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Corporate Governance in an Era of Compliance

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ABSTRACT

Compliance is the new corporate governance. The compliance function is the means by which firms adapt behavior to legal, regulatory, and social norms. Formerly, this might have been conceived as a typical governance matter to be handled at the discretion of the board of directors. Compliance, however, does not fit traditional models of corporate governance. It does not come from the board of directors, state corporate law, or federal securities law. Compliance amounts instead to an internal governance structure imposed upon the firm from the outside by enforcement agents. This insight has important implications, both practical and theoretical, for corporate law and corporate governance.

This Article pairs a detailed descriptive study of the contemporary compliance function with a normative account of its incompatibility with current conceptions of corporate governance. It argues that compliance alters the political economy of American business, challenges governance efficiency, and makes old theories of the firm new again. Prescriptively, the Article calls for greater transparency and a more limited role for government in designing corporate governance mechanisms.

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"About the only thing bank directors have more of these days is meetings," joked one senior Wall Street executive who has frequent interaction with his board.... "Regulators have all but stripped boards of the main powers they had before the crisis." [1]

INTRODUCTION

American corporate governance has undergone a quiet revolution. Much of its basic role—the oversight and control of internal corporate affairs—has been overtaken by compliance. Although compliance with law and regulation is not a new idea, the establishment of an autonomous department within firms to detect and deter violations of law and policy is. American corporations have witnessed the dawn of a new era: the era of compliance.

That we now live in an era of compliance is beyond serious doubt. Over the past decade, compliance has blossomed into a thriving industry, and the compliance department has emerged, in many firms, as the co-equal of the legal department. Compliance is commonly headed by a Chief Compliance Officer (CCO) who reports directly to the Chief Executive Officer (CEO) and, often, to the board as well. Moreover, firms have gone on a hiring spree to staff compliance, with large firms adding hundreds, even thousands, of compliance officers at a time.[2]

The reorganization of American business around compliance, by itself, is not necessarily remarkable. After all, firms routinely reorganize their businesses, and such reorganizations, because they take place under the fundamental authority of the board of directors, do not challenge basic structures of authority. For example, the

1. Susanne Craig, *At Banks, Board Pay Soars Amid Cutbacks*, N.Y. TIMES: DEALBOOK (Mar. 31, 2013, 9:57 PM), http://dealbook.nytimes.com/2013/03/31/pay-for-boards-at-banks-soras-amid-cutbacks [https://perma.cc/3RA4-H455].

2. *See* Sam Fleming, *The Age of the Compliance Officer Arrives*, FIN. TIMES (Apr. 24, 2014, 12:19 AM), http://www.ft.com/intl/cms/s/0/cadd54a6-c3bd-11e3-a8e0-00144feabdc0.html#axzz3yHSCEAqQ [https://perma.cc/WAP2-GZ63] (arguing that boom in compliance hiring and salaries comes at risk of business exit from higher cost business lines); Gregory J. Millman & Samuel Rubenfeld, *Compliance Officer: Dream Career?*, WALL ST. J. (Jan. 15, 2014, 8:13 PM), http://www.wsj.com/articles/SB10001424052702303330204579250722114538750 [https://perma.cc/V3AH-27RH]; Aruna Viswanatha, *Wall Street's Hot Trade: Compliance Officers*, REUTERS (Oct. 9, 2013, 7:05 AM), http://www.reuters.com/article/2013/10/09/us-usa-banks-compliance-idUSBRE9980EE20131009 [https://perma.cc/FX7B-X5FX].

establishment of an Information Technology department, headed by a Chief Technology Officer, can hardly be seen as a fundamental shift in corporate governance. Compliance, however, is different. The contemporary compliance function serves a core governance function, yet its origins cannot be traced to a board delegation or other traditional source of governance authority. Unlike other governance structures, its origins are exogenous to the firm.

The impetus for compliance does not come from a traditional corporate constituency—in other words, not from shareholders, managers, employees, creditors, or customers. Instead, it comes from the government. Compliance is a de facto government mandate imposed upon firms by means of ex ante incentives, ex post enforcement tactics, and formal signaling efforts. The imposition of governance structures aimed at compliance is a novel exercise of government power. In imposing these structures, the government is not simply making rules that firms must follow, as it does when it passes new laws and regulations, nor is it adjusting its traditional tools—the amount of enforcement and the size of sanctions—to assure compliance with existing law and regulation. Instead, through compliance, the government dictates how firms must comply, imposing specific governance structures expressly designed to change how the firm conducts its business.[3]

Moreover, government interventions in compliance come not through the traditional levers of state corporate or federal securities law, but rather through prosecutions and regulatory enforcement actions.[4] The resulting reforms are thus not the product of a transparent

3. For a discussion of some of the differences between making and enforcing law versus imposing governance structures, see *infra* Part III.A.

4. This Article treats federal prosecutors and enforcement agents as essentially interchangeable with regard to the development of compliance. *See* Brandon L. Garrett, *Collaborative Organizational Prosecution*, *in* PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT 154, 154-55 (Anthony S. Barkow & Rachel E. Barkow eds., 2011) (disputing rigid institutional separation of civil versus criminal enforcement in light of collaborative efforts between prosecutors and regulators and the far-reaching deterrent effects of enforcement actions). The important differences between the role of federal prosecutors and federal agencies and the dynamics of the interaction between the two are largely outside of the scope of this Article. For a discussion of these differences, see generally Daniel Richman, *Prosecutors and Their Agents, Agents and Their Prosecutors*, 103 COLUM. L. REV. 749 (2003). Regulatory examinations, such as those conducted in the banking industry, constitute another category of compliance intervention that is largely consistent with this Article's account of enforcement. *See, e.g.*, Dennis Townley & Paula Caughey, *Regulatory Compliance Issues for*

and politically accountable legislative process, nor are they the product of regulatory rule making, subject to cost-benefit analysis and public comment. Rather, they are extracted in an opaque settlement process under the Sword of Damocles.[5] Compliance thus presents a profound challenge to theories of corporate law and corporate governance.

The contemporary compliance function subverts the notion that corporate governance arrangements both are and ought to be the product of a bargain between shareholders and managers. Compliance rewrites Ronald Coase's famous passage on the internal organization of firms.[6] Compliance officers come into an organization not necessarily (or not entirely) at the behest of an "entrepreneur-coordinator, who directs production,"[7] but rather pursuant to the directive of a government enforcer. Seen through the prism of compliance, the corporation no longer resembles a nexus of contracts but rather a real entity, subject to punishment and rehabilitation at the pleasure of a sovereign. Compliance thus rejects mainstream accounts of the firm in favor of older, largely discarded theories.

Furthermore, the imposition of intrafirm governance from extrafirm sources introduces a host of outside interests and incentives into firm decision making. Once corporate governance is no longer seen as the exclusive domain of shareholders and managers, questions arise over what purpose or purposes the firm should serve. Compliance thus revives the "other constituencies" debate—that is, the argument over whether corporations should serve constituencies other than shareholders and interests other than wealth maximization. Compliance also raises the question whether the authorities pressing for corporate reforms have the right incentives and the right information to do so. If they do not, the development of compliance may merely result in the imposition of inefficient governance structures on firms.

Small Banks, ASPATORE (2013), 2013 WL 5293293 (describing how the burdens of the regulatory examination process have grown).

5. *See infra* Part I.A.2.

6. Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 387 (1937) ("If a workman moves from department *Y* to department *X*, he does not go because of a change in relative prices, but because he is ordered to do so.").

7. *Id.* at 388.

Yet, in spite of squarely challenging current orthodoxy on corporate law and governance, compliance is largely absent from the mainstream corporate law literature.[8] Aspects of compliance, especially those relating to the prosecution and settlement of cases against corporations, do appear in scholarship on criminal law and regulatory enforcement.[9] Mainstream corporate law scholarship, however, remains centrally focused on the agency cost problem and, because compliance is not principally concerned with agency costs,[10] blithely unaware of the challenge posed by compliance to its underlying assumptions.[11] Because it appears as an unexplained and, under current models, unexplainable phenomenon, compliance

8. Some exceptions include: Stephen Bainbridge, Caremark *and Enterprise Risk Management*, 34 J. CORP. L. 967 (2009); Lawrence A. Cunningham, *Deferred Prosecutions and Corporate Governance: An Integrated Approach to Investigation and Reform*, 66 FLA. L. REV. 1 (2014); James Fanto, *Paternalistic Regulation of Public Company Management: Lessons from Bank Regulation*, 58 FLA. L. REV. 859 (2006) (foreshadowing the era of compliance by arguing that the SEC should adopt a bank-regulatory model in regulating the governance of public firms); Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487 (2003) [hereinafter Krawiec, *Cosmetic Compliance*]; Kimberly D. Krawiec, *Organizational Misconduct: Beyond the Principal-Agent Model*, 32 FLA. ST. U. L. REV. 571 (2005); Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems,"* 31 J. CORP. L. 949 (2006); Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71; Omari Scott Simmons, *The Corporate Immune System: Governance from the Inside Out*, 2013 U. ILL. L. REV. 1131 (focusing on compliance as part of the "internal immune system" of corporate governance); Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation Through Non-Prosecution* (N.Y. Univ. Sch. of Law, Public Research Paper No. 16-04, 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id+2731351 [https://perma.cc/C5U9-JS9M].

9. *See, e.g.*, IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION TRANSCENDING THE DEREGULATION DEBATE 101-32 (1992) (discussing compliance as a kind of "enforced self-regulation"); BRANDON GARRETT, TOO BIG TO JAIL: HOW PROSECUTORS COMPROMISE WITH CORPORATIONS (2014) (discussing compliance reforms as a common outcome of corporate prosecutions); SHARON ODED, CORPORATE COMPLIANCE: NEW APPROACHES TO REGULATORY ENFORCEMENT (2013) (providing an account of which enforcement policies most efficiently induce proactive compliance); Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949 (2009) (discussing corporate compliance in connection with the "New Governance" literature).

10. Compliance may be understood to focus on a different agency cost problem than the issues on which mainstream corporate law scholarship focuses. *See* ODED, *supra* note 9, at 10 (emphasizing that her work on compliance "does not address the well-established *principal-agent problem* between corporate management and shareholders, but rather focuses on a different agency problem; the one that exists between corporations (or the management thereof) and corporate employees undertaking corporate activity").

11. *See infra* notes 217-21 and accompanying text.

exposes deficiencies in corporate law theory. Likewise, compliance itself is undertheorized.

This Article aims to change that by launching compliance as a field of inquiry for scholars of corporate law and corporate governance. Its descriptive account documents the origins of compliance and demonstrates its maturation into a corporate governance function. The central argument in this Article is that the contemporary compliance department is the product of a de facto government mandate that, although felt most strongly by firms in highly regulated industries, has become a market-wide concern.

This Article's normative portion then draws out the implications, both theoretical and pragmatic, of the descriptive account. It demonstrates how compliance challenges settled theories of the firm and upsets the political economy of corporate governance. Fundamentally, compliance begs the foundational question of who the author of corporate governance arrangements ought to be. The Article's normative account also addresses more pragmatic problems of agency costs and information asymmetries and the implications for firm efficiency. Finally, the Article offers two directions for reform—one focused on changing enforcement tactics, the other on increasing transparency. At this stage in the debate, however, solving the problems posed by compliance may be less important than raising them. That is the fundamental contribution of this Article—to engage scholarly debate and provide a framework for dialogue between prosecutors, policymakers, and scholars of corporate law and corporate governance.

From this Introduction, the Article proceeds as follows. Part I documents the era of compliance in which all firms now live, probing the origins of compliance and showing compliance in action, as it is actually practiced by firms today. Part II then examines the connection between what we now call compliance and what has traditionally been understood as corporate governance. It shows how the compliance function largely supplants traditional modalities of corporate governance and highlights the radically divergent approaches to compliance taken by traditional governance authorities on the one hand, and enforcement authorities on the other. Part III expands on the problems inherent in this arrangement, demonstrating both the incompatibility of compliance with the theoretical underpinnings of mainstream corporate law scholarship as well as more pragmatic considerations of agency costs, externalities, and information asymmetries. Part IV offers two ways of addressing the issues posed by compliance with a goal more of starting the scholarly conversation on compliance than of putting the issue to rest. The Article then closes with a brief summary and Conclusion.

I. Compliance

All firms exist within a nexus of legal, regulatory, and social norms. The contemporary compliance function is the means by which firms adapt their behavior to these constraints. More concretely, compliance is the set of internal processes used by firms to adapt behavior to applicable norms.[12]

Compliance establishes internal mechanisms to prevent and detect violations of law and regulation. Compliance officers thus build and administer programs to prevent money laundering, bribery, and fraud.[13] But the scope of compliance is greater than the enforcement of law and regulation. Compliance officers also administer corporate "ethics" policies on a wide variety of subjects.[14] Other soft standards such as "reputation risk" also come within the ambit of the contemporary compliance function.[15] Because any significant scandal or

12. GEOFFREY P. MILLER, THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE 3 (2014) (defining compliance as "the *processes* by which an organization seeks to ensure that employees and other constituents conform to applicable norms—which can include either the requirements of laws or regulations or the internal rules of the organization"); *accord* DELOITTE & COMPLIANCE WEEK, IN FOCUS: 2014 COMPLIANCE TRENDS SURVEY 7 (2014), http://www2.deloitte.com/content/dam/Deloitte/us/Documents/risk/us_aers_dcrs_deloitte_compliance_week_compliance_survey_2014_05142014.pdf [https://perma.cc/9KRW-JTWB] (defining compliance as the "alignment between their organization's behavior and professed values").

13. Because the goal of this Article is to analyze the development of compliance across industries, it avoids going into the details of industry-specific compliance regulation. One implication of this choice is that this Article focuses on the greatest cross-industry compliance risks, such as fraud and corruption. *See* GARRETT, *supra* note 9, at 5. Nevertheless, compliance officers frequently cite industry-specific regulation as their core compliance concern. *See infra* note 108 and accompanying text.

14. *See generally* Detlev Nitsch et al., *Why Code of Conduct Violations Go Unreported: A Conceptual Framework to Guide Intervention and Future Research*, 57 J. BUS. ETHICS 327 (2005); Daniel Rottig et al., *Formal Infrastructure and Ethical Decision Making: An Empirical Investigation and Implications for Supply Management*, 42 DECISION SCI. 163 (2011).

15. *See* Michele DeStefano, *Creating a Culture of Compliance: Why Departmentalization*

wrongdoing associated with the business can be and often is characterized as a "compliance failure," the compliance function effectively assumes general responsibility for business conduct consistent with social norms.

Because conduct that violates social norms can also lead to significant losses, the compliance function may be seen to overlap significantly with risk management.[16] Compliance is a core part of "Enterprise Risk Management," a management system that seeks to provide an integrated response to all sources of risk to the business enterprise.[17] In a similar vein, industry insiders frequently talk of the merger of governance, risk, and compliance.[18] Compliance may thus be seen as a risk or control function, the core mission of which is to minimize downside risk associated with misconduct.

This Part provides analytical perspective on the contemporary compliance function, describing where it comes from, what it is, and what it does. Section A begins by tracing the origins of compliance. Section B then distills the common core of compliance. Section C looks at compliance in action, describing the function as it is currently practiced across industry categories.

A. Federal Origins

The origins of compliance can be traced to the federal government's interventions in corporate affairs. These government incursions into private law have not been led by regulators or legislators enacting amendments to corporate or securities law—the government's traditional inroads to corporate affairs. Rather, com-

May Not Be the Answer, 10 HASTINGS BUS. L.J. 71, 95 n.100 (2014) ("Chief compliance officers also advise on business and reputation risks.").

16. Risk management is a business operation of the firm typically focused on the quantitative modeling of business risk. *See* MILLER, *supra* note 12, at 2.

17. *Cf.* Bainbridge, *supra* note 8, at 968 ("Risk management and law compliance differ only in degree and not in kind.").

