ Some examples illustrate the industry viewpoint that increased profits was more important than a commitment to fair and accurate reports and recommendations by analysts.

At Merrill Lynch, analysts provided Infospace, Inc. with the firm's highest rating, but privately the analysts labeled Infospace "a powder keg" and a "piece of junk."⁵⁰ Similarly, Merrill Lynch "was urging customers to buy [Lifeminders, Inc.] while Merrill Lynch analysts privately were referring to the company as a 'p.o.s.' Let [us] simply say that p.o.s. is a euphemism for an extremely poor investment."⁵¹ At UBS Warburg, positive recommendations were issued by an analyst on Interspeed, which was one of the firm's investment banking clients, but

47. The SEC's on-site examination of nine full secure brokerage firms found that in 26 of 97 lock-ups reviewed, research analysts may have issued "booster shot" research reports. Testimony of Laura S. Unger, *supra* note 35. See generally Orcutt, *supra* note 26, at 25.

48. *Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking* (Apr. 28, 2003), available at <http://www.sec.gov/news/press/2003-54.htm> (last visited Jan. 21, 2006) (declaring that Bear Stearns, Credit Suisse, Goldman Sachs, Lehman Brothers, J.P. Morgan, Merrill Lynch, Morgan Stanley, Salomon, UBS Warburg and Piper Jaffray all agreed to substantial penalties and disgorgement of profits); *Deutsche Bank Securities Inc. and Thomas Weisel Partners LLC Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking* (Aug. 26, 2004), available at <http://www.sec.gov/news/press2004-120.htm> (last visited Jan. 21, 2006).

49. E.g., Roel Campos, *Comment & Analysis: Let Issuers Pay for Analysts' Research*, FIN. TIMES, Nov. 20, 2002 at 21 (stating that recent disclosures suggest that for years analysts' research has been improperly influenced by pressure to issue positive research to attract underwriting and investment banking business).

50. *Hearing on Corporate Governance Before the U.S. Senate Comm. On Commerce, Science and Tech., Sub-Comm. On Consumer Affairs, Foreign Commerce and Tourism, 107th Cong.*, (June 26, 2002) (testimony of Eliot Spitzer, N.Y. Att'y Gen.), available at <http://www.commerce.senate.gov/hearings/062602spitzer.pdf>.

51. *Id.*

privately the analyst stated that the stock should be shorted.⁵² At Salomon Smith Barney, analyst Grubman reiterated a “buy” recommendation in February 2001 on Focal, an investment banking client, and a target price of \$30 (twice the stock price). The same day, an institutional investor e-mailed a research analyst who worked for Grubman, “McLeod [McLeod USA Inc.] and Focal are pigs aren’t they?” and asked whether Focal was a short. The analyst responded, “Focal definitely”⁵³ In April 2001, Grubman stated privately the need to downgrade Focal, but nevertheless once again advised investors to buy Focal.⁵⁴ At Credit Suisse, Digital Impact received a “buy” or “strong buy” rating from January 2000 to April 2001, even while the stock price declined from \$50 to less than \$2.⁵⁵ In May through September 2001, a new analyst stated privately he wanted to drop coverage on the company because of its difficult market environment. However, he did not drop coverage due to pressure from investment bankers, and left the buy rating unchanged until October 2001.⁵⁶ At Bear Stearns, Micromuse, Inc. received a “buy” rating while an analyst of the firm privately characterized the stock as “dead money.”⁵⁷ At Lehman Brothers, an analyst who covered RSL Communications, Inc. stated privately, “I have attempted to downgrade RSLC THREE times over the last year, but have been held off for banking reasons each time.”⁵⁸ At Deutsche Bank Securities, an analyst issued positive recommendations on Oracle but privately expressed the view to a large institutional investor that the stock should be sold.⁵⁹ Similarly, an

52. SEC v. Citigroup Global Markets Inc., SEC Litigation Release No. 18111, (Apr. 28, 2003), *available at* <http://www.sec.gov/litigation/litreleases/lr18111.htm>.

53. U.B.S. Warburg, LLC., SEC Litigation Release No. 18112, 2003 SEC LEXIS 1008 (S.D.N.Y. Apr. 28, 2003).

54. *Id.* In April 2001, Grubman expressed the need to downgrade six telecom companies. Investment bankers pressured Grubman not to downgrade the companies, and he did not. He continued to advise investors to buy the stocks.

55. SEC v. Credit Suisse First Boston, SEC Litigation Release No. 18110, (Apr. 28, 2003) *available at* <http://www.sec.gov/litigation/litreleases/lr18110.htm>.

56. *Id.*

57. SEC v. Bear, Stearns & Co. Inc., SEC Litigation Release No. 18109, (Apr. 28, 2003), *available at* <http://www.sec.gov/litigation/litreleases/lr18109.htm>.

58. SEC v. Lehman Brothers Inc., SEC Litigation Release No. 18116, (Apr. 28, 2003), *available at* <http://www.sec.gov/litigation/litreleases/lr18116.htm>.

59. SEC v. Deutsche Bank Securities Inc., SEC Litigation Release No. 18854, (Apr. 26, 2004), *available at* <http://www.sec.gov/litigation/litreleases/lr18854.htm>.

analyst issued a “market perform” rating on Eprise Corporation while privately referring to the company as “permanent toast.”⁶⁰

The persistence of an industry-wide culture of ignoring the federal antifraud law’s underlying purpose is witnessed in reactions and responses to the global settlement reached with the SEC. Statements made soon after the settlement were to the effect that the securities firms had done nothing that should be of concern to their clients.⁶¹ This reaction received a rebuke from the SEC.

Similarly, actions taken soon after the settlement also evidence a culture of ignoring the law’s purposes and perhaps its literal requirements. The settlement prohibited analysts from engaging in marketing or selling efforts to investors with respect to investment banking transactions. Yet Bear Stearns distributed to clients an internet “roadshow” broadcast in which one of its senior analysts glowingly touted iPayment Inc., a company Bear Stearns was taking public.⁶² In addition, Bear Stearns, Citigroup and other investment banks distributed analysts’ revenue and earnings estimates for companies whose initial public offerings they were underwriting.⁶³ In the latter case, the firms claimed analysts could, under the settlement, prepare internal use memoranda and participate in efforts to educate the sales force. Yet, the reports were being distributed to investors, and the settlement also stated that firms could not do indirectly what they are barred from doing directly.⁶⁴

D. Conclusion

A vague statutory standard was not determinative of analyst conduct in the securities industry. The purpose behind the legal standard was ignored and, at times, the legal standard itself was violated by many members of the industry.

These findings contradict the assumption in the *Principles of Corporate Governance* that the law determines corporate conduct. What

60. *Id.*

61. *See infra* note 76 and accompanying text.

62. Ann Davis & Randall Smith, *Deals & Deal Makers: Investment Bankers Wrangle Over Gray Areas In Pact On IPOs*, WALL ST. J., May 23, 2003, at C5.

63. *Id.*

64. *Id.*

is leading corporate actors to evade or ignore legal mandates? This issue is explored in Part Three of this article.

PART THREE – RECOGNIZING AND EMBRACING COST-BENEFIT ANALYSIS

Law commonly takes the form of a vague standard, whether a common law standard or a statutory standard. Law also frequently employs a disclosure standard. However, it is not the legal mandate itself but the interaction of many influences that is determining corporate conduct. These various influences can be described as costs of compliance/noncompliance, benefits of compliance/noncompliance, or the means to evaluate whether the costs exceed the benefits.

Thus, cost-benefit evaluations are not to be ignored, as demanded by the *Principles of Corporate Governance*, but need to be studied in order to make law a more effective influence on corporate behavior. Part Three of this article explores this issue by examining the role of cost-benefit evaluations in the law and in corporate decision making.

A. Cost-Benefit Evaluations in Corporate Decisions on Legal Compliance

The law and economics literature has, at times, suggested that cost-benefit analysis is relevant in determining whether corporate actors acted reasonably in discharging their legal obligations, with legal sanctions treated as prices for noncompliance.⁶⁵ This approach has been criticized, largely on normative grounds.⁶⁶ The *Principles of Corporate Governance* accepts the latter position as a normative principle and as a mandatory principle of conduct. It takes the position that the law does

65. Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155, 1168 n.36, 1177 n.57 (1982); Stephen L. Pepper, *Counseling at the Limits of the Law: An Exercise in the Jurisprudence and Ethics of Lawyering*, 104 YALE L.J. 1545, 1576-77 (1995).

66. See, e.g., John C. Coffee, *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 794 n.11, 798 (1984); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1272-73 (1999) (stating that an economic approach would significantly diminish the force of the otherwise existing social norms, such as truth-telling); Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1543 (1984) (finding that economists sometimes think of sanctions as prices, which prevents them from understanding the normative character of law).

not permit cost-benefit analysis to play a role in corporate decisions regarding legal compliance.⁶⁷ However, this view ignores that the nature of most legal regimes invites cost-benefit evaluations.

The position embraced by the *Principles of Corporate Governance* presumes that the legal mandate — i.e., when response is required and what response is required — is clear. Many legal regimes are characterized by vague legal standards. When this is the case, the corporation must assess whether its actions are in violation of a governing legal standard, and, if so, what response is required. Both assessments are being made in an environment of uncertainty regarding the legal mandate. Added to this uncertainty, at times, is additional uncertainty regarding the likelihood and type of sanction if the corporation is deemed to be in noncompliance. In choosing to define the legal mandate broadly, which would best serve the law's purpose, or narrowly, which would avoid changing current corporate practices that are profitable, cost-benefit analysis inevitably influences the corporation's assessment.

B. Evasion of Law As A Reasonable Decision

1. Decision Making in a Cost-Benefit Context

Existing studies of organizational behavior have found that both legal and non-legal factors influence corporate decisions. Factors exerting an influence,⁶⁸ although not necessarily a determinative influence, include concern over community reputation, community pressure and publicity. These are influences based, in part, on social norms. Other factors exerting an influence are competitive pressures and reputation among peers. These are influences based, in part, on industry norms. Other influences on corporate behavior are assessments of costs of compliance and financial capabilities. Finally, the factors exerting an influence on corporate decisions include legal regimes. This encompasses not only the law's mandate, which was examined in Part Two of this article, but also enforcement measures, such as inspection

67. ALI, *supra* note 10.

68. *Supra* notes 20-21.

frequency and type of sanction.

All of these influences, including the type of legal mandate imposed, can be best understood as interacting in the context of a cost-benefit evaluation. Some influences are costs or benefits of compliance. These include direct costs of compliance, competitive pressures, severity of legal sanctions and publicity (either favorable or unfavorable). Other influences are upon internal evaluation of costs and benefits. This includes the type of legal mandate. For example, a vague legal mandate permits reasonable denial of noncompliance and influences the assessment of likelihood of sanctions. Factors influencing corporate evaluations also include factors affecting evaluations of risk, such as inspection frequency and likelihood of imposition of sanctions based on past practices. Finally, they include factors that help the corporate actor weigh costs versus benefits and arrive at a decision regarding corporate behavior. These include industry norms and community pressures. Thus, all influences uncovered in past studies and in the case studies in this article are best understood when they are viewed in the context of the overall approach taken by corporate actors to decision making. Namely, they are best understood not when studied individually but when studied as components of an interacting group of influences all of which play a role in corporate cost-benefit evaluations.

How does complexity, namely the synergistic interaction of distinct influences, affect this viewpoint? Existing studies have largely taken a reductionist view of individual influences. They have sought the one or several influences that alone or in conjunction determine corporate conduct. However, complexity theory forces us to recognize that human behavior results from the interaction of many influences, with the role played by individual influences varying in differing contexts and the synergy produced by the interaction of influences leading to unpredictable outcomes.⁶⁹

This is not to say, however, that we cannot draw conclusions regarding frequently recurring outcomes to test general propositions. Examination of market outcomes allows us to see results produced after the interaction of a variety of influences. Such market outcomes were examined in the case studies in Part Two. What recurring conclusions were witnessed? First, the law's mandate was not determinative of corporate behavior. This reflects the weak influence of social norms,

69. NICOLIS & PRIGOGINE, *supra* note 3.

not only the general norm of compliance with law, but also specific social norms reflected in the specific purposes behind the mandates studied in Part Two.⁷⁰ Second, a variety of other influences that individually or in conjunction might lead to legal compliance, such as reputational concerns, publicity, and community pressure, in fact did not typically engender legal compliance. All of these influences, or fears of them, existed in the case study in this article, yet none led to commitment to legal compliance. This has implications for free market proponents.⁷¹ Non-legal influences, such as reputational concerns or competitive pressures, did not lead to a strong commitment to the law's mandate or its underlying purpose even when such purpose reflects accepted social norms. Thus, the free market viewpoint that inspection and enforcement measures are unnecessary, or that a legal signal (a legal regime) is itself unnecessary, is discredited in the case studies in Part Two.

How then can organizational behavior be changed so as to embrace a greater commitment to legal compliance? The position in this article is that recognizing corporate cost-benefit evaluations and incorporating such evaluations into legal regimes would achieve this result. The means to accomplish this result while embracing complexity theory and evidence of complexity in organizational behavior is discussed section C, below.

However, this article first examines the role played by psychological influences on organizational behavior, their effects on evaluations of risks and benefits, and the reason such influences lead to lack of commitment to legal compliance in many legal regimes that have been utilized. It then explores an alternative legal regime that exerts greater influence on corporate behavior.

70. The legal mandate discussed in this article reflects social norms that direct members of our society to avoid taking financial advantages of others who may not be able to protect themselves (e.g., the securities industry case study).

71. See discussion, *supra* note 20.

2. Psychological Influences on Evaluation of Risks

Denial As A Behavioral Tendency

Two types of behavioral tendencies lead corporate actors to choose to evade legal mandates and purposes when commitment to compliance undermines maximization of profits.⁷² The first behavioral tendency is denial. This includes denial of responsibility or fault, which undermines the potential influence of the social norm of conformity with law. For the individual, corporate structures allow individuals to deny personal moral responsibility for corporate actions by claiming they are merely agents rather than decision makers.⁷³ Given the large number of individuals involved in corporate decisions, as well as the inherent nature of the corporate structure in which all directors and senior officers are merely agents for shareholders, corporate structures permit denial of responsibility even among senior level executives and corporate directors.