18. *See* ECONOMIST INTELLIGENCE UNIT, THE ECONOMIST, GOVERNANCE, RISK AND COMPLIANCE IN FINANCIAL SERVICES (2008), http://www.eiu.com/report_dl.asp?mode=fi&fi=1083557493.PDF [https://perma.cc/5RU8-Y9YG] (advocating the integration of governance, risk, and compliance functions); KPMG, THE CONVERGENCE EVOLUTION: GLOBAL SURVEY INTO THE INTEGRATION OF GOVERNANCE, RISK AND COMPLIANCE (2012), https://www.kpmg.com/NO/NB/Nyheter-Innsikt/artikler-og-publikasjoner/rapporter/Rapporter-2013/Documents/The-Convergence-Evolution.pdf [https://perma.cc/JWP8-GMGU].

pliance has been championed by the government's enforcement agents. This Section describes the origins of compliance and the role played by the federal government—first, in creating a role for compliance in corporate criminal sentencing, and second, in modifying prosecutorial tactics to make widespread use of deferred and non-prosecution agreements in which compliance reforms came to figure prominently.

1. Sentencing Guidelines

Although it has earlier precursors,[19] the present era of compliance began in 1991 with the adoption of the U.S. Sentencing Commission's Sentencing Guidelines for Organizations (the "Guidelines").[20] The Guidelines offered a carrot and a stick to induce greater corporate compliance with federal law. The carrot was the government's pledge to mitigate penalties if the corporation had implemented and maintained an effective compliance program.[21] The stick was a

19. There was an impetus toward compliance starting with the federal antitrust prosecutions in the 1960s through the criminalization of various corporate acts in the 1970s, including bribery, money laundering, and pollution. *See* Foreign Corrupt Practices Act of 1977, 15 U.S.C. § 78dd-1 (2012) (foreign bribery); Bank Secrecy Act of 1970, 31 U.S.C. § 5318(h) (2012) (barring money laundering and setting forth the "four pillars" of anti-money laundering (AML) compliance); National Environmental Policy Act of 1969, 42 U.S.C. § 4321 (2012) (pollution). However, enforcement was often lax under these early statutes, and penalties were often slight, providing little incentive to develop robust compliance programs. *See* Mark A. Cohen, *Corporate Crime and Punishment: An Update on Sentencing Practice in the Federal Courts, 1988-1990*, 71 B.U. L. REV. 247, 254-56 (1991) (showing that, as of the mid-1980s, most corporate fines were under $10,000, and the average fine was just over $48,000).

20. Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 839 (1994).

21. U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f) (U.S. SENTENCING COMM'N 2015) [hereinafter SENTENCING GUIDELINES], http://www.ussc.gov/sites/default/files/pdf/guidelines-manual/2014/CHAPTER_8.pdf [https:// perma.cc/M7LK-8GF9] (listing maintenance of an effective compliance program as a mitigating factor for the company's "culpability score"). Various governmental authorities had previously sought to induce corporations to implement compliance programs. *See, e.g.*, JAY A. SIGLER & JOSEPH E. MURPHY, INTERACTIVE CORPORATE COMPLIANCE: AN ALTERNATIVE TO REGULATORY COMPULSION 155-56 (1988) (discussing the Occupational Health and Safety Administration's "Star Program," which provides for relief from regulation for firms with strong compliance programs). However, the Guidelines were the government's first articulation of a promise to mitigate penalties for compliance on a global basis. *See* Memorandum from William C. Hendricks III, Chief of the Fraud Section Criminal Div., U.S. Dep't of Justice [DOJ], to all U.S. Attorneys (July 17, 1987), *in* ABA PUBLIC CONTRACT LAW SECTION, REPORT OF THE SPECIAL COMMITTEE ON VOLUNTARY DISCLOSURE 6-7 (1987) (describing the importance of compliance in charging decisions for criminal investi-

substantial increase in the penalties associated with criminal violations.[22]

The carrot came after the stick. Early drafts of the Guidelines increased penalties on corporations but offered no opportunity for mitigation.[23] In response, American corporations lobbied for a system of credits to offset the increase in penalties, offering internal compliance programs as the basis of the bargain.[24] Industry associations joined the effort.[25] The result was the inclusion of an "effective compliance program" on the list of mitigating factors.[26]

Having given compliance a formal role in reducing the applicable legal sanction for corporate wrongdoing, the Guidelines went a step further and articulated the necessary elements that make a program "effective." The draft Guidelines focused on four components: policies and procedures, communication, monitoring, and enforcement.[27] Since then, the definition of effective compliance has been

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gations of defense contractors).

22. *See* Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 745 (1997).

23. For example, mitigation was absent from the 1989 preliminary draft of the Guidelines. *See* NOLAN EZRA CLARK, COMPLIANCE PROGRAMS AND THE CORPORATE SENTENCING GUIDELINES: PREVENTING CRIMINAL AND CIVIL LIABILITY § 2:16, Westlaw (database updated Oct. 2015).

24. These companies included General Electric, Atlantic Richfield, Bristol-Myers Squibb, ITT, and Martin Marietta. *See id.* § 2:17 ("[T]he biggest concern that I have is in trying to help you find a balance between imposing sentences on corporations for their wrongdoing and at the same time trying to incentivize corporations to develop meaningful compliance programs." (quoting Martin Marietta's General Counsel)); *id.* ("The Commission should adjust the credits ... so that there may be no penalty fine for a corporation that has developed and implemented stringent policies and training, and yet has a low-level employee go astray." (quoting comments of General Electric Company et al. on the Sentencing Commission's proposed organizational sanctions)).

25. For example, at a meeting with the Sentencing Commission, the Business Roundtable urged:

> We very much believe that compliance programs are the best way to encourage compliance with the law, respect for the law by corporate employees and agents. We very much feel that the likelihood of reducing [the] number of corporate crimes is going to best be served by trying to encourage, enhance, build, [and] expand not only the presence of compliance programs in corporations but also the effectiveness and vigor with which they are administered and enforced inside the corporation itself.

Id. § 2:22 (first alteration in original); *see also id.* § 2:17 ("A substantial compliance program should receive a substantial reduction in fines.").

26. *Id.* § 2:18.

27. The Fall 1990 draft defined "effective" compliance as follows:

substantially revised,[28] and alternative definitions have been offered by multiple authorities.[29] Nevertheless, the Guidelines represent the foundational document in which the government not only gave legal effect to corporate compliance programs but also sketched their content. Through the Guidelines, the government engaged in program design.

Still, the Guidelines formally mandate compliance for no corporation. And the Guidelines force no company to adhere to its vision of "effective" compliance.[30] The Guidelines merely specify the sentences that judges can impose in cases in which corporations are convicted of criminal misconduct.[31] Such cases, of course, are rare.[32] As a result, the Guidelines are most important for setting the parameters of what might happen if the prosecutor and the corporate defendant fail to settle. How compliance figures into that bargain is the subject of the next Section.

2. Enforcement Tactics

Corporate prosecutions, like most criminal cases, typically settle.[33] In the wake of the Guidelines, federal prosecutors began to

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> First, the organization must have policies defining the standards, rules, and procedures to be followed by its employees. Second, the organization must communicate its policies effectively to employees, e.g., by training programs and publications. Third, the organization must use due diligence to ensure that its policies are complied with, e.g., by utilizing a monitoring system reasonably designed to ferret out criminal conduct by its employees and by having in place and publicizing to employees a reporting system whereby employees can report criminal conduct within the organization without fear of retribution. Fourth, the policies must be enforced, e.g., through disciplinary mechanisms.

Id. § 2:23.

28. The current Guidelines now feature seven factors, including: (1) rules, (2) high-level engagement and appropriate delegation, (3) diligence in hiring, (4) communication and training, (5) monitoring and testing, (6) alignment of incentives, and (7) appropriate remediation. SENTENCING GUIDELINES, *supra* note 21, § 8B2.1(b).

29. *See infra* note 69 and accompanying text.

30. *See* SENTENCING GUIDELINES, *supra* note 21, at 495 (introductory comment).

31. *Id.*

32. *See* Peter J. Henning, *The Organizational Guidelines: R.I.P.?*, 116 YALE L.J. POCKET PART 312, 312 (2007), http://yalelawjournal.org/forum/the-organizational-guidelines-rip [https://perma.cc/U5VW-RBEN] (arguing that the scarcity of corporate *convictions* as opposed to *settlements* "means that the Organizational Guidelines are largely irrelevant").

33. In the corporate context, prosecuting such cases is extremely costly in terms of time and resources. Vikramaditya Khanna & Timothy L. Dickinson, *The Corporate Monitor: The*

offer corporate defendants settlements that took compliance programs into account.[34] In an effort to standardize this practice, the Department of Justice (DOJ) articulated a set of principles for federal prosecutions, known after its author as the "Holder Memorandum."[35] The Holder Memorandum commits prosecutors to weigh, along with other factors such as voluntary disclosure and willing cooperation, "[t]he existence and adequacy of the corporation's compliance program."[36] Unlike the Guidelines, however, the Holder Memorandum did not attempt to specify the elements of effective compliance.[37] Instead, the Holder Memorandum preserved prosecutors' discretion to determine whether a program was well designed and effective.[38] These principles eventually were incorporated into the United States Attorney's Manual (the "Manual").[39] The Manual, like the Holder Memorandum, does not specify the elements of effective compliance and preserves broad prosecutorial discretion.[40]

New Corporate Czar?, 105 MICH. L. REV. 1713, 1721 (2007) ("[C]orporate crime cases are difficult, complex, and expensive cases to prosecute and tend to use a great deal of resources."). Successful prosecutions also risk serious collateral consequences, such as business failure. *See* GARRETT, *supra* note 9, at 19-44 (relating the story of the prosecution and subsequent collapse of Arthur Andersen).

34. *See* Mary Jo White, *Corporate Criminal Liability: What Has Gone Wrong?*, *in* 2 37TH ANNUAL INSTITUTE ON SECURITIES REGULATION 815, 818 (2005) (describing use, by U.S. Attorney's Office for the Southern District of New York, of deferred prosecution agreements in the early 1990s).

35. Memorandum from Eric Holder, Deputy Attorney Gen., to All Component Heads and U.S. Attorneys (June 16, 1999), http://www.justice.gov/sites/default/files/criminal-fraud/legacy/2010/04/11/charging-corps.PDF [https://perma.cc/2SN5-8UMU] [hereinafter Holder Memorandum].

36. *Id.* at para. II.A.4-6.

37. *Id.* at para. VII.B ("The Department has no formal guidelines for corporate compliance programs.").

38. *Id.* ("In answering these questions, the prosecutor should consider the comprehensiveness of the compliance program, the extent and pervasiveness of the criminal conduct; the number and level of the corporate employees involved; the seriousness, duration, and frequency of the misconduct, and any remedial actions taken by the corporation, including restitution, disciplinary action, and revisions to corporate compliance programs.").

39. DOJ, UNITED STATES ATTORNEYS' MANUAL § 9-28.700-.900 (2015), http://www.justice.gov/usam/usam-9-28000-principles-federal-prosecution-business-organizations [https://perma.cc/W4RH-G2N2].

40. *Id.* § 9-28.800.B ("The Department has no formulaic requirements regarding corporate compliance programs."). If anything, the Manual increases prosecutorial discretion by adding "good faith" to the list of things prosecutors may consider in assessing a program's effectiveness. *Id.*

This formal recognition of a role for compliance in the charging decision coincided with a dramatic shift in the prosecution of business organizations.[41] After the financial frauds and accounting scandals of 2001 and 2002, prosecutors sought to devise a strategy whereby they could investigate and punish corporate wrongdoing without investing the resources or taking the risks associated with full criminal prosecution.[42] The solution that emerged was a process whereby prosecutors would extract concessions from the corporation in exchange for a conditional promise *not* to prosecute, in the form of either a deferred prosecution agreement (DPA) or a nonprosecution agreement (NPA).[43] DPAs and NPAs reduce the costs associated with prosecutorial action—there is still the cost of investigation, but there are no trials, no risk of loss, and no collateral consequences—while simultaneously offering the prospect of large monetary recoveries from corporate defendants.[44] Not surprisingly, their use has dramatically increased.[45] The government has entered into over two hundred such agreements since the practice began,[46] at a rate that has gone from one or two per year in the early years to several dozen such agreements per year now.[47]

In addition to extracting fines, DPAs and NPAs often condition the government's forbearance on reform of the defendant corpora-

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41. *See* Lawrence D. Finder & Ryan D. McConnell, *Devolution of Authority: The Department of Justice's Corporate Charging Policies*, 51 ST. LOUIS U. L.J. 1, 1-2 (2006) (connecting the fact that "from 2002 to 2005, the DOJ has entered into twice as many non-prosecution agreements (NPAs) and deferred prosecution agreements ... as it had over the previous ten years" to shifts in department policy on corporate prosecutions).

42. *See* GARRETT, *supra* note 9, at 54-60 (discussing creation of the Corporate Fraud Task Force to coordinate corporate prosecutions and the adoption of the so-called Brooklyn Plan, according to which corporations would pay a fine and adopt compliance reforms in exchange for an agreement not to prosecute).

43. The government investigates but, in the case of an NPA, does not file formal charges or, in the case of a DPA, files charges but simultaneously suspends prosecution. Benjamin M. Greenblum, *What Happens to a Prosecution Deferred? Judicial Oversight of Corporate Deferred Prosecution Agreements*, 105 COLUM. L. REV. 1863, 1863-65 (2005).

44. *See* Leonard Orland, *The Transformation of Corporate Criminal Law*, 1 BROOK. J. CORP. FIN. & COM. L. 45, 53, 57 (2006).

45. *See id.* at 45-46.

46. Wulf A. Kaal & Timothy Lacine, *The Effect of Deferred and Non-Prosecution Agreements on Corporate Governance: Evidence from 1993-2013*, 70 BUS. LAW. 61, 85 fig.1 (2014) (reporting publicly available DPAs/NPAs from 1993-2013).

47. *See id.* (reporting 271 DPAs/NPAs from 1993-2013); *see also* GARRETT, *supra* note 9, at 65 (reporting 255 DPAs/NPAs from 2001-2012).

tion's compliance program.[48] Compliance reforms in DPAs/NPAs typically focus on improvements to policies and procedures, training, and employee monitoring.[49] The specifics of reform are often not described in great detail in the settlement agreements themselves, but may instead be contained in separate undisclosed agreements with enforcement authorities or industry regulators.[50] Of those that do appear in DPAs/NPAs, typical reforms include: improved corporate communications and training (45 percent of DPAs/NPAs), revisions to compliance policies (27 percent of DPAs/NPAs), and the formal adoption of a compliance code (19 percent of DPAs/NPAs).[51] DPAs/NPAs also make reforms to specific business processes—for example, requiring the closure of a business line, or making changes to compensation practices.[52] Agreements often require the hiring of new employees in compliance,[53] and occasionally also provide for a new CCO[54] or the establishment of a board-level compliance committee.[55] DPAs/NPAs may also mandate the appointment of a corporate monitor whose job is to evaluate compliance at the firm and report back to the prosecutor on an ongoing basis.[56] Alternatively, DPAs/

48. *See, e.g.*, United States v. HSBC Bank USA, N.A., 2013 WL 3306161, at *6-11 (E.D.N.Y. July 1, 2013); Cunningham, *supra* note 8, at 2-3; *see also* GARRETT, *supra* note 9, at 72 ("Most agreements required compliance reforms (63 percent, or 160 of 255 agreements) ... while others cited compliance reforms that regulators required (28 percent, or 71 of 255 agreements)."); Kaal & Lacine, *supra* note 46, at 93 fig.7 (reporting compliance reforms implemented in 75 percent of publicly available DPAs/NPAs from 1993 through 2013).

49. GARRETT, *supra* note 9, at 72 ("The agreements ask that higher-ups endorse new policies, new trainings of employees, and new forms of supervision of employees, and that they provide periodic reports summarizing their progress.").

50. *See id.* at 74 (noting that 71 of 255 agreements studied referred to compliance reforms subject to agreements with industry regulators). The lack of specificity may also reflect the company's implementation of compliance reforms, likely with the prosecutor's input or blessing, prior to completion of the settlement. *See id.* at 74-75 (noting that 162 of 255 agreements referred to compliance reforms already adopted by the corporate defendant).

51. Kaal & Lacine, *supra* note 46, at 107 fig.18.

52. *See* GARRETT, *supra* note 9, at 72 (noting examples, including the requirement that an accounting firm shut down its private tax practice and a builder shut down a subsidiary that had engaged in fraudulent mortgage practices).

53. *Id.* (reporting that 88 of the 255 agreements studied provided for hiring new employees).

54. Kaal & Lacine, *supra* note 46, at 107 fig.18 (finding this requirement in 11 percent of the DPAs/NPAs in their sample).

55. GARRETT, *supra* note 9, at 72-73; *see also* Kaal & Lacine, *supra* note 46, at 96 fig.10 (reporting that, although 31 percent of all agreements including board reforms focused on increased reporting to the board, only 8 percent mandated committee reforms).

56. *See generally* Cristie Ford & David Hess, *Can Corporate Monitorships Improve*

NPAs may require the engagement of an outside consultant, often a law firm, to evaluate the efficacy of the compliance program.[57] Enforcement authorities have thus embarked upon a far-reaching program of reforms through settlement agreements.[58] As one scholar summarized:

> The terms of NPAs, DPAs, and state settlement agreements abound with regulations that go far beyond simple commands to companies to stop disobeying the law or to pay for prior violations. These agreements insist on new business models and practices, and they have contained regulations that have covered everything from personnel decisions to the rates companies charge customers. In many instances, prosecutors have not stopped with the regulation of single companies; they have commanded entire industries to comply with new terms. These prosecutorial commands have been imposed without legislative guidance, much less relatively clear rules or intelligible principles.[59]

In addition to *direct* interventions in compliance through DPAs, NPAs, and other settlement agreements, government enforcers channel the development of compliance in a number of *indirect* ways as well. First, in an accretive process not unlike the common law, the actions brought by prosecutors and reforms won in settlement of those actions have a precedential impact on similarly situated firms.[60] Companies track enforcement activity and heed the elements of compliance that enforcement authorities have either applauded or found lacking in peer firms.[61] DPAs/NPAs thus have

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Corporate Compliance?, 34 J. CORP. L. 679 (2008) (describing the evolution of corporate monitorships as part of settlement agreements and analyzing how they function in practice).

57. *See* GARRETT, *supra* note 9, at 174-78 (discussing the appointment of monitors and finding such appointments in 65 of 255 agreements studied).

58. *See* Arlen & Kahan, *supra* note 8 (critiquing prosecutors' interventions in corporate governance through DPAs/NPAs). The tactic was recently exported to the United Kingdom. *See* Press Release, The Serious Fraud Office, SFO Agrees First UK DPA with Standard Bank (Nov. 30, 2015), https://www.sfo.gov.uk/2015/11/30/sfo-agrees-first-uk-dpa-with-standard-bank/ [https://perma.cc/5L64-WTW2] (the first DPA entered into by British authorities).

59. Rachel E. Barkow, *The Prosecutor as Regulatory Agency*, *in* PROSECUTORS IN THE BOARDROOM, *supra* note 4, at 177, 177.

60. However, unlike the common law, there is no adjudication and no meaningful judicial review. *See infra* note 213 and accompanying text.

61. *See* PRICEWATERHOUSECOOPERS, STATE OF COMPLIANCE 2014 SURVEY: WHAT IT MEANS

a strong signaling effect on firms not party to the immediate settlement, pushing them to adopt compliance mechanisms similar to those imposed upon their peers.[62] The result can be thought of as "compliance creep," in which compliance features converge as a result of the precedential effect of settlements and the widespread mimicry of peer firms.

The second *indirect* mode of government intervention in compliance is inherent in the flexible and largely discretionary definitions of "effective" compliance.[63] This definitional flexibility allows the government to influence compliance simply by signaling changes to what it will count as "effective." It sends these signals not only through its enforcement and settlement practices but also through speeches and other hortatory pronouncements made by government agents.[64] Corporations pay close attention and adjust their programs accordingly. For example, the Resource Guide to the Foreign Corrupt Practices Act (FCPA) (the "Resource Guide"), issued jointly by the DOJ and the Securities and Exchange Commission (SEC), contains an extensive discussion of the elements of an effective FCPA compliance program, along with specific examples of successful and unsuccessful programs.[65] The Resource Guide is not law. In fact, it contains several highly contestable legal propositions.[66] Neverthe

TO BE A "CHIEF" COMPLIANCE OFFICER: TODAY'S CHALLENGES, TOMORROW'S OPPORTUNITIES 17-18 (2014), http://www.pwc.com/us/en/risk-management/state-of-compliance-survey/assets/pwc-state-of-compliance-2014-survey.pdf [https://perma.cc/A9QU-BLTK].

62. *See id.* at 17 ("In the event of a compliance failure, government investigators often compare the organization's compliance program to those of similar organizations (in terms of size, complexity, industry, geographic footprint, etc.). Companies whose programs are not comparable to those of their peers could be subject to harsher penalties.").

63. *See supra* notes 37-40 and accompanying text.

64. *See generally* Nestor M. Davidson & Ethan J. Leib, *Regleprudence—at OIRA and Beyond*, 103 GEO. L.J. 259 (2015) (discussing the law-like customs and practices that govern the administrative state outside the purview of the courts and APA-based policing).

65. Although it acknowledges that there is no "one-size-fits-all program," the Resource Guide emphasizes top-level commitment, clearly articulated policies and procedures, sufficient resources dedicated to oversight and monitoring, regular risk assessments, training and advice, disciplinary measures, third-party vetting, confidential reporting and internal investigations, and periodic testing and review. DOJ & SEC. & EXCH. COMM'N [SEC], A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT 57-62 (2012) [hereinafter FCPA RESOURCE GUIDE]. The Resource Guide also discusses the infamous Garth Peterson incident as an example of effective compliance resulting in a declination. *Id.* at 61.

66. *See* Mike Koehler, *Grading the Foreign Corrupt Practices Act Guidance*, 7 WHITE COLLAR CRIME REP. 961 (2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2189072 [https://perma.cc/H579-HFSB] (arguing that the Resource Guide "is an advocacy piece ...

less, practitioners have analyzed it closely and regularly use it to advise clients. The Resource Guide can thus be seen as a rhetorical tool by which the government channels corporate reforms. Similarly, the less formal pronouncements of various government officials on compliance are likewise geared toward influencing corporations to enact compliance reforms.[67]

In sum, the government has been the leading force in the development of compliance; first through the incentives offered to firms in the Guidelines and the Holder Memorandum, then through the proliferation of DPAs/NPAs and a host of hortatory pronouncements. Compliance can thus be seen as a product of government intervention in corporate governance, a subject to which this Article shall return.[68] Before getting there, however, there is more work to be done in defining compliance. Is it possible to distill a common core of compliance? And, if so, how do these elements work in practice? These questions are taken up in the next two Sections.

B. The Common Core

A multitude of authorities have attempted to say what compliance is or ought to be.[69] Their efforts typically take the form of

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replete with selective information, half-truths, and, worse, information that is demonstratively false").

67. *See, e.g.*, Thomas C. Baxter, *Keynote Address: The Changing Face of Corporate Compliance and Corporate Governance*, 21 FORDHAM J. CORP & FIN. L. 61, 63 (2016) (published speech by the General Council of the New York Federal Reserve Bank urging companies to integrate ethics and compliance); Leslie R. Caldwell, Assistant Attorney Gen. for the Criminal Div., DOJ, Remarks at the 22nd Annual Ethics and Compliance Conference (Oct. 1, 2014) (discussing enforcement policy regarding specific aspects of compliance programs).

68. *See infra* Part II.

69. For a partial list of relevant texts, see generally Bank Secrecy Act of 1970, 13 U.S.C. §§ 5318(h)(1)(A)-(D) (2012) (defining the four pillars of AML compliance); Volcker Rule, 17 C.F.R. § 75.20(b) (2014); BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, COMPLIANCE AND THE COMPLIANCE FUNCTION IN BANKS (2005), http://www.bis.org/publ/bcbs113.pdf [https://perma.cc/A9L7-95NH] [hereinafter BIS]; COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, INTERNAL CONTROL—INTEGRATED FRAMEWORK: EXECUTIVE SUMMARY (2013), https://na.theiia.org/standards-guidance/topics/Documents/Executive_Summary.pdf [https://perma.cc/RS96-U3QK]; COMPTROLLER OF THE CURRENCY ADM'R OF NAT'L BANKS, BANK SUPERVISION PROCESS: CONTROLLER HANDBOOK 72-74 app. D (2007), http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/bsp-2.pdf [https://perma.cc/FL4L-EE3M] [hereinafter OCC]; FCPA RESOURCE GUIDE, *supra* note 65; MINISTRY OF JUSTICE, THE BRIBERY ACT 2010—GUIDANCE (2011), https://www.justice.gov.uk/downloads/legislation/bribery-act-2010-guidance.pdf [https://perma.cc/8ZHA-KHDX] [hereinafter MOJ];

multi-factor lists. The lists vary widely in emphasis and in the level of detail, often depending on the regulatory context, such that an aggregation of the elements of compliance may seem haphazard.[70] Notwithstanding differences in emphasis, however, it is possible to uncover common themes. Indeed, the common core of compliance has not changed much since the first articulation of "effective" compliance in the draft Guidelines.[71] The common core of compliance consists of four functional elements: (1) a structural nexus, (2) information flows, (3) monitoring and surveillance, and (4) risk-rated enforcement. Each of these is described in greater detail below.

1. Structural Nexus

First, authorities uniformly emphasize the development of policies and procedures for compliance, tailored to the firm.[72] The development of policies and procedures must, of course, cover applicable legal and regulatory rules. But authorities have recently emphasized the development of policies and procedures that go beyond narrowly applicable rules and regulations and that are designed

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ORG. FOR ECON. CO-OPERATION & DEV., GOOD PRACTICE GUIDANCE ON INTERNAL CONTROLS, ETHICS, AND COMPLIANCE (2010), http://www.oecd.org/daf/anti-bribery/44884389.pdf [https://perma.cc/8U39-KBYX] [hereinafter OECD]; Letter from Deborah P. Bailey, Deputy Dir., Div. of Banking Supervision & Regulation, and Glenn E. Loney, Deputy Dir., Div. of Consumer and Cmty. Affairs, to Officer in Charge of Supervision & Appropriate Supervisory & Examination Staff at each Fed. Reserve Bank & Certain Orgs. Supervised by Fed. Reserve, SR 08-8/CA 08-11 (Oct. 16, 2008), http://www.federalreserve.gov/boarddocs/srletters/2008/sr0808.htm [https://perma.cc/M4CY-J2WJ] [hereinafter SR Letter 08-8]; Caldwell, *supra* note 67.

70. *See* Geoffrey Miller, Professor of Law, N.Y. Univ. Sch. of Law, Remarks at Fordham Journal of Corporate & Financial Law Symposium: Changing Face of Corporate Compliance and Corporate Governance (Feb. 9, 2015) (transcript on file with author) [hereinafter Compliance Symposium Panel] (comparing the lists to the eclectic and haphazard classification of animals in Jorge Luis Borges's story, *The Celestial Emporium of Benevolent Knowledge*).

71. *See supra* note 27 and accompanying text.

72. In the words of the Guidelines, "[t]he organization shall establish standards and procedures to prevent and detect criminal conduct." SENTENCING GUIDELINES, *supra* note 21, § 8B.21(b)(1); *accord* 31 U.S.C. § 5318(h)(1)(A) (2012) (internal policies, procedures); Volcker Rule, 17 C.F.R. § 75.20(b)(1) (2015) (written policies, reasonably designed); FCPA RESOURCE GUIDE, *supra* note 65, at 57-58 (code of conduct, policies, procedures); OCC, *supra* note 69, at 21 (established policies, procedures); OECD, *supra* note 69 (clearly articulated and visible policy); MOJ, *supra* note 69, at 21 ("proportionate procedures" that are "clear, practical, accessible, effectively implemented, and enforced"); Caldwell, *supra* note 67 (clear policy, written code).

more broadly to promote a "culture" of compliance.[73] For example, at a workshop on compliance recently convened at the Federal Reserve Bank of New York, the use of compliance programs as a lever into corporate culture was emphasized in both the keynote address[74] as well as in panels of eminent practitioners.[75] Designing policies and procedures to aim broadly at cultural norms rather than simple regulatory rules suggests a "spirit as well as the letter of the law" approach to compliance.

The creation of even well-designed policies and procedures, however, is not sufficient in itself. The firm must also delegate responsibility for their implementation, ongoing management, and revision. In other words, compliance must be housed somewhere in the organization, where a responsible agent has specific authority over it along with sufficient staff to perform necessary compliance-related tasks.[76] Compliance authority need not reside in a CCO,

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73. For example:

> One of the very exciting areas in compliance today relates to how a company's strong ethical culture can impact corporate behavior. One aspect of this behavioral change relates to the greater tendency of corporate constituents to follow the applicable rules when the culture is right. Looking to the future, I envision we will see much more empirical research that shows the benefits of merging ethics with compliance, and placing both in the hands of a trusted corporate officer with a catchy new name—the Chief Ethics and Compliance Officer. As we move to the next level, ethics and compliance will increasingly become a part of a single program.

Baxter, *supra* note 67, at 3.

74. FED. RESERVE BANK OF N.Y., WORKSHOP ON REFORMING CULTURE AND BEHAVIOR IN THE FINANCIAL SERVICES INDUSTRY 2, https://www.newyorkfed.org/medialibrary/media/newsevents/events/banking/2014/Summary-Culture-Workshop.pdf [https://perma.cc/DS48-LNMR] (summarizing keynote address of David Walker, Chairman of Barclays, emphasizing policies and procedures, training, compensation practices, and performance metrics).

75. Participants at the workshop regularly emphasized the role of compliance in reforming culture as well as the incorporation of incentives for ethical behavior in the design of compensation policies. *Id.* at 2-5.

76. SENTENCING GUIDELINES, *supra* note 21, § 8B2.1(b)(2)(C) ("Specific individual(s) within the organization shall be delegated day-to-day operational responsibility for the compliance and ethics program."); *accord* 31 U.S.C. § 5318(h)(1)(B) (designate CCO); BIS, *supra* note 69, at 10 (independent compliance function, designated officers); OCC, *supra* note 69, at 21 (capable compliance management); SR Letter 08-8, *supra* note 69 (independent compliance staff); Caldwell, *supra* note 67 (responsible designee). Relatedly, the firm is expected to exercise due diligence to ensure that none of the individuals hired into this function have engaged in illegal acts or conduct inconsistent with the firm's policies and procedures. SENTENCING GUIDELINES, *supra* note 21, § 8B2.1(b)(3).

although some authorities do require this.[77] But it plainly must reside somewhere in the organization, lest the policies and procedures become inert, outdated examples of "paper compliance."[78] Moreover, authorities insist that it be given a high place in the organization, with the visible support of top management.[79] The combination of policies and procedures with personnel makes compliance a living part of the organization, able to adapt and change. This is the first step in compliance—the creation of a structural nexus.

2. Information Flow

Second, the compliance function attends to the flow of information within the organization. Information flows up and down in firms—up from lower-level employees to senior management and down from senior management to employees on the production line or out in the field.[80] Compliance must engage critically with both flows of information, through the reporting function and through training. Through the reporting function, compliance ensures that lower-level employees can safely report concerns to their managers and that information concerning potential violations is quickly related to the appropriate level in the organization.[81] Reporting lines are therefore a critical aspect of effective compliance, and many authorities expressly require that compliance programs have a reporting line to

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77. *See* Bank Secrecy Act of 1970, 31 U.S.C. § 5318(h)(1)(b); BIS, *supra* note 69, at 7, 10; SR Letter 08-8, *supra* note 69.

78. *See* Krawiec, *Cosmetic Compliance*, *supra* note 8, at 491-95 (explaining that policies can look good on paper but nevertheless fall short of actual compliance).

79. *See* Caldwell, *supra* note 67 ("A company should assign responsibility to senior executives for the implementation and oversight of the compliance program.... Those executives should have the authority to report directly to independent monitoring bodies, including internal audit and the Board of Directors, and should have autonomy from management.").

80. *See, e.g.*, Lawrence E. Mitchell, *Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, 70 BROOK. L. REV. 1313, 1351-54 (2005) (describing how "structural holes" in firms encourage fraud).