For the corporation as an entity, the denial of responsibility or fault takes various forms. First, there is a denial of legal noncompliance. Given the vague nature of most legal mandates, such denial is almost always an option. Neither the legal mandate nor the required course of action is clear, and, therefore, denial of noncompliance becomes a prevailing practice.⁷⁴

In the securities industry, members strongly denied any wrongdoing when charges were brought by regulators based on securities analysts' conduct. Merrill Lynch, for example, stated it always had procedures in place to protect the independence of research analysts and claimed that evidence uncovered by the New York State Attorney General merely "may have appeared" inconsistent with Merrill Lynch's published recommendation.⁷⁵ Morgan Stanley's CEO stated, "I don't see anything

72. Dennis Fox, *The Law Says Corporations Are Persons, but Psychology Knows Better*, 14 BEHAV. SCI. & L. 339, 348-49 (1996).

73. *Id.*

74. See Smith, *supra* note 2, at 1300 (noting the ambiguity of rules created through statutory and judicial means).

75. Press Release, Merrill Lynch & Co. Inc., Merrill Lynch Announces Agreement With New York State Attorney General (May 21, 2002) (on file with author); Press Release, Merrill Lynch & Co. Inc., Merrill Lynch Statement on Action by N.Y. Attorney General (Apr. 5, 2002).

in the settlement that will concern the retail investor about Morgan Stanley.”⁷⁶ He received a strong rebuke from SEC Chairman Donaldson and then apologized for the remark.⁷⁷ Similarly, Citigroup claimed that changes it had agreed to in its settlement were merely aimed to ensure that the firm “adhere to the new standards that are emerging.”⁷⁸ In other words, past actions fully complied with standards traditionally imposed but were criticized only due to the emergence of new standards. Merrill Lynch’s CEO wrote an editorial in the *Wall Street Journal* in which he stated:

Risk-taking is essential to capitalism. Without it, the system can’t function Of course, in any system predicated on risk-taking, there are failures, sometimes spectacular failures. But for every failure to be viewed as fraudulent or even criminal bodes ill for our economic system. The message to CEOs, to entrepreneurs and to venture capitalists right now is that you cannot afford to be wrong.⁷⁹

In other words, there was no wrongdoing — only losses resulting from normal investment risks. Both responses evidence denial of noncompliance as one level of corporate response.

A second form of denial is denial of responsibility for outcomes. At times, this takes the form of shifting blame to external forces such as market conditions. The securities industry case study provides such an example, with investors’ losses blamed on the decline in the value of telecommunications stocks and not on the misleading analyst recommendations.⁸⁰

76. U.S. SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, *THE IMPACT OF THE GLOBAL SETTLEMENT* (2003), available at <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Testimony&TestimonyID=177&HearingID=28>.

77. 35 *Sec. Reg. & L. Rep.* (BNA) 789 (May 13, 2003).

78. CITIGROUP, *BUSINESS PRACTICES PROGRESS REPORT* (Aug. 7, 2002), <http://www.citigroup.com/citigroup/press/citigroup2002.htm>.

79. Stan O’Neal, *Risky Business*, *WALL ST. J.*, Apr. 24, 2003, at A16 (discussing that Citigroup blamed investors’ losses on a collapse in the telecommunications sector and not on the quality of Jack Grubman’s stock recommendations). Citigroup, *Telecom Analyst Jack Grubman to Leave Salomon Smith Barney* (Aug. 15, 2002), <http://www.citigroup.com/citigroup/press/citigroup2002.htm>.

80. *Id.*

Decision Making Heuristics

The second type of behavioral tendency that leads corporate actors to evade legal mandates and purposes is resorting to decision making heuristics that exaggerate benefits and minimize risks of noncompliance. For the purposes of this article, the most relevant heuristic devices witnessed that minimize risks of noncompliance are skewed risk perception, simplified decision making strategy and omission bias. The most relevant heuristic devices witnessed that exaggerate benefits of noncompliance are the endowment effect and combined loss aversion/risk aversion.

Skewed risk perception is the inverse relationship found in individuals' perceptions of risks versus benefits. When a high benefit is perceived (e.g., high profits produced by a course of action), then any risk posed by the activity is viewed as a low risk, whereas when a low benefit is perceived, then any risk posed by the activity is viewed as a high risk. This is regardless of the actual objective level of risk that a disinterested third party would perceive.⁸¹

Simplified decision making strategy is a response to complexity when individuals are faced with a number of interacting variables and uncertainty in expected future outcomes. Such complexity (e.g., determining the adverse profit consequences of a change in product design, or the probability of exposure to legal liability when liability is based on numerous, vague prerequisites to recovery) is beyond human cognitive ability to process.⁸² As a result, individuals resort to a simplified decision making strategy. They typically give the highest value to the choice that is most important to the decision maker,⁸³ (e.g., preserving high profits). In addition, they typically ignore risks that are viewed as low probability risks⁸⁴ (e.g., successful private lawsuits where a cause of action is difficult to prove).

81. See CASS R. SUNSTEIN, *RISK AND REASON* 40-41 (2002).

82. See Russell B. Korobkin and Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1077 (2000).

83. *Id.* at 1077-78 (showing research involving decision making by consumers); See also Charles Yablon, *The Meaning of Probability Judgments: An Essay On the Use and Misuse of Behavioral Economics*, 2004 U. ILL. L. REV. 102-03, 110-13 (discussing the subjective nature of probability judgments).

84. Robert Prentice, *Chicago Man, K-T Man, and The Future of Behavioral Law and Economics*, 56 VAND. L. REV. 1663, 1758 (2003).

Omission bias, sometimes referred to as regret theory, refers to the finding that individuals regret adverse consequences stemming from their actions more than adverse consequences stemming from inaction.⁸⁵ Thus, risks from maintaining the status quo (e.g., risk of exposure to liability) are minimized while risks of changing the status quo (e.g., loss of profits) are exaggerated.

Turning to the perception of benefits of noncompliance, the endowment effect is a finding that individuals place greater value on what they already own than on what benefit they might receive from a future change in conduct.⁸⁶ This is related to risk aversion. Risk aversion is a finding that individuals are averse to expected gains from a change in a course of action. They prefer greater certainty when the benefit is a proposed future gain as opposed to the predicted gain from maintaining the status quo.⁸⁷ Loss aversion is a finding that individuals fear losses, indeed they fear losses roughly twice as much as they enjoy gains.⁸⁸ The result of these three heuristics is that benefits of maintaining the status quo, which evidences a low commitment to legal compliance, are exaggerated. The obvious benefit sought to be preserved is high profits from the current corporate course of conduct. At the same time, a change in course of conduct is resisted in part because gains are uncertain.

Many of the psychological studies exploring human decision making have been conducted on individuals, responding as individuals.⁸⁹ However, further studies have found no differences in uses of decision making heuristics in group decision making, such as may exist in an organizational setting.⁹⁰

These decision making heuristics are evidenced in the conduct of corporate actors. This evidence is explored below.

85. *Id.* at 1700, 1760.

86. Korobkin & Ulen, *supra* note 82, at 1107-08; Prentice, *supra* note 84, at 1674-75, 1700.

87. Korobkin & Ulen, *supra* note 82, at 1104.

88. Prentice, *supra* note 84, at 1674; SUNSTEIN, *supra* note 81, at 42.

89. Prentice, *supra* note 84, at 1714.

90. *Id.*

Citigroup's Reasonable Response to the Risk of Civil Penalties and
Lawsuits Seeking Damages

Citigroup's cost associated with a strong commitment to compliance with federal securities regulations governing analysts' conduct would be the loss of investment banking fees and brokerage commissions produced by trading in recommended shares. Court documents reveal the investment banking fees earned by Salomon Smith Barney due to specific technology stocks for which its top telecommunications analyst, Jack Grubman, provided misleading buy recommendations. These commissions exceeded \$1 billion in the years 1998 through 2001.⁹¹ This was the revenue produced by wrongdoing on the part of only one analyst. Moreover, it does not include brokerage commissions earned due to trading in the stocks in question. Thus, the overall benefit of noncompliance to Citigroup was significantly more than \$1 billion. Indeed, Citigroup's head of equity research saw a threat to \$16 billion in fees. What were the risks of noncompliance?