81. *See* SENTENCING GUIDELINES, *supra* note 21, § 8B2.1(b)(5)(C) (requiring the firm "to have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation"); *accord* FCPA RESOURCE GUIDE, *supra* note 65 (system for confidential reporting); Caldwell, *supra* note 67 ("A company should have an effective system for confidential, internal reporting of compliance violations.").

the CEO and often to the board of directors as well.[82] Likewise, compliance authorities uniformly emphasize training.[83] The compliance function is expected to train employees on the organization's policies and procedures[84] and to ensure that the highest levels of the organization remain knowledgeable and engaged.[85]

3. Monitoring and Surveillance

The third essential function of compliance is monitoring employee conduct to ensure adherence to the firm's policies and procedures.[86] Monitoring is fundamentally about data collection and analysis.[87] It

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82. SENTENCING GUIDELINES, *supra* note 21, § 8B21(b)(2)(C) ("Individual(s) with operational responsibility shall report periodically to high-level personnel and, as appropriate, to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program. To carry out such operational responsibility, such individual(s) shall be given adequate resources, appropriate authority, and direct access to the governing authority or an appropriate subgroup of the governing authority."); *accord* BIS, *supra* note 69, at 9-12 (board involvement); SR Letter 08-8, *supra* note 69 (firmwide approach); Caldwell, *supra* note 67 (noting that compliance authorities "should have the authority to report directly to independent monitoring bodies, including internal audit and the Board of Directors").

83. *See* Caldwell, *supra* note 67 ("A company should implement mechanisms designed to ensure that its compliance code is effectively communicated to all directors, officers, employees. This means repeated communication, frequent and effective training, and an ability to provide guidance when issues arise.").

84. *See* SENTENCING GUIDELINES, *supra* note 21, § 8B2.1(b)(4) ("The organization shall take reasonable steps to communicate periodically and in a practical manner its standards and procedures, and other aspects of the compliance and ethics program ... by conducting effective training programs and otherwise disseminating information appropriate to such individuals' respective roles and responsibilities."); *accord* Volcker Rule, 17 C.F.R. § 75.20(b)(3) (2015) (clear framework of responsibility and accountability).

85. *See* SENTENCING GUIDLINES, *supra* note 21, § 8B2.1(b)(2)(A) ("The organization's governing authority shall be knowledgeable about the content and operation of the compliance and ethics program and shall exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program."); *id.* § 8B2.1(b)(2)(B) ("High-level personnel of the organization shall ensure that the organization has an effective compliance and ethics program .... Specific individual(s) within high-level personnel shall be assigned overall responsibility for the compliance and ethics program."); *accord* Caldwell, *supra* note 67 (emphasizing "high-level commitment" and "tone at the top").

86. SENTENCING GUIDELINES, *supra* note 21, § 8B2.1(b)(5)(A) (requiring reasonable steps "to ensure that the organization's compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct").

87. *Id.* § 8B2.1(b)(5)(B) (requiring periodic evaluation of "the effectiveness of the organization's compliance and ethics program"); *accord* BIS, *supra* note 69, at 8 (periodic review by internal audit); FCPA RESOURCE GUIDE, *supra* note 65, at 61-62 ("continuous improvement" through "periodic testing and review"); Caldwell, *supra* note 67 ("A company should conduct

can occur through random compliance audits of business processes as well as through more systematic business monitoring, performed in real time, in a designated "control room."[88] Monitoring implicates surveillance of employee communications. Technological tools are frequently employed to sift data and to screen for risks,[89] and the data-gathering and data-processing capabilities of these tools are only likely to increase.[90] Indeed, compliance officers already report that they capture more data than they could possibly analyze.[91] The frontiers of technology and compliance thus involve the adaptation of "big data" analytical tools to monitor the firm.[92]

In the event that a firm's monitoring efforts uncover potential wrongdoing, an internal investigation is likely to follow.[93] Employees must submit to interrogation or face termination.[94] The internal

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periodic reviews and testing of its compliance code .... [C]ompliance programs must evolve with changes in the law, business practices, technology, and culture.").

88. COMPLIANCE & LEGAL DIV., SEC. INDUS. ASS'N, WHITE PAPER ON THE ROLE OF COMPLIANCE 5 (2005), http://www.sifma.org/uploadedfiles/societies/sifma_compliance_and_legal_society/role_of_compliance_white_paper%20(2).pdf [https://perma.cc/2QYT-TXK7] ("Compliance Department personnel generally operate a firm's 'control room' that, among other things, administers information barriers between business units. For example, Compliance personnel maintain watch and restricted lists, and handle wall crossings by firm personnel as necessary and appropriate.") (footnote omitted).

89. For example, brokerage houses might use trade surveillance in, or automated screening against, lists of sanctioned individuals or organizations. *See, e.g.*, *Bridger Insight XG*, LexisNexis, www.lexisnexis.com/risk/produdcts/bridger-insight [https://perma.cc/SG5Q-QBV9] (last visited Apr. 15, 2016) (promoting software product as "a fully integrated compliance platform").

90. Kenneth Bamberger, *Technologies of Compliance: Risk and Regulation in a Digital Age*, 88 TEX. L. REV. 669, 674 (2010) (describing the large and increasing market for compliance-technology products).

91. *See* Stuart Breslow, Managing Dir. & Chief Compliance Officer, Morgan Stanley, & Alan Cohen, Exec. Vice President & Global Head of Compliance, Goldman Sachs Grps., Inc., Compliance Symposium Panel, *supra* note 70 (Breslow noting that "we have 3 million e-communications a day at our organization," and Cohen noting that "[e]very month we record, if you played it end to end, 10 years' worth of voice").

92. *Id.* (Breslow noting: "[W]e're all in the same boat in this in terms of trying to use big data providers ... to pull together lots of information from lots of different data sources within the organizations. Boy, is that hard.").

93. *See* Miriam H. Baer, *When the Corporation Investigates Itself*, *in* RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING 1, 1-2 (Jennifer H. Arlen ed., forthcoming 2016) (summarizing the literature on internal investigations and analyzing the problem of detection avoidance).

94. Although the underlying misconduct may be criminal and the results are likely to be turned over to the government, employees subject to internal corporate investigation do not need to be given *Miranda* warnings and cannot assert Fifth Amendment protections. Bruce

investigation thus closes the loop on items uncovered in the firm's monitoring efforts, with the typical result that evidence of significant wrongdoing is offered to the government in hopes of mitigating the ultimate penalty assessed against the firm.[95]

Finally, regulators have recently emphasized that the monitoring and surveillance function applies not only to employees and intrafirm sources of compliance risk, but also to third parties contracting with the firm.[96] Third-party vetting has been an interest, at least in some areas, for several years. For example, in the context of corruption, where rules could easily be circumvented by passing bribes through third parties, government authorities have warned that the regulated entity would be expected to engage in extensive due diligence, training, and monitoring of third-party agents.[97] The same is true in the context of correspondent banking.[98] In demanding effective compliance from third parties in a business relationship with the subject firm,[99] compliance authorities seem to be indicating that they intend to extend the monitoring and surveillance aspects of compliance beyond the boundaries of the firm.[100]

A. Green & Ellen S. Podgor, *Unregulated Internal Investigations: Achieving Fairness for Corporate Constituencies*, 54 B.C. L. REV. 73, 87 (2013); *see also* Miriam Hechler Baer, *Corporate Policing and Corporate Governance: What Can We Learn from Hewlett-Packard's Pretexting Scandal?*, 77 U. CIN. L. REV. 523, 554-55 (2008) (arguing that "policing" and "governance" are incompatible because the former involves deceit whereas the latter trumpets transparency).

95. *See* Caldwell, *supra* note 67 ("A company should establish an effective process with sufficient resources for responding to, investigating, and documenting allegations of violations.").

96. *See id.* ("A company should institute compliance requirements pertaining to the oversight of all agents and business partners.").

97. FCPA RESOURCE GUIDE, *supra* note 65, at 60-61.

98. THE WOLFSBERG GRP., WOLFSBERG ANTI-MONEY LAUNDERING PRINCIPLES FOR CORRESPONDENT BANKING 1-2 (2014), http://www.wolfsberg-principles.com/pdf/standards/Wolfsberg-Correspondent-Banking-Principles-2014.pdf [https://perma.cc/3TBD-SWAA] (industry association compliance guidelines).

99. *See* Caldwell, *supra* note 67 ("*I cannot emphasize strongly enough* the need to sensitize third parties.") (emphasis added).

100. *See id.* ("[T]hese partners need to understand that the company really expects its partners to be compliant. This often means more than just including a boilerplate paragraph in a contract in which the partner promises to comply with the law and company policies. It means warning, even terminating, relationships with partners who fail to behave in a compliant manner.").

4. Risk-Rated Enforcement

Finally, authorities emphasize that for a compliance function to be effective, it must enforce the rules.[101] Moreover, most authorities also emphasize that internal enforcement efforts should be directed at areas with the highest risk of noncompliance. In order to achieve this, firms must engage in regular compliance risk assessments in which emergent risks are identified, mapped to the relevant policy and control processes, and residual risks are quantified. This aspect of compliance overlaps with the firm's risk function, applying similar processes to risks arising from legal rules, regulatory standards, and other norms. But it is not merely a quantitative exercise. The compliance risk assessment has a strategic aspect, requiring forethought and planning. Regular risk assessment also implies regular revision.[102] If the organization is deficient, the firm must reform the compliance function.[103] Risk-rated enforcement thus loops back into the design of policies and procedures and ensures the regular updating and continued relevance of the compliance function.

That it is possible to distill a common core of compliance should not be taken to imply that the compliance function is practiced in the same way across firms. Indeed, there is considerable variation, especially among firms in different industries. This is the subject of the next Section.

C. Compliance in Action

Having mapped the common core of compliance, the question of how companies operationalize the basic structure remains. This is where differences emerge among firms, especially among firms in

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101. *See id.* (emphasizing even-handed enforcement and noting: "People watch what people do more carefully than what they say. When it comes to compliance, you must both say and do.").

102. *See* SENTENCING GUIDELINES, *supra* note 21, § 8B2.1 cmt. n.2 ("An organization's failure to incorporate and follow applicable industry practice or the standards called for by any applicable governmental regulation weighs against a finding of an effective compliance and ethics program.").

103. *Id.* § 8B2.1(b)(7) ("After criminal conduct has been detected, the organization shall take reasonable steps to respond appropriately to the criminal conduct and to prevent further similar criminal conduct, including making any necessary modifications to the organization's compliance and ethics program.").

different industry categories. For example, firms in some industries—most notably financial services, pharmaceuticals, and defense/aerospace—are often seen as having more highly developed compliance functions.[104] However, some investment in compliance is common across industry categories.[105] How, then, does compliance work in practice? What issues does it cover? How is it organized? And how much authority does it possess?

Unfortunately, the answers to these questions depend upon information that is not publicly available. Firms are not required to report information on compliance in their public filings.[106] Instead, the best insight into compliance as it is actually practiced must be gleaned from the answers compliance insiders give in interviews and surveys. Although these sources are a distant second best to systematic reporting by the firms themselves, they nevertheless allow outsiders to glimpse contemporary compliance in action.[107]

1. Scope and Organization

Judging from surveys, the contemporary compliance function has a mandate far beyond narrowly ensuring compliance with applicable law. Asked to name their top areas of focus, compliance officers

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104. Breslow & Cohen, Compliance Symposium Panel, *supra* note 91 ("[F]inancial services is far more mature when it comes to compliance than virtually any other industry. [Except m]aybe pharma and some aerospace."). Although outside the scope of this Article, the development of compliance has to do with patterns of regulation and enforcement in these industries. *See id.* Financial services compliance expanded as a result of the government's interest in terrorist finance and with the need to respond to the financial crisis. *See id.* Pharmaceutical compliance has to do principally with consumer protection concerns relating to the marketing of drugs and with government contracts through Medicare/Medicaid. *See id.* Likewise, defense/aerospace has to do with the demands of government procurement. *Compliance*, AEROSPACE INDUS. ASS'N, http://www.aia-aerospace.org/industry_issues/compliance/ [https://perma.cc/3N7D-R2YV] (last visited Apr. 15, 2016).

105. Moreover, industries that experience an uptick in enforcement activity may also see a renewed push in compliance. *See, e.g.*, Jesse Newman, *Criminal Cases Roil Food Industry*, WALL ST. J. (May 20, 2015, 7:42 PM), http://www.wsj.com/articles/more-food-safety-lapses-prosecuted-as-crimes-1432165360 [https://perma.cc/83CQ-PLUQ] (reporting on increased focus in criminal investigations and prosecutions of companies in the food industry and concomitant "efforts to bolster food safety" by firms in the industry).

106. *See infra* Part IV.B (advocating public disclosure of compliance details).

107. Survey responses may not be representative. Moreover, the consulting firms that take the surveys may also be guilty of overemphasizing the importance of compliance in order to persuade firms to upgrade their compliance departments and, not coincidentally, to sell their consulting services.

included legal and regulatory risks, such as "industry-specific regulations," "bribery/corruption," "conflicts of interest," and "fraud," but they listed several other areas as well, including "strategic risk," "regulatory quality," "business continuity," and "consumer protection."[108] The breadth of compliance can also be seen in the wide variety of topics that are the subject of written corporate policies maintained by compliance departments. For example, in a recent survey, respondents listed twenty-five such topics, from such core legal and regulatory concerns as "harassment, discrimination, and conflicts of interest," to more recent areas of concern, including "data privacy," "information security," and "social media."[109] Indeed, compliance has a tendency to subsume risks emerging from the crisis *du jour*. For example, the inclusion of "data privacy and confidentiality" as a top area of attention for compliance followed several high-profile corporate data breaches.[110] The reactive nature of the compliance function underscores its role as the downside risk department.

With regard to organization, there has been a steady march towards the "departmentalization" of compliance.[111] The culmination of this process is a compliance function that is fully independent from the legal department and headed by a CCO who reports di-

108. DELOITTE & COMPLIANCE WEEK, *supra* note 12, at 11 (noting that the five most commonly listed CCO responsibilities are "compliance training," "code of conduct," "whistleblower programs," "compliance with domestic regulations," and "compliance strategy & process," and the five least commonly listed CCO responsibilities are "regulatory filings," "regulatory relationship management," "records management," "culture assessment," and "business continuity"); *see also* PRICEWATERHOUSECOOPERS, *supra* note 61, at 4.

109. SOC'Y OF CORP. COMPLIANCE & ETHICS & NYSE GOVERNANCE SERVS., COMPLIANCE AND ETHICS PROGRAM ENVIRONMENT REPORT 42 (2014) [hereinafter SCCE & NYSE REPORT]; *see also* PRICEWATERHOUSECOOPERS, *supra* note 61, at 21 (emphasizing social media as an area coming within the ambit of compliance).

110. PRICEWATERHOUSECOOPERS, *supra* note 61, at 4. Recent high-profile examples include the December 2013 data breach at Target and the December 2014 breach at Morgan Stanley. *See* Justin Baer, *U.S. Shifts Focus of Morgan Stanley Breach Probe*, WALL ST. J. (Feb. 18, 2015), http://www.wsj.com/articles/u-s-shifts-focus-of-morgan-stanley-breach-probe-1424305501 [https://perma.cc/QHC2-D8VA] (describing December 2014 breach of Morgan Stanley client information); *Data Breach FAQ*, TARGET, https://corporate.target.com/about/shopping-experience/payment-card-issue-faq [https://perma.cc/NJ4X-JW85] (last visited Apr. 15, 2016) (answering questions for guests impacted by the Target data breach).