The perceived legal risks were the imposition of sanctions by the SEC and, possibly, awards of damages in lawsuits brought by investors. At the time of the wrongdoing both risks were low probability risks.

Conflicts of interest faced by securities analysts had existed industry wide for many years and had not been challenged by regulators.⁹² If actions had been taken, the cost was predicted to be small. Prior to the SEC's fine levied against the bankrupt WorldCom

91. Complaint at ¶ 51, *New York v. Anschutz*, available at http://www.oag.state.ny.us/press/2002/sep/sep30c_02_complaint.pdf (summarizing investment banking revenues produced by Grubman in the telecommunications sector, for which he served as an analyst, in 1998-2001); Assurance of Discontinuance at ¶ 32, *In the Matter of Citigroup Global Markets, Inc.*, http://www.oag.state.ny.us/investors/citigroup/citigroup_aod.pdf (summarizing same for 1999-2001). These fees totaled:

1998	\$ 255,735,000
1999	\$ 359,189,000
2000	\$ 331,142,000
2001	<u>\$ 101,000,000</u>
	\$1,047,066,000

92. J. ROBERT BROWN, *THE REGULATION OF CORPORATE DISCLOSURE* § 8.04 (3d ed. 1998) (The SEC has occasionally brought enforcement actions directly against analysts for violations of the securities laws. Most involved analysts who misappropriated information and tipped it to others. No cases involved analysts qua analysts). See also Fisch & Sale, *supra* note 26, at 1061 ("after . . . 1991 . . . the SEC stopped bringing selective disclosure actions based on [§] 10(b)").

Inc., the SEC's biggest fine against an operating company had been just \$10 million.⁹³

Private lawsuits alleging securities law violations against analysts were viewed as difficult to prove and, therefore, unlikely to be successful.⁹⁴ The difficulty lies in proving all of the elements for recovery, including scienter and causation.⁹⁵ Each of these elements may be justified in isolation,⁹⁶ but they lead to the conclusion that risk of liability is a low probability risk and, therefore, can be ignored or assumed when the firm is faced with large profits from a particular course of conduct. Indeed, the experience of plaintiffs' attorneys in lawsuits later filed based on misleading securities analysts reports have confirmed the assessment that few can be successful.⁹⁷

93. Deborah Solomon, *As Corporate Fines Grow, SEC Debates How Much Good They Do*, WALL ST. J., Nov. 12, 2004, at A1.

94. David J. Labhart, *Securities Analysts: Why These Gatekeepers Abandoned Their Post*, 79 IND. L.J. 1037, 1041-44 (2004) (discussing heightened pleading requirements imposed by the Private Securities Litigation Reform Act of 1995, as well as requirements such as false statements of fact (rather than opinion), scienter, and proximate cause); Fisch & Sale, *supra* note 26, at 1057-58 (finding that suits against analysts alleging fraud have been rare). See also John C. Coffee, Jr., *Understanding Enron: "Its About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1409-10, nn.29-32 (2002) (discussing decreased risks of lawsuits in the 1990s against gatekeepers, such as auditors, based on legislative enactments and Supreme Court decisions decreasing the statute of limitations applicable to securities fraud and eliminating private "aiding and abetting" liability).

95. See *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005) (dismissing investors' lawsuit against securities firm and its research analyst for failure to adequately plead that conflicts of interest and misrepresentations by the research analyst caused their financial loss).

96. See *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627 (2005) (stating that the securities law seeks to protect investors against those economic losses that misrepresentations actually cause and the statute imposes the burden of proving loss causation on the plaintiffs).

97. Susanne Craig, *Lawsuits Seeking to Cash In Amid the \$1.4 billion Accord Mostly Have Garnered Nothing*, WALL ST. J., Jan. 17, 2005, at C1. Securities industry arbitration panels have rejected the vast majority of cases decided thus far. Most of the arbitration cases from the stock research settlement have been filed by Richard Lott's firm and another pair of lawyers, James Hooper and Robert Weiss. Mr. Lott filed about 300 cases against Merrill Lynch and has lost all 25 cases that have completed the process. Messrs. Hooper and Weiss filed 800 cases against Citigroup and they have won just 37 cases and lost 97). *Id.*

In 2003, Citigroup settled with the SEC and state securities regulators by agreeing to pay \$400 million in monetary sanctions, which included \$150 million as a penalty.⁹⁸ This sanction was unexpected.⁹⁹ Some lawsuits brought by investors have yielded large recoveries. For example, a settlement of a class action lawsuit by investors in WorldCom, Inc., which focused in part on misleading ratings by telecommunications analyst Jack Grubman, was for the sum of \$2.65 billion,¹⁰⁰ or \$1.64 billion after tax.¹⁰¹ However, this was an unusually large settlement. Previous large settlements in securities class action cases have been in the hundreds of millions of dollars.¹⁰² Citigroup's settlement with investors over the collapse of Global Crossing was for the sum of \$75 million, or \$46 million after tax.¹⁰³ Both the size of the

98. SEC v. Citigroup Global Markets, Inc., Civ. Action No. 03 Civ. 2945 (S.D.N.Y. 2003), available at <http://www.sec.gov/litigation/litreleases/judge18111.pdf> (including \$150 million as a penalty, \$150 million as disgorgement of commissions and other monies, \$75 million for procurement of independent research, and \$25 million for investor education). This is the largest settlement against the 10 firms subject to the global research analyst settlement; see also Order Approving Settlements and Entering Final Judgments, <http://www.sec.gov/spotlight/globalsettlement/appnewinvestedplan.pdf>. Part of the settlement is tax deductible for the firms. SEC Chairman Donaldson clarified that the \$387.5 million disgorgement amount in the \$1.4 billion dollar settlement probably can be deducted as well as independent research and investor education models. Senator Dodd estimated that only about one third of the settlement is a penalty on which the firms will not get a tax deduction or insurance coverage. Sec. Reg. & L. Rep. (BNA), May 12, 2003, at 790. Citigroup hopes to recover at least part of its share of the settlement from its insurer; Patrick McGeehan, *Wall St. Firms Want Insurers to Cover Fines*, N.Y. TIMES, Jan. 18, 2003, at C1 (apart from recovery of some of the costs of the settlement with regulations, restitution money to investors, like damages awarded in court, can be recovered under certain types of insurance policies).

99. See generally Gretchen Morgenson, *Accord Highlights Wall St. Failures*, N.Y. TIMES, Dec. 20, 2002, at C1. The settlement and investigation that let up to it show a serious breakdown in self-policing by the brokerage firms, and how regulators fell down on their jobs during the stock surge of the late 1990s. The SEC seemed unconcerned about tainted analysis. It took New York Attorney General Spitzer to spotlight the issue.

100. Mitchell Pabelle, *Citigroup Will Pay \$2.65 billion to Settle WorldCom Investor Suit*, WALL ST. J., May 11, 2004, at A1.

101. *Citigroup Settles Round 2*, N.Y. TIMES, May 12, 2004, at A22

102. Kara Scannell & Mitchell Pabelle, *Wall Street Gets Sticker Shock from Citigroup*, WALL ST. J., May 12, 2004, at C1.

103. *Global Crossing Investors Settle with Citigroup*, N.Y. TIMES, Mar. 3, 2005, at C2. See also Susan Harrigan, *Citigroup Settles for \$75M*, NEWSDAY, Mar. 3, 2005, at

WorldCom settlement and Citigroup's possible exposure to liability was unexpected before the fact.

In hindsight, Citigroup's decision not to strongly commit to legal compliance could be viewed as an unreasonable decision. Losses from noncompliance have been substantial. However, this is an assessment made in hindsight. At the time the decisions were made, they could be viewed as reasonable decisions made in light of cost-benefit evaluations. At the time, risks of noncompliance were low probability risks. Moreover, when the WorldCom settlement is viewed as an atypically large settlement, Citigroup's decision may not even be clearly unreasonable. Apart from the WorldCom settlement, when all lawsuits involving misleading analyst statements are settled, revenue benefits of noncompliance may still exceed costs of noncompliance.

Finally, it is not even clear that the large fine and settlement due to analyst activities would itself alter industry conduct in future activities. There have been one-time, large settlements in the past,¹⁰⁴ yet they did not alter industry commitment to legal mandates and their purposes, as evidenced by conduct in recent years. Perhaps each large settlement is viewed as a unique occurrence, and each factual setting in which fraud is alleged is viewed as a unique factual context.

As discussed above in the Citigroup example, at the time corporate decisions were made the actual risks of noncompliance could be viewed as low probability using an objective measure of risk. Moreover, when skewed risk perception is introduced as a decision making heuristic, the assessment of probability drops even further. This is because the high benefit produced, in the form of billions of dollars in revenues, further diminishes the assessed probability of risk. Simplified decision making

A46 (\$75 million is "about one day's worth of free cash flow" for Citigroup says analyst Richard Bove).

104. See Gretchen Morgenson, *Corporate Conduct: News Analysis; Accord Highlights Wall St. Failures*, N.Y. TIMES, Dec. 20, 2002, at C1 (reporting fines paid by investment companies related to bad investment advice including: Prudential Securities, 1993-95, \$1.5 billion paid in fines and restitution to investors who lost money in risky limited partnerships; Nasdaq and 30 securities firms, 1996-97, \$1 billion paid to settle claims of price fixing in trading of Nasdaq stocks; Drexel Burnham Lambert, 1988, \$650 million paid for trading on inside information; Merrill Lynch, 1997-98, \$470 million paid to settle lawsuits alleging the firm provided bad investment advice that pushed Orange County into bankruptcy; Salomon Brothers, 1992, \$290 million paid for submitting fake bids to buy Treasury securities).

strategy confirmed this conclusion with regard to investor lawsuits. Such suits required proof of numerous legal prerequisites for recovery, including intent, reliance, and causation.¹⁰⁵ As a result, processing probable outcomes was beyond human cognitive ability. Using simplified decision making strategy, the highest value is given to the outcome that is most important to the decision maker — e.g., preserving existing high revenues — while low probability risks are ignored.¹⁰⁶

This approach, combined with omission bias, also skews decisions in favor of maintaining the status quo rather than actively committing the firm to greater commitment to legal compliance. The actual adverse impact on revenues of modifying analysts' research reports and recommendations is unknown and unknowable. However, risk of changing the status quo (e.g., loss of revenues) is exaggerated in the mind of the decision maker. The endowment effect and loss aversion serves to confirm the conclusion that noncompliance is a wise course of action in the mind of the corporate decision maker, because existing, high profits from current conduct (the status quo) are most important to that decision maker.

Overall, the law's vague mandate to the securities industry — to avoid fraudulent conduct — generates denial rather than compliance. In addition, cost-benefit evaluations made in light of behavioral heuristics lead to the conclusion that evasion, rather than commitment to the law and its purposes, is the reasonable course of conduct.

C. An Alternative Regime: Market-Based Sanctions as a Strange Attractor

The evidence presented in this article leads to the conclusion that the law must overcome three substantial barriers regarding legal compliance. First, industry norms must be overcome. Part Two of this article documented prevailing industry practices — practices seeking to avoid or evade compliance with law when it will adversely affect corporate profits. In the securities industry case study, regulators eventually took action to stop misleading statements due to analyst conflicts of interest that were no secret in the securities industry and had

105. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 13.2.1 (3d ed. 1996) (discussing the development, use, success and elements of Rule 10b-5 cases).

106. See Prentice, *supra* note 84, at 1758.

existed for decades.¹⁰⁷

Second, the behavioral tendency to deny responsibility and fault must be overcome. One conclusion that can be drawn from the case studies is that greater certainty in the law is one approach to overcoming denial of responsibility. Yet there are significant limitations to relying solely on this approach. First, it addresses only one form of denial — denial of noncompliance. It does not address the other denial strategies — e.g., denial of responsibility.¹⁰⁸ Second, in many situations certainty in the legal mandate — i.e., certainty in the required course of conduct for corporate actors — is a difficult or infeasible option. For example, what precise disclosures of risks or likelihood of benefits would be imposed on all securities analysts in all future research reports? Certainty in proscribed courses of conduct is often not a practical, and at times not even a possible, alternative. In addition, at times certainty in proscribed conduct is counterproductive, in that corporations, faced with continuing pressure to maximize profits, search for and exploit loopholes in the proscribed standard.¹⁰⁹ Thus, more is needed. What is needed is a legal regime that motivates corporate actors to commit to legal compliance rather than to seek ways to avoid or evade the law. This requires overcoming industry norms, behavioral tendencies of denial, and decision making heuristics that currently favor maintaining strategies that evade the law even in the face of potential or actual sanctions.

The alternative proposed is one that uses industry norms and

107. See Richard Perez-Pena & Patrick McGeehan, *Assault on Wall St. Misdeeds Raises Spitzer's U.S. Profile*, N.Y. TIMES, Nov. 4, 2002, at B6; see also Gretchen Morgenson, *Requiem for an Honorable Profession*, N.Y. TIMES, May 5, 2002, § 3 at 1 (stating that interviews with former analysts at a variety of firms provide evidence that in recent years analysts were driven not to provide the best advice for investors but to generate investment banking fees).

108. See discussion, *supra* note 80 and accompanying text.

109. E.g., Julie Claire Diop, *Young Workers Easily Cheated by Some Firms*, THE BALTIMORE SUN, Apr. 4, 2004, at 5D (stating that one way unscrupulous companies cheat younger workers is by wrongly classifying them as interns or contract employees, which don't count as employees subject to the Fair Labor Standards Act's provisions on wages); Steven Greenhouse, *Middlemen in the Low-Wage Economy*, N.Y. TIMES, Dec. 28, 2003, Week in Review at 10 (noting that, after federal agents raided 60 Wal-Mart stores, the company claimed it did not know that labor contractors for the firm hired illegal immigrants or cut corners by not paying overtime and social security taxes).

decision making heuristics in a manner that compels greater commitment to legal compliance. The proposal is one that embraces the corporate strategy of employing cost-benefit evaluations in making decisions on legal compliance but skews evaluations in such a manner that benefits of compliance outweigh costs of noncompliance more often than under current legal regimes.

The proposal relies on market-based sanctions, as opposed to the sanctions of injunctive relief, fines or recovery of damages that are typically relied upon currently. The proposal is best understood by first examining complexity theory's concept of strange attractors.