111. DeStefano, *supra* note 15, at 103-04 ("Recently, [governmental authorities] have forced corporations ... to develop a distinct compliance department and designate a chief compliance officer that does not report to the general counsel but instead to the CEO with direct access to the board. Other corporations ... have followed suit.").

rectly to the CEO, and maintains regular contact with the board of directors or a committee of the board.[112] Recent surveys found that a substantial majority of companies have a CCO.[113] However, the CCO is not always a stand-alone position, and the officer principally responsible for compliance may also have a role in the legal or audit departments.[114] Moreover, although the compliance function most often reports to the CEO, many firms still have compliance officers reporting into the legal department or elsewhere in the organization.[115] Nevertheless, compliance officers typically have access to, and regular contact with, the board of directors or a committee of the board.[116]

2. Budgets and Staffing

Looking at the compliance function through the lens of budget and staffing reveals growth across industries.[117] Although figures vary widely depending upon company size, average compliance budgets are in the millions of dollars for multinational companies

112. *See, e.g.*, PRICEWATERHOUSECOOPERS, *supra* note 61, at 8 (advocating this structure by asserting that "all companies, regardless of size or industry sector, could benefit by naming a chief compliance officer" and noting that companies investigated by the government "often find themselves later required to establish and maintain a CCO function"). For a contrary view, see generally Vikramaditya Khanna, *An Analysis of Internal Governance and the Role of the General Counsel in Reducing Corporate Crime*, *in* RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING, *supra* note 93 (summarizing the literature and arguing that separating compliance from legal may lead to less effective compliance because it weakens intrafirm information flows and leads to costly duplication of effort).

113. *See* PRICEWATERHOUSECOOPERS, *supra* note 61, at 7-8 (finding that although 69 percent of all respondents have a CCO, 88 percent of large companies do, and 86 percent of all companies in more highly regulated industries do).

114. *See* DELOITTE & COMPLIANCE WEEK, *supra* note 12, at 5 (finding that 50 percent of respondents have a stand-alone CCO); PRICEWATERHOUSECOOPERS, *supra* note 61, at 10 (reporting that 54 percent of respondents indicated that the CCO "wears multiple hats"); *accord* DeStefano, *supra* note 15, at 100 (summarizing studies and finding that "[t]he number of corporations in which the general counsel is also the chief compliance officer and in which the chief compliance officer reports to the general counsel appears to be decreasing").

115. PRICEWATERHOUSECOOPERS, *supra* note 61, at 9 (finding that 34 percent of respondents report to the CEO, 27 percent to legal, 17 percent to the board, 8 percent to the CFO, 6 percent to the chief risk officer); SCCE & NYSE REPORT, *supra* note 109, at 11 (finding 38 percent of respondents report to the CEO, 20 percent to some other officer or entity, 19 percent to the board, 18 percent to the chief legal officer).

116. SCCE & NYSE REPORT, *supra* note 109, at 12 (finding that 79 percent of CCOs have dotted-line reporting to the board); *id.* at 6 (noting regularity of board contact).

117. PRICEWATERHOUSECOOPERS, *supra* note 61, at 14.

and for companies in regulated industries.[118] Moreover, the majority of respondents to a 2014 survey indicated that budgets were increasing in highly regulated industries and increasing or staying the same in less regulated industries.[119] Only rarely did respondents report a decrease in compliance budgets.[120] Most 2014 survey respondents reported having at least six full-time employees in compliance.[121] Again, these figures differ widely by industry and size, with larger firms having more full-time compliance staff.[122]

3. Industry Variation

As the statistics for budget and staffing demonstrate, aggregating data across company size and industry category may conceal as much as it reveals. Therefore, it may be useful to review the development of compliance on an industry-by-industry basis. For example, an industry-specific focus on financial services reveals that 93 percent of such firms have a CCO and that the vast majority of these officers (73 percent) attend to compliance alone.[123] Financial services firms tend to have increasing compliance budgets and are focused principally on industry-specific regulation.[124] Likewise, pharmaceutical industry respondents overwhelmingly reported having dedicated CCOs (84 percent) in a stand-alone role (62 percent), the majority of whom report directly to the CEO (52 percent).[125] Pharmaceutical firms also reported increasing budgets

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118. DELOITTE & COMPLIANCE WEEK, *supra* note 12, at 9 (reporting that half of all respondents who knew their compliance budget reported that it was at least $1 million); PONEMON INST., THE TRUE COST OF COMPLIANCE: A BENCHMARK STUDY OF MULTINATIONAL ORGANIZATIONS (2011) (reporting average compliance budget for a multinational firm in their sample at over $3.5 million); PRICEWATERHOUSECOOPERS, *supra* note 61, at 15 (noting that "42% of [respondents] in heavily regulated industries have budgets of at least $1 million").

119. PRICEWATERHOUSECOOPERS, *supra* note 61, at 14.

120. *Id.*

121. DELOITTE & COMPLIANCE WEEK, *supra* note 12, at 9.

122. *See* SCCE & NYSE REPORT, *supra* note 109, at 26.

123. PRICEWATERHOUSECOOPERS, STATE OF COMPLIANCE 2014: FINANCIAL SERVICES INDUSTRY BRIEF 3 (2014), https://www.pwc.com/us/en/risk-management/state-of-compliance-survey/assets/pwc-soc-financial-services.pdf [https://perma.cc/D3WE-P79J].

124. *Id.* at 5, 9.

125. PRICEWATERHOUSECOOPERS, STATE OF COMPLIANCE 2014: PHARMACEUTICAL AND LIFE SCIENCES INDUSTRY BRIEF 6-8 (2014), https://www.pwc.com/us/en/risk-management/state-of-compliance-survey/assets/pwc-soc-pharma-and-life-sciences.pdf [https://perma.cc/KRN7-QA42].

and listed their principal compliance concern to be bribery and corruption.[126] By contrast, although most respondents from the manufacturing and retail industries reported having a CCO, the vast majority of these wear multiple hats.[127] Manufacturing and retail respondents reported flat staffing levels and budgets, and named "bribery/corruption" and "privacy and confidentiality," respectively, as their top compliance concerns.[128]

Differences in compliance across industries are often seen as differences in the "maturity" of compliance between different industries,[129] with some industries seen as further along on the "compliance maturity curve."[130] Such comments reveal a progressive view of compliance, in which the future lies in ever more extensive (and expensive) compliance structures.[131] And there is at least some evidence that compliance has evolved in this direction. For example, when Wal-Mart came under investigation by federal authorities for paying bribes to foreign officials, it designed an expansive compliance infrastructure similar to that of financial institutions.[132] In

126. *Id.* at 14-16.

127. PRICEWATERHOUSECOOPERS, STATE OF COMPLIANCE 2014: MANUFACTURING INDUSTRY BRIEF 7-8 (2014), http://www.pwc.com/us/en/risk-management/state-of-compliance-survey/assets/pwc-soc-manufacturing.pdf [https://perma.cc/Z3W8-NS8X] [hereinafter MANUFACTURING BRIEF] (reporting that 60 percent of respondents in the manufacturing industry have a CCO but that 69 percent of these wear multiple hats); PRICEWATERHOUSECOOPERS, STATE OF COMPLIANCE 2014: RETAIL AND CONSUMER INDUSTRY BRIEF 6-7 (2014), http://www.pwc.com/us/en/risk-management/state-of-compliance-survey/assets/pwc-soc-retail-and-consumer.pdf [https://perma.cc/5UHX-RWWY] [hereinafter RETAIL AND CONSUMER BRIEF] (reporting that 48 percent of respondents in the retail and consumer industries have a CCO and that 70 percent of these wear multiple hats).

128. PRICEWATERHOUSECOOPERS, MANUFACTURING BRIEF, *supra* note 127, at 15-17; PRICEWATERHOUSECOOPERS, RETAIL AND CONSUMER BRIEF, *supra* note 127, at 14-15.

129. *See supra* note 104.

130. PRICEWATERHOUSECOOPERS, *supra* note 61, at 10; *see also* ECONOMIST INTELLIGENCE UNIT, THE ECONOMIST, ASCENDING THE MATURING CURVE: EFFECTIVE MANAGEMENT OF ENTERPRISE RISK AND COMPLIANCE 1 (2011) (reporting results demonstrating different levels of "maturity" of compliance across industries).

131. *See* RONALD E. BERENBEIM, UNIVERSAL CONDUCT: AN ETHICS AND COMPLIANCE BENCHMARKING SURVEY 5 (2006).

132. Like financial institution compliance, the new Wal-Mart compliance structure is hierarchical and centralized around a home office CCO. Responsibilities are also divided by region and risk and allocated to an individual compliance manager, much as a global bank might have a CCO but also segregate risk by region and employ a separate compliance manager for AML, for bribery and corruption, for sanctions, and for product risk. *See Global Compliance Program Report on Fiscal Year 2014*, WAL-MART, http://corporate.walmart.com/global-responsibility/global-compliance-program-report-on-fiscal-year-2014 [https://perma.cc/

doing so, Wal-Mart may have viewed banking industry compliance structures as the gold standard and therefore the best way to avoid future difficulties. Or it may have been pushed to adopt this infrastructure by enforcement authorities who have this view. Whatever the ultimate source, the convergence on more extensive—and expensive—compliance structures supports the view of those who see cross-industry differences as differences in "maturity." Whether this form of convergence makes any sense is explored immediately below.

4. Metrics and Effectiveness

In spite of all of this effort, it remains difficult to demonstrate the effectiveness of the compliance function.[133] The absence of government intervention is an insufficient indication of program effectiveness.[134] Therefore, firms have sought to develop metrics for effective compliance. To evaluate their effectiveness, compliance departments analyze internal audit findings, track hotline calls, monitor training completion rates, review the disposition of internal investigations, perform self-assessments, survey employees, compare themselves against peer companies, retain outside professionals to review the compliance function, and track performance on regulatory reviews.[135] Yet in one study, only 52 percent of CCOs surveyed indicated that they were "confident" or "very confident" that the metrics used by their organization gave them a true sense of the effectiveness of the compliance function.[136] Metrics are often backward-looking rather than forward-looking.[137] Moreover, many compliance metrics track *activity* rather than *impact*, thereby demonstrating that compliance may be busy but not necessarily

3DWP-SERA] (last visited Apr. 15, 2016).

133. *See* Baxter, *supra* note 67, at 5 ("We simply do not have a tool that will give us an accurate and reliable measure of program effectiveness.").

134. *See* ECONOMIST INTELLIGENCE UNIT, *supra* note 130, at 4 (reporting that most respondents view their compliance functions as above average until they experience a failure).

135. DELOITTE & COMPLIANCE WEEK, *supra* note 12, at 13.

136. *Id.* at 12.

137. For example, although financial services CCOs focus heavily on compliance audits and risk assessments, both of which have a forward-looking element, CCOs in other industries report that they principally track rates of completion for compliance trainings. *Compare* PRICEWATERHOUSECOOPERS, *supra* note 61, at 16, *with* SCCE & NYSE REPORT, *supra* note 109, at 93-94.

effective.[138] As a result, CCOs candidly admit that they do not know how effective their programs are in spite of the metrics they keep.[139] In the words of a major financial institution CCO:

> We do have our metrics around surveillance and testing, but in the end, do we know if we have an effective program? We haven't figured that out yet. We do know we have a program in size. We just don't know if it works. We do know that for purposes of the federal sentencing guidelines we have a program that ticks all the boxes. We've had independent law firms come in and validate that for us. We do know how our size compares to others .... [But] in terms of ... impact on the organization ...? Don't know.[140]

The metrics, in other words, do not answer the crucial question of efficacy.

II. GOVERNANCE

Corporate governance is the set of mechanisms by which corporations are directed and controlled. On this definition there is widespread agreement, both among academics[141] and governance

138. *See* PRICEWATERHOUSECOOPERS, *supra* note 61, at 16 (illustrating the point with the following example: "[M]any organizations use training completion rates and hotline metrics in their program evaluations. These statistics are useful, but other measures may do a better job of helping management to understand whether the organization is more or less exposed to risk.").

139. *See* Compliance Symposium Panel, *supra* note 70 (major financial institution CCO describing his compliance program: "We have all the core elements and beyond ... but in the job of preventing and detecting the firm, engaging in conduct that would either violate rules or cause reputational damage or in other ways result in a bad impact, I think only results tell us that.").

140. *Id.* (another major financial institution CCO).

141. *See, e.g.*, STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 2 (2012) ("Corporate governance, broadly defined, consists of the institutional structures, legal rules, and best practices that determine which body within the corporation is empowered to make particular decisions, how the members of that body are chosen, and the norms that should guide decision making."); MARGRET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 3 (defining corporate governance as "the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated"); MILLER, *supra* note 12, at 2 (noting that governance "has to do with the structure of control within an organization").

authorities.[142] And from this definition, the overlap between compliance and governance is clear: both compliance and governance lay claim to internal mechanisms of control.[143] The overlap is not total. Compliance lays no claim, for example, to questions such as how to design or improve products or how to finance operations. Nevertheless, basic compliance mechanisms—such as the design of policies and procedures, monitoring, and enforcement—feed back into fundamental business operations of a firm to such an extent that compliance resembles a "universal corporate governance activity"[144] and some firms, recognizing the overlap, have merged their governance, risk, and control functions.[145]

Of course, overlap does not necessarily imply conflict. If compliance and governance had wholly consistent objectives, they could be seen as complimentary means of achieving the same ends. However, this is not the case. Compliance and governance come from different places and serve different interests. Compliance cannot be explained by reference to traditional governance authorities, whether the board of directors, state corporate law, or federal securities law. Rather, compliance is *sui generis*. Far from being subsumed by governance, it is closer to the truth to say that compliance supplants traditional corporate governance modalities.

A. The Board of Directors and Compliance

The board of directors is the fundamental endogenous corporate governance mechanism and the source of management authority within firms.[146] The board can delegate this authority, and corporate

142. *See* ADRIAN CADBURY, REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE 14 (1992) ("Corporate governance is the system by which companies are directed and controlled.").

143. Scholars have defined compliance, on the one hand, as the internal processes used to bring organizational behavior in line with relevant norms, and governance, on the other, as the mechanisms by which corporations are directed and controlled. *See supra* text accompanying notes 12-14 (compliance), 142 (governance).

144. Baer, *supra* note 9, at 951-52.

145. *See supra* note 18 and accompanying text.

146. *See, e.g.*, OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 306 (1985) ("The board of directors thus arises endogenously, as a means by which to safeguard the investments of those who face a significant risk of expropriation."); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 311 (1983) (describing the board of directors as a basic decision-control system); *see also* DEL. CODE ANN. tit.

management derives its authority from a delegation of the board.[147] However, the board retains primary authority over the firm, with the power to alter firm-governance at will, subject only to the strictures contained in the charter and bylaws.[148] By contrast, compliance does not arise from a delegation of the board, nor is the compliance function wholly subordinate to the board, as other management structures are. Rather, compliance arises from an exogenous source that abrogates board authority.

In one sense, compliance is plainly subject to the authority of the board. CCOs report to the board, not vice-versa, and board committees oversee compliance staffing and budgets. In a deeper sense, however, authority means the power to decide. As a result, the question of the authority of compliance vis-à-vis the board ultimately resolves into the question whether the board has the authority to decide *not* to implement a compliance function. If so, then boards retain full primacy over compliance, and compliance can be viewed as a simple delegation of board authority. But if boards *must* erect a compliance function, then the development of compliance has in fact supplanted some authority of the board.

In some industries, the answer is simple. Boards must install a compliance function, and it must comport with regulatory demands. For example, banks must have a compliance function pursuant to dictates of the Federal Reserve.[149] Similarly, securities law requires investment advisers to maintain a compliance function.[150] In such industries, because boards in fact cannot decide whether to install compliance, the board must be seen to have ceded some degree of authority over intrafirm governance to the compliance function.[151]

8, § 141(a) (2015).

147. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(c).

148. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 559-60 (2003).

149. SR Letter 08-8, *supra* note 69.

150. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (requiring investment advisors with significant assets under management to register with the SEC and maintain a compliance function). The Act also created an Office of Compliance Inspections and Examinations within the SEC to enforce the requirement. *See Office of Compliance Inspections and Examinations*, SEC, http://www.sec.gov/ocie [https://perma.cc/WA6D-TVE9] (last visited Apr. 15, 2016).

151. *See* John Carney, *Big-Bank Board Game Puts Shareholders in Second Place*, WALL ST. J. (Apr. 5, 2015), http://www.wsj.com/articles/big-bank-board-game-puts-shareholders-in-second-place-heard-on-the-street-1428255363 [https://perma.cc/SN5M-9EFV] (describing reg-

In industries where a regulatory authority does not formally mandate compliance, the federal government still imposes compliance obligations through the Guidelines and enforcement tactics.[152] In some cases, these are in fact mandates. As already noted, prosecutors often require the installation of robust compliance programs for firms entering DPAs and NPAs.[153] In such cases, the government intervenes directly to impose compliance on corporations. In other cases, the government creates such powerful incentives that they effectively operate as mandates. As described above, the government articulates its vision of compliance in formal and informal pronouncements, then makes a credible commitment to this vision through enforcement and settlement practices.[154] Companies closely follow these signals and frequently adopt the practices of their peers in order to keep from falling behind the industry standard.[155] Thus, in spite of the absence of a formal mandate, the consequences associated with having no compliance program, or even having an "ineffective" program, are so grave as to effectively mandate the compliance function. No firm can say no.[156] In this way, the government imposes a de facto compliance mandate on American corporations.