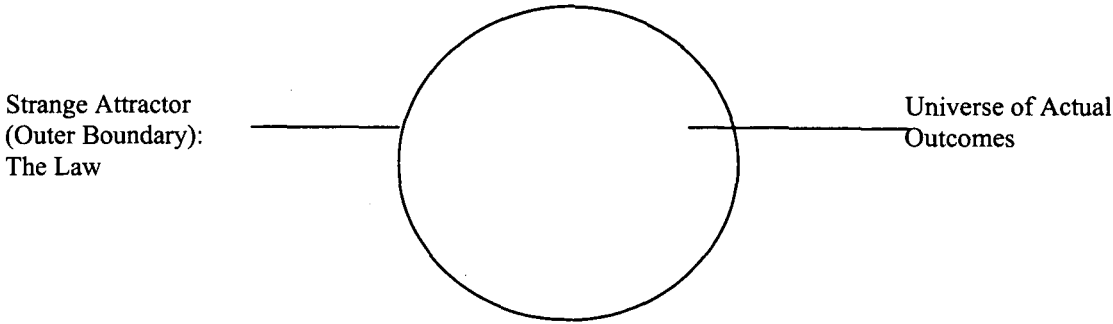
Complexity theory recognizes that human behavior results from the interaction of many factors and, therefore, precise outcomes are unpredictable. However, such outcomes are not chaotic. Rather, there is an outer boundary that constrains outcomes. Precise outcomes can fall anywhere within the outer boundary. Such boundary, or strange attractor, can be the result of self-organization,¹¹⁰ or it can be externally imposed.¹¹¹

The *Principles of Corporate Governance* assume that the law acts as the outer boundary for corporate ethical behavior.¹¹² Thus, actual conduct will vary from firm to firm but conduct will always fall within the outer boundary which is the legal mandate applicable to a particular situation. Schematically, this can be represented as follows:

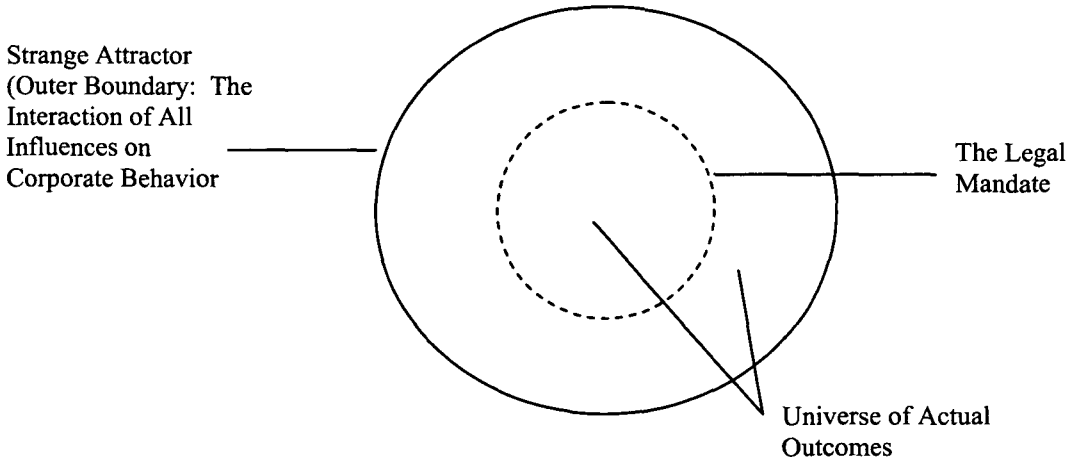
110. See generally ILYA PRIGOGINE & ISABELLE STENGERS, ORDER OUT OF CHAOS 141-42 (1984) (concluding that nature searches for a new order after the onset of turbulence).

111. See JACK COHEN & IAN STEWART, THE COLLAPSE OF CHAOS 396-99 (1994) (finding that strange attractors are the organizing constraint to the seemingly chaotic nature of change).

112. See ALI, *supra* notes 5-7 and accompanying text.



However, the case studies in Part Two of this article demonstrate that this is not the case, particularly when the legal mandate is vague. Law serves as only one influence on corporate behavior, but it is not determinative of corporate behavior. Thus, in reality, law and other influences become self-organizing influences to form an outer boundary to corporate behavior, but the boundary is not equivalent to the legal mandate. Schematically, actual corporate conduct under currently prevailing legal regimes can be represented as follows:



The challenge is to draw the actual strange attractor (outer boundary) to corporate behavior, as evidenced by actual outcomes in the market, closer to the legal mandate. The alternative legal regime I

propose is a greater use of market-based sanctions.

Experience in the banking industry with the Community Reinvestment Act (CRA) provides support for this alternative. The proposal is to rely on loss of market share as a sanction for noncompliance with law. This sanction can be combined with a clear legal mandate, or it can be combined with a vague legal mandate, as it has been in the CRA experience. Thus, continued use of vague legal standards becomes a possibility without sacrificing corporate commitment to compliance.

Citigroup's response to a variety of charges of violations of law also illustrates the effectiveness of market-based sanctions. In recent years, Citigroup faced a number of scandals involving violations of law, including misleading reports issued by securities analysts, mutual fund abuses, and aiding fraud committed by clients such as Enron.¹¹³ Yet a strong commitment to legal compliance emerged only after Japanese authorities shut down its private bank operations and banned Citigroup from participating in its government bond auctions.¹¹⁴

After these actions on the part of Japanese authorities, as well as the possibility that European government officials would forgo choosing Citigroup to underwrite international bond offerings because of ethical lapses in Europe, the cost-benefit evaluation changed dramatically for Citigroup.¹¹⁵ Lost business and market share was no longer a cost of compliance but instead a cost of noncompliance. Once again,

113. Mara Der Hovanesian & Paula Dwyer, *Can Chuck Prince Clean Up Citi?*, BUS. WK., Oct. 4, 2004, at 32.

114. *Id.* (CEO Prince has now begun to overhaul the risk and compliance hierarchy in New York, establish a set of compliance reports to be sent to the audit committee of Citi's board, establish a Policy Compliance Assessment Group, and mandate ethics training for all employees); Mitchell Pacelle, Martin Fackler & Andrew Morse, WALL ST. J., Dec. 22, 2004, at A1 (CEO Prince is now acknowledging that he and his colleagues were too focused on the bottom line, and in a series of sweeping moves he has beefed up compliance and sent a message that top managers could be held accountable for regulatory lapses anywhere in their domain). In addition to the market based response of Japanese authorities, Citigroup has angered governmental authorities in England, Belgium and Italy which often give Citi lucrative contracts to handle their international bond offerings. DeHovanesian and Dwyer, *supra* note 113.

115. DeHovanesian and Dwyer, *supra* note 113, at 32 (In a Sept. 20 report, in which he downgraded the bank's shares to neutral from buy, Merrill Lynch & Co. banking analyst Guy Moszkowski charged that Citi's "aggressive profit incentives [are] overriding judgment").

noncompliance was no longer a reasonable corporate decision.

Self-regulatory agencies and the SEC are exploring greater use of a form of market-based sanction, by imposing business line suspensions, such as five-day suspensions for registrations of brokers, on securities firms charged with regulatory wrongdoing.¹¹⁶ This article urges greater use of market-based sanctions.

The Community Reinvestment Act¹¹⁷ offers a model of a legislative scheme that completely alters corporate cost-benefit evaluations and leads to heightened commitment to compliance with law. The statutory mandate is a vague one — namely, a financial institution must meet “the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of such institution”¹¹⁸ The regulations implementing the Act did little to clarify the financial institution’s obligation. There was no required level of commitment and no stipulated activities or course of conduct.¹¹⁹ The corporation itself was asked to determine what specific action and what level of commitment would meet the statutory mandate. Indeed, the corporation itself was asked to define the assessment area in which the sufficiency of its activity would be judged.¹²⁰ On its face, this vague legal regime should encourage cost-benefit evaluations. Indeed, the statute itself spoke of the balancing of safety and soundness considerations against the duty to serve a community’s credit needs. As a result, denial of noncompliance, a narrow reading of statutory obligations, and lack of commitment to the law’s purpose should have

116. Jenny Anderson, *Wall St. Turns to the Timeout as Punishment*, N.Y. TIMES, Dec. 8, 2004, at C1 (noting that suspensions imposed by the NASD, NYSE and SEC informed firms that they have the authority to suspend business and will use it under appropriate circumstances).

117. 12 U.S.C. §§ 2901-2908 (2005).

118. 12 U.S.C. § 2903(a)(1) (2005).

119. See Statement of the Federal Financial Supervising Agencies Regarding the Community Reinvestment Act, 43 Fed. Reg. at 47, 148. Prior to 1995 compliance was judged based on the efforts of the institutions rather than the outcomes produced. See Community Reinvestment Act Regulations and Home Mortgage Disclosure, Final Rules, 60 Fed. Reg. 22, 156 and 22, 159 (1995). After 1995, performance based standards were used — with evaluations of loans made, investments made, and accessibility of branches and credit services. *Id.* at 22, 162-67. Yet even after 1995 no particular level of activity or mix of activity was mandated.

120. 12 C.F.R. § 228.41 (1999).

been the outcome.

In the early years of the Act's existence, there was indeed a very modest level of corporate response. In the first ten years of the Act, the banking industry committed approximately \$5 billion in loans pursuant to the Act.¹²¹

However, the Act contained an important enforcement mechanism — one not commonly employed. It permitted, but did not require, the federal regulators to deny an “application for a deposit facility” based on a poor CRA commitment.¹²² This could serve as an important market based sanction. The term “application for a deposit facility” encompasses the opening of a new bank branch, the acquisition of a new line of business, and even the merger of financial institutions.¹²³ Thus, denying these applications would deny the institution market share and profits. At times, this could deprive the institution of a small additional market presence and profit center (e.g., denial of an application to open a new branch). At other times it could deprive the institution of substantial additional market share and profits (e.g., denial of an application for a merger).

However, in the early years of the Act the potential enforcement tool was a very low probability risk. In the first ten years of the Act, only eight of an estimated 40,000 applications were denied on CRA grounds.¹²⁴ Indeed, it was not until 1989 that a merger application was denied to a big bank on CRA grounds.¹²⁵ This type of application would cause the greatest loss of market share and lost profit opportunity. Thus, cost-benefit evaluation led to the reasonable conclusion that very modest commitment to the law's mandate was a reasonable response. Indeed, many institutions could conclude that no response at all was also a reasonable response when faced with lost profits due to the extra costs of CRA commitment and possible increased risks of default by CRA borrowers.

This evaluation began to change after 1988. In the 1989-94 period,

121. See *infra* note 130.

122. 12 U.S.C. § 2903 (a)(2) (2005).

123. 12 U.S.C. § 2902(3) (2005).

124. Allen J. Fishbein, *The Community Reinvestment Act After Fifteen Years: It Works, but Strengthened Federal Enforcement Is Needed*, 20 FORDHAM URB. L.J. 293, 298 (1993) (calculation by the Center for Community Change).

125. Kenneth H. Thomas, *CRA at 25: Reforming an Almost Perfect Law*, AM. BANKER, Dec. 13, 2002, at 6.

the number of applications denied more than doubled.¹²⁶ In addition, perception of increased risk of enforcement and sanction resulted from a more than doubling of the approval of applications subject to conditions or commitments imposed by federal regulations.¹²⁷ Finally, after 1989, the regulators stopped the practice of permitting the institution to agree to conditions or commitments to offset prior, poor CRA performance and thereby cause regulators to grant approval for applications for deposit facilities.¹²⁸

These increased enforcement measures changed the cost-benefit calculation. Loss of market share due to legal sanction was no longer a very low probability risk. Lost profits became a cost of noncompliance rather than a cost of compliance. This view was embraced even though the overall frequency of market sanctions might be deemed to be low.¹²⁹ Incentive to comply was generated due to the large cost of the sanction when it was imposed. In other words, the threshold for viewing the risk of sanction to be substantial was not a high threshold because the loss of market share and profits could be substantial.

The industry response was dramatic. By early 1988, only approximately \$5 billion had been committed by banks to CRA loans.¹³⁰ However, by 1993, more than \$30 billion had been committed as a result of the CRA.¹³¹ By the summer of 1995, this figure had risen to more

126. There were 17 denials on CRA grounds, compared with 8 in the first 10 years of the Act. See U.S. GEN. ACCOUNTING OFFICE, PUB. NO. GAO/GGD-96-23, COMMUNITY REINVESTMENT ACT: CHALLENGES REMAIN TO SUCCESSFULLY IMPLEMENT CRA, at 30 (1995) (discussing the effectiveness of CRA and major problems with its implementation).

127. Conditions or commitments were imposed 58 times in the 1977-82 period but were imposed 167 times in the 1989-94 period. *Id.* at 31.

128. See Vincent M. Di Lorenzo, *Equal Economic Opportunity: Corporate Social Responsibility in the New Millennium*, 71 U. COLO. L. REV. 51, 95 (2000).

129. *Id.* at 100.

130. A 1985 study by the Hubert Humphrey Institute of Public Affairs found banks had committed \$3.7 billion under the CRA. *Community Reinvestment Act: Hearings before the Senate Comm. on Banking, Hous., and Urban Affairs*, 100th Cong., at 99 (1988) (Statement of Calvin Bradford, Senior Fellow, Hubert Humphrey Inst. of Pub. Affairs). Thereafter, the Center for Community Change estimated an additional \$1.5 billion in commitments had been made by early 1988. *Id.* at 149 (statement of Allen J. Fishbein, Gen. Counsel, Ctr for Cmty. Change).

131. Fishbein, *supra* note 124, at 294, 298.

than \$61 billion.¹³² Through the first quarter of 1998, the figure rose to more than \$397 billion.¹³³ Thereafter, the figure jumped to more than \$1 trillion by the year 2000 in the midst of the bank mega mergers.¹³⁴ In other words, market based sanctions induced significantly greater commitment to compliance with the law's purpose, and in turn market conditions multiplied the overall quantitative manifestation of that commitment. This heightened commitment to the Act's purposes has continued in recent years, with Bank of America, for example, increasing its CRA commitment from \$350 billion in 1998¹³⁵ to \$750 billion in 2004.¹³⁶

Dollar volume of CRA commitments is only one measure of the Act's success. Another measure is the prevalence of CRA lending programs among financial institutions subject to the Act. In 1992, a survey of its members conducted by the Consumer Bankers Association (CBA) found 91.4 percent of respondents had loan programs in place targeting low- to moderate-income housing.¹³⁷ These programs included special affordable mortgage products, enhanced marketing plans targeting minority and low-income groups, and automatic review of loan rejections.¹³⁸ They increased in frequency between 1992 and 1993.¹³⁹ A

132. See NAT'L CMTY. REINVESTMENT COALITION, CRA DOLLAR COMMITMENTS SINCE 1977 (1995) (calculations completed by the author).