The imposition of this mandate comes at the expense of board authority. Being forced not only to do something, but to do it in a particular way—so that the government deems it "effective"—demonstrates a clear lack of authority. Boards do not delegate authority to compliance. They cede it. In spite of the board's traditional authority to manage internal corporate affairs, the ultimate source of authority for compliance is derived not from the board, but from the government.

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ulatory intrusions on board authority); Craig, *supra* note 1 (same). The board retains some authority over the design and operation of this function, but even so, boards are not completely free in exercising that authority.

152. *See supra* Part I.A.

153. *See supra* notes 48-59 and accompanying text.

154. *See supra* notes 60-67 and accompanying text.

155. *See supra* text accompanying note 62.

156. As noted, however, there is significant industry variation among different industries as to the extent to which this mandate is imposed. *See supra* Part I.C.3.

B. Governance Authorities and Compliance

The exogenous origins of compliance do not make it completely unique. Corporate governance, after all, is not entirely endogenous.[157] Firms also exist within a governance framework imposed by law. The traditional sources of exogenous corporate governance are state corporate law and federal securities law.[158] Insofar as the impetus toward compliance is derived from these governance authorities, it may still fit within conventional accounts focusing on the relationship between corporations on the one hand, and Delaware and the SEC on the other. The Sections that follow examine each of these traditional governance authorities, finding each lacking as an explanation for the development of the contemporary compliance function.

1. State Corporate Law

State corporate law defines the duties of corporate boards vis-à-vis shareholders.[159] Some aspects of this relationship are defined in minute detail—for example, board responsibilities in takeover contests[160] and the incremental value of supplemental disclosures in

157. *See* D. Daniel Sokol, *Competition Policy and Comparative Corporate Governance of State-Owned Enterprises*, 2009 BYU L. REV. 1713, 1717-18 (discussing the difference between exogenous and endogenous theories of corporate governance).

158. Stock exchanges have also been a source of governance authority. *See* Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1455 (1997). Increasingly, however, exchanges have become a means through which the government exerts regulatory authority. *See* William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1, 5 (2013) (arguing that exchanges, as self-regulatory organizations, are becoming a "'fifth branch' of government"); Robert B. Thompson, *Corporate Federalism in the Administrative State: The SEC's Discretion to Move the Line Between the State and Federal Realms of Corporate Governance*, 82 NOTRE DAME L. REV. 1143, 1177 (2007) (discussing how, by acting through exchanges, the SEC can "extend its reach further into the domain traditionally reserved for state law than would be available to it if it directly sought to promulgate the same substantive rule through federal regulation"). They are therefore excluded from this account for the sake of brevity.

159. This Section will focus predominantly on Delaware law, which is so often chosen by corporations as to amount to national corporate law. *See* Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 350 (2001) ("The aggregated choices of a majority of publicly traded U.S. corporations have resulted in a convergence on the Delaware General Corporation Law as a de facto national corporate law.").

160. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 185 (Del. 1986)

proxy statements.[161] Yet state corporate law is silent, or nearly so, on compliance.

Corporate statutes do not address the compliance function.[162] Instead, any impetus toward compliance has been left to courts interpreting fiduciary duty standards, where the development of compliance has been effectively curtailed by application of the business judgment rule.[163] When courts have addressed compliance, it has typically been to reject the claim that a compliance failure amounts to a breach of fiduciary duty. For example, in *Graham v. Allis Chalmers Manufacturing Co.*, the Delaware Supreme Court expressly disclaimed any board obligation, absent clear "red flags" of wrongdoing, to install compliance programs.[164] Later, in the *In re Caremark* opinion, Chancellor Allen hinted that a board that did not develop an effective compliance program might fail in its monitoring and oversight duties.[165] However, this possibility was swept aside in *Stone v. Ritter*, in which the Delaware Supreme Court held that courts would *not* inquire into the objective adequacy of a firm's monitoring and oversight mechanisms.[166] Instead, courts would limit

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(creating special scrutiny of fiduciary duty when a company is sold); *see also* Kahn v. M & F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014) (allowing procedural protections—special committee approval and majority of the minority shareholder ratification—to shift the standard of review for controlling shareholder mergers).

161. *See, e.g.*, *In re* Sauer-Danfoss Inc. S'holders Litig., 65 A.3d 1116, 1137 (Del. Ch. 2011) (setting price parameters for awarding fees in a merger litigation settlement).

162. There is no compliance mandate in either the Delaware General Corporation Law or the Model Business Corporation Act. *See generally* DEL. CODE ANN. tit. 8, ch. 1 (2010); MODEL BUS. CORP. ACT (2008).

163. The business judgment rule is a judicial presumption that boards act in good faith, in the best interests of the corporation, and with adequate information and deliberation. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 87 (2004) ("The business judgment rule .... is better understood as a doctrine of abstention pursuant to which courts in fact refrain from reviewing board decisions unless exacting preconditions for review are satisfied."); *see also* Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) (justifying the business judgment rule by the need to avoid inducing risk aversion on the part of boards of directors).

164. 188 A.2d 125, 130 (Del. 1963) (holding that, absent red flags, directors were under "no duty ... to install and operate a corporate system of espionage to ferret out wrongdoing").

165. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) (suggesting that fiduciary duty might require corporate directors to "exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner").

166. 911 A.2d 362, 372-73 (Del. 2006). In retrospect, *Caremark* probably never deserved the

their inquiries into the subjective basis of the board's failure to monitor and oversee the firm.[167] Thus, although directors can be held liable for intentionally (or recklessly) acting contrary to the best interests of the corporation, they cannot be held liable for the objective inadequacy or ineffectiveness of the firm's compliance or monitoring program.[168] In case there was any doubt on this point, Delaware retreated still further during the financial crisis by flatly refusing to use fiduciary duty standards to impose liability on the boards of financial institutions that had contributed to the crisis.[169]

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attention it received—it was merely a decision approving settlement of a derivative suit. *See In re Caremark*, 698 A.2d at 960. In order to approve the settlement, which involved only corporate therapeutics and no monetary relief, Chancellor Allen first had to decide that the settlement was fair in light of the merits of the claim. *Id.* at 961. In other words, he had to decide that the claim had some positive value, a conclusion he could not have reached under *Graham v. Allis Chalmers Manufacturing Co*. He therefore faced a stark choice—reject the settlement or criticize *Graham*. *See id.* at 969-70. Because the settlement was unopposed and public policy generally favors private resolution of disputes, he elected to approve the settlement but, notably, only after substantially reducing attorneys' fees. *Id.* at 972. The decision's criticism of *Graham* thus belonged to a special context that ultimately could not support all of the weight that was subsequently put on it. *See* Jennifer Arlen, *The Story of* Allis-Chalmers*,* Caremark*, and* Stone*: Directors' Evolving Duty to Monitor*, *in* CORPORATE LAW STORIES 323, 345-46 (J. Mark Ramseyer ed., 2009).

167. *See Stone*, 911 A.2d at 369 (providing for liability "where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act" (quoting *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006))).

168. Although *Stone* contemplates that the requisite state of mind may be shown by demonstrating that the board has "utterly failed to implement any reporting or information system or controls," the emphasis on the *utter* failure to implement *any* such system plainly demonstrates the court's lack of interest in deciding close questions about the relative effectiveness of compliance programs. *Id.* at 370. Consequently, lack of oversight claims have been acknowledged as "one of, if not the most, difficult theories upon which to prevail." *In re* Fed. Nat'l Mortg. Ass'n Sec., Derivative & "ERISA" Litig., 503 F. Supp. 2d 9, 18 (D.D.C. 2007). Difficult, but not impossible. *See, e.g.*, Am. Int'l Grp., Inc. v. Greenberg, 965 A.2d 763, 799 (Del. Ch. 2009) (refusing to dismiss plaintiffs' failure to monitor claim against the AIG board in connection with inadequate internal controls over financial reporting, holding that plaintiffs' allegations fairly support the inference that defendants led a "criminal organization").

169. *See, e.g.*, *In re* Goldman Sachs Grp., Inc. S'holder Litig., No. 5215-VCG, 2011 WL 4826104, at *20 (Del. Ch. Oct. 12, 2011) ("The conduct at issue here involves, for the most part, *legal* business decisions that were firmly within management's judgment to pursue.... Legal, if risky, actions that are within management's discretion to pursue are not 'red flags' that would put a board on notice of unlawful conduct."); *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 131 (Del. Ch. 2009) ("While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different. Citigroup was in the business of taking on and managing investment and other business risks. To impose oversight liability

Corporate law courts occasionally do make pronouncements about compliance. The flexible nature of fiduciary duty jurisprudence allows judges to weigh in on a case-by-case basis to approve or disapprove of the practices at particular firms. For example, three 2013 Court of Chancery opinions emphasize the oversight responsibilities of directors of Delaware-incorporated firms whose business is based primarily overseas.[170] These cases underscored, once again, the importance of a system of monitoring and controls that the board has sought to implement and verify in good faith.[171] Nevertheless, judicial intervention in this area is episodic, resolutely fact-specific, and generally limited to cases with extreme facts. Thus, although it is fair to say that corporate law encourages corporations to have some basic system of internal monitoring and reporting, it provides no guidance as to adequacy. Corporate law looks to the motives of the board in implementing the system rather than the efficacy of the system itself.[172]

As a result, state corporate law has not meaningfully contributed to the development of compliance. Whatever compliance may be, it is not a product of corporate law. Indeed, it is more correct to say that compliance does what corporate law's duty of care might have

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on directors for failure to monitor 'excessive' risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors.").

170. *See* Rich *ex rel.* Fuqi Int'l, Inc. v. Yu Kwai Chong, 66 A.3d 963, 982-84 (Del. Ch. 2013) (refusing to dismiss an oversight claim against a foreign-based Delaware company because it had "no *meaningful* controls in place" and, further, that the board's failure to monitor what controls it did have in place could potentially support liability); *In re* China Agritech, Inc. S'holder Derivative Litig., No. 7163-VCL, 2013 WL 2181514, at *20-21 (Del. Ch. Feb. 21, 2013) (refusing to dismiss a *Caremark* claim against a board of a foreign-based Delaware corporation that allegedly defrauded investors); Transcript of Oral Argument at 17-18, 21, *In re* Puda Coal, Inc. Stockholders Litig., No. 6476-CS, 2013 WL 769400 (Del. Ch. Feb. 6, 2013) [herinafter Puda Coal Transcript] (emphasizing fiduciary duties of directors of foreign-based Delaware companies with regard to accounting controls).

171. *See, e.g.*, Puda Coal Transcript, *supra* note 170, at 17-21 (emphasizing that directors must be physically present and possess language skills sufficient to verify the adequacy of the corporation's system of controls as well as the capabilities of the lawyers and accountants charged with administering that system).

172. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996) ("Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities ... only a sustained or systematic failure of the board to exercise oversight ... will establish the lack of good faith that is a necessary condition to liability."). Delware may provide a basis for director liability on the basis of a compliance system implemented as a sham—that is, not implemented in good faith. *See, e.g.*, *Yu Kwai Chong*, 66 A.3d at 984-85.

done, had the business judgment rule not eviscerated duty of care jurisprudence. Compliance now occupies the space left in the wake of corporate law's retreat.

2. Federal Securities Law

The federal securities laws establish the SEC as the primary regulator of the securities industry.[173] They also create a mechanism for federal intervention in corporate governance more generally.[174] This is accomplished through the registration requirement. All public companies must register with the SEC, which, as a result, renders them subject to SEC regulation.[175] This mechanism effectively establishes the federal government, through the SEC, as an exogenous source of governance authority. If the SEC does not like a governance term, it can obstruct the firm's capital-raising efforts.[176] As we shall see, the SEC can also effectively require registered firms to adopt specific governance terms.

The SEC's interventions in corporate governance have traditionally focused on measures to improve the accuracy of financial reporting.[177] However, the SEC also makes demands of public companies that have no obvious relationship to financial reporting. For example, the SEC makes rules for takeovers and proxy contests,[178] mandates shareholder advisory votes on executive compensation

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173. *See The Laws that Govern the Securities Industry*, SEC (Oct. 1, 2013), http://www.sec.gov/about/laws.shtml [https://perma.cc/RPX4-6WVX].

174. *See generally* Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 LAW & CONTEMP. PROBS. 215, 215-25 (1999) (describing traditional federal and state spheres with regard to corporate governance and means by which the federal government, through the SEC, can engage in greater corporate governance rule making); *see also* Fanto, *supra* note 8, at 914 (advocating a more expansive corporate governance role for the SEC).

175. *See* 15 U.S.C. § 78*l* (2012).

176. *See, e.g.*, Carl W. Schneider, *Arbitration in Corporate Governance Documents: An Idea the SEC Refuses to Accelerate*, 4 INSIGHTS 21, 21 (1990) (discussing the SEC's refusal to accelerate effectiveness of an IPO because of the presence of a mandatory arbitration clause in the company's organizational documents).

177. *See* Roberta S. Karmel, Comm'r, SEC, Speech to the Public Securities Association, Marco Island, Florida: What Should Be the Role of the SEC in the Public Securities Markets? (Oct. 20, 1978), https://www.sec.gov/news/speech/1978/102078karmel.pdf [https://perma.cc/259V-52YD] ("The Commission's traditional role ... is primarily that of an advocate for investor protection.").

178. 17 C.F.R. § 240.14a-2 (2015); *see also* 15 U.S.C. § 78m(d)-(f).

arrangements,[179] and requires all publicly traded firms to have an audit committee consisting exclusively of independent directors.[180] The Agency also prescribes an annual audit of all public firms' internal accounting controls.[181] Each of these rules amounts to government intervention in corporate governance since boards are not free to choose otherwise.[182] Although such interventions are often controversial, the government's authority to regulate corporate governance through SEC rule making is well established.[183] Through the SEC, the government effectively creates mandatory terms of corporate governance.[184] Perhaps compliance can be understood in the same way.

When the government acts through the SEC to regulate corporate governance, it acts subject to important institutional constraints, including the requirement that the Agency perform a persuasive cost-benefit analysis.[185] The D.C. Circuit emphasized this requirement in three major decisions addressing the SEC's cost-benefit analyses.[186] In particular, these decisions underscored the importance

179. 17 C.F.R. § 240.14a-21 (2015); *see also* 15 U.S.C. § 78n-1.

180. 17 C.F.R. §§ 240.10A-2, 10A-3(b) (2015); *see also* 15 U.S.C. §§ 78j-1(m)(3)(A), 7201(3).

181. 17 C.F.R. § 210.2-02 (2014); *see also* 15 U.S.C. § 7262(a). This requirement was subsequently interpreted to require an audit of the design and effective operation of the company's internal accounting controls. *See* PUB. CO. ACCOUNTING OVERSIGHT BD. [PCAOB], RELEASE NO. 2004-001, AUDITING STANDARD NO. 2 (2004), http://pcaobus.org/Rules/Rulemaking/Docket008/2004-03-09_Release_2004-001-all.pdf [https://perma.cc/VJ94-YR9M].

182. *See generally* Bainbridge, *supra* note 148, at 573 (modeling the central question of corporate law as the trade-off between authority and accountability).

183. Edgar v. MITE Corp., 457 U.S. 624 (1982); *see also* Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 81 (2005).

184. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

185. *See* Jill E. Fisch, *The Long Road Back: Business Roundtable and the Future of SEC Rulemaking*, 36 SEATTLE U. L. REV. 695, 709-12 (2013); Eric Posner & Glen Weyl, *Benefit-Cost Paradigms in Financial Regulation* 2 (Coase-Sandor Inst. for Law & Econ., Working Paper No. 660, 2014), http://ssrn.com/abstract=2346466 [https://perma.cc/AM5W-HPBF].