133. See NAT'L CMTY. REINVESTMENT COALITION, CRA COMMITMENTS 1977-1997, at 11 (1999).

134. Policy Link, Community Reinvestment Act: More Than \$1 Trillion Invested Through CRA, <http://www.policylink.org/EDTK/CRA/action.html> (last visited Jan. 24, 2006).

135. Olaf de Senerpont Domis & Jaret Seiberg, *Nations Bank, Bank America Challenge Critics on CRA*, AM. BANKER, July 10, 1998, at 1 (10 year commitment).

136. Laurie Kulikowski, *B of A Details \$750 B Commitment*, WALL ST. J., Oct. 26, 2004, at 27 (10 year commitment made in light of bank's merger with Fleet Boston). In 2005, the Nat'l Cmty. Reinvestment Coalition reported that CRA agreements have led to commitments totaling more than \$4.2 trillion. NAT'L CMTY. REINVESTMENT COALITION, CRA COMMITMENTS 1 (2005), available at <http://www.ncrc.org/policy/cra/documents/2005-09-21CRACommitmentsUpdated.pdf> (Sept. 21, 2005).

137. See Griffith L. Garwood and Dolores S. Smith, *The Community Reinvestment Act: Evolution and Current Issues*, 79 FED. RESERVE BULL. 251, 262 (1993); New Survey Fills Gaps in HMDA Data, Shows Commitment By Bankers, CBA Says, 59 Banking Rep. 629 (BNA) (Nov. 2, 1992).

138. See Edward Kulkosky, *More Flexibility Seen in Lending to Needy*, AM. BANKER, Oct. 7, 1993, at 10.

139. *Id.* A reduced down payment requirement was reported by 91.2% of

survey by the New York Banking Department similarly found a substantial change in bank lending practices over the 1991 to 1993 period.¹⁴⁰ The CBA survey was limited to retail banking institutions who were members of the CBA. Such institutions focus on home equity lending.¹⁴¹ A later survey of the largest retail banking institutions, including both commercial banks and savings associations, conducted by the Federal Reserve Board in 2000, found 73 percent of respondents offered at least one CRA special lending program.¹⁴²

CONCLUSION AND IMPLICATIONS

Law is not necessarily determinative of corporate conduct. In an industry subject to a vague legal standard, the influence of law on corporate conduct is weakest. This article examined the conduct of securities analysts in response to the vague legal mandate provided in the federal securities law. Yet the legal regime faced by securities analysts is a regime that is common in United States law. It is a regime based on (a) a vague legal mandate, that leads to ease of denial of

respondents in 1993, up from 88.6% in 1992. More flexible debt-to-income requirements were reported by 83.5% of respondents, compared to 82.1% a year earlier. Relaxed loan-to-value ratios were reported by 80.1% of respondents, up from 71.5% a year earlier. Increased flexibility in employment requirements was reported by 74.7% of respondents, against 56.9% a year earlier. In addition, 89% reported accepting alternative credit histories, such as utility bill and rent payments. This question was not asked in the earlier survey. *See id.*

140. *See* N.Y. State Banks Have Changed Mortgage Lending Practices, Banking Dep't Reports, 61 Banking Rep. 759 (BNA) (Nov. 15, 1993). Sixty percent of respondents had made changes in their lending practices during this period, including requiring lower down-payments, permitting higher housing or debt ratios, and allowing greater flexibility in the source of funds for down payments and closing costs. Seventy-eight percent of respondents had procedures for a second review of rejected mortgages, up from half that had such a procedure in place prior to 1991.

141. Consumer Bankers Association, <http://www.cbanet.org> (last visited Jan. 12, 2006).

142. Robert B. Avery, Raphael W. Bostic, and Glenn B. Canner, *CRA Special Lending Programs*, 86 FED. RESERVE BULL. 711, 714 (2000). The most frequently mentioned special lending programs offered were more flexible underwriting criteria, a second review of loan applicants to determine qualifications, special outreach and marketing activities, waived or reduced fees, pre-loan education or counseling to applicants, and reduced interest rates.

wrongdoing and cost-benefit evaluations, (b) prerequisites to legal liability, that may be individually justified but are difficult to establish and cause actors to view the risk of sanction as a low probability risk, and (c) reliance on sanctions such as fines or lawsuits seeking recovery of damages that impose costs that do not outweigh large perceived benefits of evasion of the law or, at times, noncompliance.

One response could be to impose clearer legal mandates. The recent legislative and regulatory response to the conflicts of interest faced by securities analysts is an example of that sort of response.¹⁴³ This can reduce the reasonable use of the behavioral tendency to deny wrongdoing. If vigorously enforced, it can help deter noncompliance, although not necessarily deter evasion. However, it is unrealistic to expect that the law can resort to clear legal prohibitions in most cases, in the sense that denial of noncompliance becomes impossible or at least implausible. Vague prohibitions and mandates will continue to be the norm.

How do we achieve a strong commitment to a legal mandate and to its underlying purposes while utilizing a general (vague) standard that can apply in a variety of contexts over time? The evidence presented in

143. The Sarbanes-Oxley Act of 2002 requires the SEC or self-regulatory organizations to adopt rules that, *inter alia*, (a) restrict prepublication clearance or approval by investment banking departments of analysts' research reports, (b) limit supervision and compensatory evaluations of securities analysts to officials not engaged in investment banking, and (c) define periods during which brokers or dealers participating in a public offering should not publish or distribute research reports relating to the issuer. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 501 (a) (2002). The SEC has approved such rules proposed by The New York Stock Exchange and the National Association of Securities Dealers. Order Approving NYSE Proposed Rule Changes Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 34-48252, 68 Fed. Reg. 45875 (Aug. 4, 2003) (stating that analyst compensation is approved by a compensation committee and may not be based on the analyst's contribution to the firm's overall investment banking business, analysts may not participate in pitches or other communications for the purpose of soliciting investment banking business, and persons not directly responsible for research are restricted from prepublication review and approval of research reports); Order Granting Accelerated Approval of Amendments to NYSE Proposed Rule Change Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 34-45908, 67 Fed. Reg. 34968 (May 16, 2002) (showing the prohibition on investment banking personnel supervising analysts or approving research reports, prohibition on tying analyst compensation to a specific investment banking transaction, and a prohibition on offering favorable research to induce investment banking business).

this article supports three conclusions. First, contrary to the position adopted in the *Principles of Corporate Governance*, we must recognize that cost-benefit evaluations will play an important role in corporate decisions regarding legal compliance. Second, cost-benefit evaluations can be used to fashion future responses to corporate misconduct. Any proposed change in the law should be examined with reference to how it will change the corporation's cost-benefit evaluation. It is that evaluation that appears to play a significant role in the misconduct being addressed. Therefore, the proposed change in the law should have a direct impact on that evaluation. In an ideal scenario, the proposed change in the law should significantly increase the risks of noncompliance to the point where such risks outweigh the benefits of noncompliance. The final conclusion is that a market based system of sanctions serves this purpose. The most important benefit to the industry of any course of conduct is profits based on operations and market share. A system of market-based sanctions changes this from a lost benefit due to compliance to a feared loss of benefit due to noncompliance. As demonstrated by the banking industry experience under the CRA, this change leads to significantly greater corporate commitment to legal compliance.

Notes & Observations