186. *See* Bus. Roundtable v. SEC, 647 F.3d 1144, 1151 (D.C. Cir. 2011) (vacating proxy access proposal on basis of flawed cost-benefit analysis because the SEC "discounted the costs of [the proposed rule]—but not the benefits"); Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 179 (D.C. Cir. 2010) (vacating proposed rule for failure to conduct adequate cost-benefit analysis, specifically failure "to determine whether, under the existing regime, sufficient protections existed to enable investors to make informed investment decisions and sellers to make suitable recommendations to investors"); Chamber of Commerce v. SEC, 412 F.3d 133, 136 (D.C. Cir. 2005) (holding that the SEC violated the Administrative Procedure Act "by failing adequately to consider the costs mutual funds would incur in order to comply with the

of defining a convincing baseline for comparison,[187] considering less costly alternatives,[188] and focusing on marginal costs and benefits—that is, the incremental benefits achieved for additional units of cost.[189] In response, the SEC issued guidance on cost-benefit analysis[190] and also pledged to start from a relevant baseline,[191] identify reasonable alternatives to the proposed rule,[192] and quantify benefits and costs where possible.[193] As the D.C. Circuit emphasized, the broader purpose of this analysis is not only to inform the regulator of relevant costs, benefits, and alternatives, but also to inform "the public and the Congress," in whose name the action is taken, making the regulator's actions open and notorious and subject to appropriate public contestation.[194]

By contrast, when the government intervenes in compliance, it does not act as a regulator and thus is not subject to the constraints of public comment and cost-benefit analysis.[195] Rather, as described above, the government imposes compliance through enforcement.[196] Enforcement is not the same as regulation.[197] Whether the enforcer

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conditions").

187. *Am. Equity*, 613 F.3d at 178 (emphasizing the importance of a baseline for comparison).

188. *Chamber of Commerce*, 412 F.3d at 145 (finding that the SEC has an obligation to consider alternatives that are "neither frivolous nor out of bounds").

189. *Bus. Roundtable*, 647 F.3d at 1150 (emphasizing the error in failing to estimate and discount the costs associated with the benefit).

190. Memorandum from SEC Div. of Risk, Strategy & Fin. Innovation & Office of Gen. Counsel to Staff of the Rulewriting Divs. & Offices 1 (Mar. 16, 2012), https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf [https://perma.cc/X4WA-GC9D].

191. *Id.* at 6 ("The baseline serves as a primary point of comparison [because] .... [a]n economic analysis of a proposed regulatory action compares the current state of the world ... to the expected state of the world with the proposed regulation (or regulatory alternatives) in effect.").

192. *Id.* at 8-9.

193. *Id.* at 13-14 (requiring that an explanation be provided where quantification is impossible).

194. *See* Chamber of Commerce v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005).

195. *See supra* Part I.A.

196. Of course, private plaintiffs also enforce certain aspects of securities law. These litigants, however, often act in the wake of a government enforcement action. *See* Sean J. Griffith, *Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees*, 56 B.C. L. REV. 1, 9-10 (2015) (discussing "tag-along" suits). In any event, the role of private plaintiffs in extracting governance reforms on behalf of plaintiffs is outside the scope of this Article.

197. *See* Barkow, *supra* note 59, at 185-92 (arguing that "[t]he model of 'prosecutor-slash-regulator' is in tension with a government based on strict separation of powers" and

is the SEC or the DOJ, there is no requirement that the compliance reforms it imposes be subject to a cost-benefit analysis.[198] Indeed, as the prior discussion of compliance metrics demonstrated, it is highly unlikely that the government would succeed under this standard. Instead, compliance programs and reforms to improve program effectiveness are foisted upon firms through an opaque settlement process, where the government has the whip hand, and the company accedes to its demands as a tactical concession regardless of whether the reforms make long-term strategic sense.[199]

In sum, compliance cannot be understood as an outgrowth of securities regulation. When the government intervenes in corporate governance through the federal securities laws, it intervenes as a regulator. When it intervenes in compliance, it intervenes as an enforcer. There are significant differences between these modes of intervention, the further implications of which are explored in the next Part.

III. IMPLICATIONS

So far, this Article has depicted compliance as an intrafirm governance function whose origins lie outside the firm and are alien to traditional corporate governance authorities. Compliance is not a delegation of board authority, nor is it a product of either state corporate or federal securities law. Rather, compliance is made by government enforcers—prosecutors and regulatory enforcers—who

problematic under the present system because prosecutors are relatively unconstrained and lack formal expertise to regulate the matters that come before them).

198. As an enforcer of securities law, the SEC brings civil actions or criminal actions for violations of securities law in concert with the DOJ. In this capacity, the SEC brings claims and settles them, just as prosecutors do, for a monetary payment and compliance reforms. *See, e.g.*, *In re* Barclays Capital, Inc., Exchange Act Release No. 73183, 109 SEC Docket 17 (Sept. 23, 2014), http://www.sec.gov/litigation/admin/2014/34-73183.pdf [https://perma.cc/5DX2-E6AQ] (cease-and-desist order in which Barclays Capital agreed to pay $15 million penalty and agreed to appoint an independent consultant to recommend compliance reforms); Litigation Release No. 23159, SEC, SEC Charges Avon Products, Inc. with FCPA Violations (Dec. 17, 2014), https://www.sec.gov/litigation/litreleases/2014/lr23159.htm [https://perma.cc/5VB3-H47T] (announcing settlement with Avon Products, Inc., involving a $67 million monetary payment and the appointment of "an independent compliance monitor to review its FCPA compliance program for a period of 18 months, followed by an 18-month period of self-reporting on its compliance efforts").

199. *See* Baer, *supra* note 9, at 952-53 (emphasizing opacity of compliance formed in an adjudicative rather than administrative context).

promulgate de facto corporate governance standards despite possessing neither statutory nor regulatory authority to do so.[200]

This Article will now turn to the normative implications of this analysis for theories of corporate law and corporate governance. In doing so, it will seek to frame the larger questions raised by the contemporary compliance function. How does the contemporary compliance function alter the political economy of corporate governance? What are the likely effects on firm efficiency? And what are the broader implications for theories of the firm? This Part takes up each of these questions in the Sections that follow.

A. The Political Economy of Compliance

Compliance represents a unique form of government intervention in corporate governance. It does not fit conventional accounts of the political economy of corporate governance, focusing either on the interstate race for corporate charters[201] or the interplay between Wilmington and Washington.[202] It is *sui generis*.

1. Weak Constraints

The traditional pattern of government intervention in corporate affairs is for legislation to follow in the wake of a scandal or a perceived market failure.[203] The government's agent in this context is the legislator, and the background of scandal is an important impetus for action. Without the environment of scandal, government intervention in corporate affairs is held in check by the lobbying power of corporate interests.[204] In an environment of scandal,

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200. *Id.* at 976.

201. *Compare* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 701-05 (1974) (proposing federal corporate uniformity standards to mitigate the "race for the bottom" among states), *with* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 289-92 (1977) (arguing that competition among states to attract business incorporation results in pro-investor law).

202. *See, e.g.*, Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003) (modeling the interplay between Delaware and the federal government in the production of corporate law rules).

203. *See* John C. Coffee, Jr., *The Political Economy of Dodd Frank: Why Financial Reform Tends to be Frustrated and Systematic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1028-29 (2012).

204. *See id.*

populist demands for greater corporate accountability overcome the corporate lobby and push legislators to pass reforms.[205] But popular pressure inevitably subsides, and corporate interests seek to limit the scope of reform. The result is a recurring pattern of reform and retrenchment,[206] taking the shape of a "Regulatory Sine Curve."[207]

Compliance, however, represents government intervention through an enforcement agent rather than a legislator. Prosecutors are not subject to either populist pressure or corporate lobbying in the same way as legislators.[208] Prosecutors prize their independence and discretion and are largely insulated from direct political accountability.[209] Because they do not need political cover to act, they do not need a market-wide scandal to press for reforms. Of course, they do need the likelihood of a successful prosecution, but in an environment where corporations are strictly liable for the acts of their agents, and settlements often entail the payment of large fines, the necessary elements of success are present in most firm crises.[210] As a result, prosecutors need much smaller scale events—firm failures rather than market failures—to intervene and press for reform. Considering that reforms undertaken by one firm are frequently adopted by industry peers, the government, through its interventions in compliance, can exert relatively steady pressure on corporate governance.

Prosecutors are not only able to intervene in corporate governance with greater regularity than legislators; intervening through

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205. *See id.* at 1021-22.

206. Mark J. Roe, *Delaware and Washington as Corporate Lawmakers*, 34 DEL. J. CORP. L. 1, 8 (2009) ("Washington acts only sporadically, it is often divided, and it often has more important issues than corporate governance rules on its agenda.").

207. Coffee, *supra* note 203, at 1029 (arguing that "regulatory oversight is never constant but rather increases after a market crash and then wanes as, and to the extent that, society and the market return to normalcy" as a result of the declining public support necessary to "oppose powerful interest groups").

208. This is not to say that prosecutors are wholly insulated from populist or other political pressures. *See generally* Daniel Richman, *Political Control of Federal Prosecutions: Looking Back and Looking Forward*, 58 DUKE L.J. 2087 (2009) (exploring political control over federal criminal enforcement); David Zaring, *Litigating the Financial Crisis*, 100 VA. L. REV. 1405 (2014).

209. *See generally* Angela J. Davis, *The American Prosecutor: Independence, Power, and the Threat of Tyranny*, 86 IOWA L. REV. 393, 397 (2001) (arguing that "prosecutors daily exercise practically unlimited discretion").

210. *See generally* Miriam H. Baer, *Choosing Punishment*, 92 B.U. L. REV. 577, 620-21 (2012).

settlement agreements rather than legislation gives the government greater freedom to press reforms when it does intervene. As noted above, there is no need to perform cost-benefit analyses, and the settlement process, in contrast to the open and notorious legislative process, is closed and opaque.[211] When Congress intervenes in corporate affairs, affected interests have an opportunity to appear at hearings, engage in lobbying, and provide comments on proposed rules. Likewise, when Delaware judges make corporate law pronouncements, they are constrained by the threat of exit should their rulings upset the delicate balance between shareholders and managers.[212]

However, the settlement of enforcement actions receives scant review, even by the judges entering the orders.[213] These settlements are negotiated privately, by the parties to the case at hand, with no notice to, or involvement of, outside interests. In spite of the precedential impact the settlement may have on an array of firms and a spectrum of outside interests, those interests have no standing to intervene and no opportunity to contest the result because they are not involved in the case at bar. There is no serious judicial oversight of the process and nowhere for firms to go if they are unhappy with the result. Compliance is thus the product of an unaccountable government agent engaged in an utterly opaque rule-making process.

2. Other Constituencies

Federal law answers to a much more diverse set of perspectives on corporate governance than does state law.[214] While state

211. *See generally id.* (contrasting regulation with prosecution); Max Minzner, *Why Agencies Punish*, 53 WM. & MARY L. REV. 853 (2012) (discussing punishment in context of regulation).

212. *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 9 (1993).

213. This is particularly true in the context of DPAs and NPAs, which, unlike guilty pleas, involve at most minimal judicial review. *See generally* Albert W. Alschuler, *The Defense Attorney's Role in Plea Bargaining*, 84 YALE L.J. 1179, 1291-94 (1975) (noting that a typical guilty plea involves judicial review, not only of the competency of the defendant to admit his or her crimes, but also of the factual basis of the plea). An NPA involves no judicial review at all because the charges, as the name suggests, are never formally filed, whereas a DPA involves minimal judicial review because of the simultaneous filing of charges and deferral of prosecution. *See* Greenblum, *supra* note 43, at 1863-65.

214. *See* Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2502-03 (2005) ("[I]n Congress, the players and ideas differ.... Interest groups that can't take the franchise tax

corporatelaw traditionally balances the interests of only two parties— managers and shareholders[215]—federal law may consider the additional interests of employees, creditors, consumers, the environment, and other social responsibility concerns.[216] Whose interests will the government consider when it acts with respect to compliance? Does the government press the interests of non-shareholder constituencies on firms when it intervenes through compliance? Should it?

The conventional view in the United States is that corporate governance arrangements are the product of a bargain between shareholders and managers. Indeed, the mainstream American view of corporate governance is decidedly shareholder-centric, taking as its central preoccupation the problem of "agency costs" or "opportunism" that arises from the separation of ownership and control.[217] As expressed by Sanjai Bhagat, Brian Bolton, and Roberta Romano, "[t]he key focus of U.S. corporate law and corporate governance systems is what is referred to as an agency problem: an organizational concern that arises when owners—in a corporation, the shareholders—are not the managers who are in control."[218] Of

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away from Delaware can play a role in Congress. The AFL-CIO comes to mind, as do public interest lobbying groups.").

215. Under traditional models, states compete for corporate charters in order to raise tax revenues. Because only shareholders and managers have input on the decision of where to incorporate, states seek to appeal to these interests alone in designing their corporate law. ROMANO, *supra* note 212, at 8-9.

216. Roe, *supra* note 206, at 17 ("[W]hen Washington acts on corporate law, it brings with it another strain of public policy: American populist sentiment and national public opinion, which are not always friendly to corporate productivity and corporate power.").

217. *Compare* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Captial Structure*, 3 J. FIN. ECON. 305 (1976) (addressing the problem of "agency costs"), *with* OLIVER E. WILLIAMSON, MECHANISMS OF GOVERNANCE 173 (1996) (noting that what agency theory refers to as "agency costs" are referred to in transaction cost economics as "opportunism," "[b]ut the concerns are the same, whence these are merely terminological differences"). The problem, however described, has been a focus of the literature since Berle and Means. *See* ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 121 (1932) (questioning whether, given diffuse ownership and centralized management, there remained "any justification for assuming that those in control of the modern corporation will ... choose to operate it in the interests of the owners").

218. Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1809 (2008); *accord* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 738 (1997) (reducing the core problem to "how investors get the managers to give them back their money").

course, corporate shareholders are not owners in a traditional sense.[219] However, shareholders' relationship with the firm is unique in its duration and in the uncertainty of their entitlement to assets, which puts them in unique risk of expropriation.[220] Corporate governance is the solution to the shareholders' risk of expropriation.[221]

Corporate governance is thus conceived of as a quasi-contractual mechanism designed to encourage investment in the modern corporate enterprise.[222] As a result, mainstream definitions of corporate governance typically reflect shareholder centricity.[223]

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219. *See* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 290 (1980) ("[O]wnership of capital should not be confused with ownership of the firm.... The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs.... [O]wnership of the firm is an irrelevant concept.").

220. As described by Oliver Williamson:

> Stockholders as a group bear a unique relation to the firm. They are the only voluntary constituency whose relation with the corporation does not come up for periodic renewal. (The public may be regarded as an involuntary constituency whose relation to the corporation is indefinite.) Labor, suppliers in the intermediate product market, debt-holders, and consumers all have opportunities to renegotiate terms when contracts are renewed. Stockholders, by contrast, invest for the life of the firm, and their claims are located at the end of the queue should liquidation occur.
>
> Stockholders are also unique in that their investments are not associated with particular assets. The diffuse character of their investments puts shareholders at an enormous disadvantage in crafting the kind of bilateral safeguards normally associated [to protect investments].... Absent the creation of some form of protection, stockholders are unavoidably [at risk of expropriation].

WILLIAMSON, *supra* note 146, at 304-05.

221. *See id.* at 305 (noting the solution, for large modern firms, is "to invent a governance structure that holders of equity recognize as a safeguard against expropriation and egregious mismanagement"); *see also* Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm*, *in* THE NATURE OF THE FIRM, ORIGINS, EVOLUTION, AND DEVELOPMENT 138, 140-42 (Oliver E. Williamson & Sidney G. Winter eds., 1993) (describing the inability of parties in an ongoing commercial relationship to anticipate all future contingencies as a transaction cost leading to the formation of firms).

222. EASTERBROOK & FISCHEL, *supra* note 184, at 36-37. The contractual intuition has deep intellectual roots. *See, e.g.*, Paul A. Samuelson, *Wages and Interest: A Modern Dissection of Marxian Economic Models*, 47 AM. ECON. REV. 884, 894 (1957) ("[I]n a perfectly competitive market it really doesn't matter who hires whom: so have labor hire 'capital.'").

223. *See, e.g.*, *The CalPERS Corporate Governance Guidelines*, 7 CORP. GOVERNANCE 218 (1999) ("Corporate [g]overnance refers to the relationship among various participants in determining the direction and performance of the corporations. The primary participants are: (1) the shareholders, (2) the management (led by the Chief Executive Officer), and (3) the board of directors.").

On the other side of this debate are those who argue that corporate governance should look to a wider set of interests.[224] This claim is often framed in terms of broad social objectives.[225] However, another version of the claim may also be advanced from an efficiency perspective, to argue that corporate governance must protect the interests of nonshareholder constituencies, such as management and labor, in order to induce them to make necessary investments to increase long-term corporate value.[226] If the recognition of other constituency interests in corporate governance is the minority view in the United States, it is not necessarily so abroad,[227] especially in countries such as Germany that recognize other constituencies' rights to board representation.[228]

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224. *See, e.g.*, Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263, 1272 (1992) (advocating a governance model under which the board of directors would serve "as a mediating body among the different corporate constituent groups .... charged with the duty to ensure that the corporation's assets are fairly distributed"). This view has a long history. *See* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1153 (1932) (arguing that boards of directors should serve as trustees for a wide array of constituencies, including shareholders, employees, suppliers, customers, and the community); Robert Dahl, *Power to the Workers*?, N.Y. REV. BOOKS, Nov. 19, 1970, at 20, 23 (proposing that "the board of directors might consist of one-third representatives elected by employees, one-third consumer representatives, and one-third delegates of federal, state, and local governments").

225. *See* Wolfgang Bessler et al., *Going Public: A Corporate Governance Perspective*, *in* COMPARATIVE CORPORATE GOVERNANCE 570, 571 (Klaus J. Hopt et al. eds., 1998) (describing a perspective that "approaches the corporate governance debate as part of the larger question of how to organize economic activity to achieve more fundamental societal objectives related to equity, fairness, freedom, and citizen responsibilities").

226. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250 (1999) (conceptualizing the corporation as the team to which various constituencies contribute, and for which governance arrangements serve as a credible commitment mechanism through which each promises not to usurp the wealth of another). A version of this view was recently articulated by researchers who found positive wealth effects from the adoption of staggered boards. *See* Martijn Cremers & Simone Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 837 (2016) (explaining their finding as relating to the need to make a credible commitment to pursue long-term value).

227. *See generally* Martin Gelter, *Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debates in a Comparative Light*, 7 N.Y.U. J.L. & BUS. 641 (2011).

228. *See, e.g.*, JEAN J. DU PLESSIS ET AL., GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT 139-40 (2d ed. 2012) (discussing German system of "codetermination" in which labor receives board representation); *see also* Martin Gelter, *Tilting the Balance Between Capital and Labor? The Effects of Regulatory Arbitrage in European Corporate Law on Employees*, 33 FORDHAM INT'L L.J. 792, 803-04 (2010) (listing countries following board models similar to that of Germany).

Broader corporate engagement with social issues is not necessarily incompatible with a shareholder-centric model of governance, provided the impetus to consider these issues comes from shareholders.[229] However, debate frequently erupts when the government imposes considerations of other constituencies on the firm.[230] Compliance presents the government with a means of doing just that.

At first glance, that the contemporary compliance function is a tool through which the government can press other constituency interests on corporations is so obvious as to appear trivial. Of course compliance reflects broader social interests. Insofar as compliance is concerned with preventing violations of law and regulation, and insofar as laws and regulations look to nonshareholder interests, compliance must necessarily reflect nonshareholder interests. The panoply of law and regulation affecting firms—rules preventing fraud, pollution, bribery, money laundering, false advertising, and dangerous workplaces—often bars conduct that would, in some situations, even produce benefits to shareholders.[231] The compliance function simply mirrors this collection of interests.

There is an important difference, however, between passing a law to protect the interests of a nonshareholder constituency and requiring corporations to adopt intrafirm governance mechanisms to carry out the interests of that constituency.[232] Formal legal rules may be more precise in defining firms' responsibilities and, in any event, contain an avenue of appeal to public authority—the courts—when they are unclear in meaning or overbroad in scope. By contrast, governance structures are designed to supply constraints that exceed basic legal commands.[233] The compliance function, in particular, is designed to inculcate norms of behavior that exceed

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229. *See* EASTERBROOK & FISCHEL, *supra* note 184, at 12-14; WILLIAMSON, *supra* note 146, at 323-25.

230. *See, e.g.*, SEC, RELEASE NO. 34-67716, CONFLICT MINERALS, 17 C.F.R. PARTS 240 AND 249B (2012), http://www.sec.gov/rules/final/2012/34-67716.pdf [https://perma.cc/KU9B-GUZH].

231. *See, e.g.*, John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1560 (2006) (noting that fraud benefits shareholders until it is detected).

232. *See generally* Carney, *supra* note 151 (describing regulatory pressure on bank boards to put other interests ahead of shareholder wealth maximization).

233. This is the traditional role of the charter and bylaws.

narrow legal obligations.[234] This is part of the reason that regulators have sought to separate compliance from the legal department.[235] Designing compliance structures on the basis of other constituency interests is a way of bringing those interests into the firm, thereby making firms servants of a wider set of social interests.[236] Moreover, this is an objective that government agents candidly admit. For example, New York Federal Reserve Chairman William Dudley has expressly stated that "financial firms exist, in part, to benefit the public, not simply their shareholders, employees, and corporate clients."[237]

Whether the role of other constituency interests in compliance is something to celebrate or decry, of course, depends upon the position one takes in the broader debate. Are corporations vehicles of wealth creation for their investors? Or are they also, in part, instruments to accomplish a broader social good? Compliance presents an opening for those who might wish to push corporations into this broader social role and a challenge for those who might wish to keep them out. At a minimum, compliance presents a new avenue for corporate law theorists to engage on these questions.

B. Incentives and Information

The government is no more monolithic than any other large organization, and identifying a set of government interests, as the prior Section sought to do, does not necessarily imply that its agents will faithfully carry them out.[238] Government enforcement agents may have their own incentives to bring particular kinds of cases.[239]

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234. *See supra* note 75 and accompanying text.

235. *See supra* note 111 and accompanying text.

236. *See supra* Part I.B.1.

237. William C. Dudley, President, Fed. Reserve Bank of N.Y., Concluding Remarks at the 2014 Workshop on Reforming Culture and Behavior in the Financial Services Industry (Oct. 20, 2014). The role of the Federal Reserve in imposing compliance reforms through the "regulatory examination" process is a special "enforcement" modality. *See* FED. RESERVE BANK OF N.Y., *supra* note 74.

238. *See* Larry E. Ribstein, *Agents Prosecuting Agents*, 7 J.L. ECON. & POL'Y 617, 633 (2011).

239. The agency itself may have interests that differ from broader government interests. For example, an agency may be tempted to bring cases that will result in large settlements or fines in order to fund itself or at least justify its budgets to lawmakers. These cases may not always coincide with merit.

And they may have their own reasons to impose excessively costly compliance programs on firms.

1. Agency Costs and Externalities

Prosecutors selecting cases may be motivated to bring cases of greater notoriety or political salience in hopes of building a reputation that they can convert into subsequent career opportunities.[240] Prosecutors with political ambitions may be motivated to make cases against firms and individuals that have aroused public ire.[241] Although it is possible that these cases correlate with the most egregious offenses, it is also possible that they principally correlate to media coverage and populist sentiment without regard to the quality of the evidence.[242] For example, the need to find a villain to satisfy public ire may partially explain the proliferation of insider trading and bad banker cases in the wake of the financial crisis.[243] On the other hand, enforcement authorities may respond to political pressure to go easier on politically connected firms.[244] These problems may be especially pronounced in a context where enforcers can

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240. *See* Stephen J. Choi & A.C. Pritchard, Securities Law and Its Enforcers (Aug. 2015) (unpublished manuscript) (on file with author) (discussing subsequent careers of SEC enforcement attorneys); *see also* Richard T. Boylan, *What Do Prosecutors Maximize? Evidence from Careers of U.S. Attorneys*, 7 AM. L. & ECON. REV. 379 (2005) (providing evidence on the subsequent career paths of former U.S. Attorneys).

241. *See* Ellen S. Podgor, *The Tainted Federal Prosecutor in an Overcriminalized Justice System*, 67 WASH. & LEE L. REV. 1569, 1573-77 (2010) (discussing federal prosecutors' political motivations).

242. *See, e.g.*, Sara Sun Beale, *The New Media's Influence on Criminal Justice Policy: How Market-Driven News Promotes Punitiveness*, 48 WM. & MARY L. REV. 397, 442-43 (2006); *see also* Stephen J. Choi et al., *Scandal Enforcement at the SEC: The Arc of the Option Backdating Investigations*, 15 AM. L. & ECON. REV. 542 (2013) (studying SEC enforcement decisions surrounding options back-dating and finding evidence that enforcement priorities shift in response to media attention and political salience).

243. *See generally* Donald C. Langevoort, *"Fine Distinctions" in the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 434 (emphasizing the "expressive function" of insider trading regulation and the underlying premise that "manifestations of greed and lack of self-restraint among the privileged ... threaten to undermine the official identity of the public markets as open and fair").

244. Maria M. Correia, *Political Connections and SEC Enforcement*, 57 J. ACCT. & ECON. 241 (2014) (finding that firms that engage in greater lobbying face fewer SEC enforcement actions and fewer penalties); Jonas Heese, *Government Preferences and SEC Enforcement* (Harvard Bus. Sch., Working Paper No. 15-054, 2015) (finding less SEC enforcement against labor-intensive firms, especially in presidential election years when the firms are located in politically contested states).

use settlement agreements to side-step both political costs and evidentiary burdens.[245]

Prosecutors have obvious reasons at settlement to favor high fines over low ones.[246] However, the question of what prosecutors should seek with regard to compliance is less clear. How are compliance reforms traded in the settlement bargain?

From a prosecutor's perspective, compliance may be seen as a means of outsourcing enforcement costs.[247] By insisting that companies install a compliance function to detect and report violations of law, prosecutors can externalize a portion of their budget. The company pays for the compliance program, and the prosecutor saves costs on its investigation. The question of how much compliance to impose thus takes on the logic of a traditional externalities analysis, with the ultimate answer being: too much.[248] Because the government receives the benefit of the compliance program (in the form of detection and investigation) but does not bear the cost, its incentive is to push firms to overinvest in compliance. Thus, just as they have idiosyncratic incentives to bring especially newsworthy cases, government enforcement agents have structural incentives to mandate excessive compliance.[249]

Across the bargaining table from the prosecutor, of course, are corporate managers whose general interest will be to minimize the

245. *See supra* Part I.A.2 (discussing the evolution of corporate enforcement tactics in favor of settlement agreements).

246. More fines likely translate into better reputation and, according to the hypothesis above, greater career options in the future. Prosecutors do not burnish their reputations by the cases they do not bring or their willingness to accede to the settlement demands of the other side.

247. *See generally* Lisa Kern Griffin, *Inside-Out Enforcement*, *in* PROSECUTORS IN THE BOARDROOM, *supra* note 4, at 110 (discussing compliance as a form of prosecutorial outsourcing).

248. Externalities lead to overconsumption. J.J. Lafont, *Externalities*, *in* 2 NEW PALGRAVE DICTIONARY OF ECONOMICS 263, 263-64 (John Eatwell et al. eds., 1998).

249. *See* Baer, *supra* note 9, at 991-99 (arguing that both prosecutors and private attorneys have incentives to push companies to overinvest in compliance). Moreover, once the enforcement agent has imposed a compliance reform, he or she will likely turn to the next case rather than monitor the quality of the compliance reforms he or she has put in place, with the result that excessive compliance mandates are rarely revised. *See* Tom C.W. Lin, *The New Financial Industry*, 65 ALA. L. REV. 567, 602 n.222 (2014) (noting the "stickiness" of regulatory reforms). Sunset provisions may be of little help in this regard if, in the meantime, the industry norm has converged on the excessive compliance mandate. In such cases, implementing a more moderate regime may expose managers to greater enforcement risk.

consequences of settlement on the firm. Managers will prefer small fines to large ones because fines erode corporate profits and thereby reduce the managers' own performance-based compensation. Managers can thus be expected to push back on prosecutorial demands for fines at settlement. The situation may be different, however, with regard to compliance reforms. Managers might be willing to accept compliance reforms in exchange for a reduction in the monetary penalty or for early termination of the investigation. Indeed, such behavior comports with the standard "agency cost" model of corporate management.[250] Monetary penalties have an immediate impact on compensation. Compliance reforms do not. Moreover, considering that firms tend to mimic the compliance reforms of their peers, the introduction of costly compliance reforms may well be copied by competitors, thereby mitigating the impact of the reforms on industry benchmarks linked to executive compensation.

2. *Information Asymmetries*

On the question of what specific mechanisms ought to be adopted by or imposed upon firms, this Article has already shown that compliance officers themselves do not always know what works in compliance.[251] For example, it is difficult, if not impossible, to show whether an investment in additional training will make a meaningful difference in employee behavior, or whether one form of compliance infrastructure is better than another, or what the right level of staffing or resource allocation is for a particular compliance department. If compliance officers cannot answer these questions definitively, there are very good reasons to suppose that generalist prosecutors who are not embedded in the day-to-day operation of the subject firm cannot answer them either.

The inability to demonstrate the effectiveness of compliance raises two difficult questions. First, why should prosecutors give firms any credit for employing compliance mechanisms whose effectiveness has not been proven? And second, why should prosecutors impose unproven compliance mechanisms on firms? In either case,

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250. *See supra* notes 217-21 and accompanying text.
251. *See supra* notes 139-40 and accompanying text.

prosecutors likely rely on heuristics. For example, a money laundering failure implies the need for more staff devoted to preventing money laundering.[252] This makes a kind of sense, but how much staff should a firm add? This is an empirical question that, at present, cannot be answered. It is not surprising, then, that prosecutors' compliance demands are occasionally vague,[253] requiring firms to conduct "appropriate due diligence," build "effective compliance," and periodically review compliance in light of current standards, all without supplying specific content.[254] Prosecutors simply do not know what to ask for. Unless and until they can pair organizational theory with empirical evidence, prosecutors are larding firms with cost for uncertain benefit.

Enforcers implicitly acknowledge their lack of information when they require the appointment of monitors or the engagement of outside consultants to review the quality of a firm's compliance program. This is a punt. Unless the third parties can accurately distinguish good compliance from bad, mandating the involvement of third parties merely amounts to a wealth transfer from the firm to the third party. Moreover, there is good reason to suspect that third-party experts do not know much more about what makes good compliance than government enforcement authorities. They are both on the outside looking in.

The information problem at the core of compliance may lead to adverse selection—the infamous "lemons problem."[255] When consumers cannot distinguish between high-quality and low-quality goods, they rationally respond by discounting the value of all goods.[256] The effect of this discount, however, is to discourage the owners of high-quality goods from bringing their wares to market,

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252. *See, e.g.*, Rachel Louise Ensign & Max Colchester, *HSBC Struggles in Battle Against Money Laundering*, WALL ST. J. (Jan. 12, 2015), http://www.wsj.com/articles/hsbc-struggles-in-battle-against-money-laundering-1421100133 [https://perma.cc/LSX9-VFUD] (detailing HSBC's efforts to comply with a DPA relating to money-laundering investigations, including billions of dollars spent and organizational restructuring so that "nearly 10% of HSBC's 258,000 employees work in risk and compliance").

253. *See supra* note 50 and accompanying text.

254. GARRETT, *supra* note 9, at 72.

255. *See generally* George A. Ackerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

256. *Id.* at 489 (developing the model by analogy to cars where consumers cannot distinguish good cars from bad ones, and the two must therefore trade at the same discounted price).

in which they would suffer the discount.[257] The unhappy result, because the owners of low-quality goods are not similarly discouraged, is that notwithstanding the discount, consumers will both buy low-quality goods and overpay for them.[258]

Firms in the market for a good compliance program face a similar problem. The good cannot be distinguished from the bad. This will discourage the development of good programs and lead many companies to overpay for bad ones. This is a double tragedy. Not only are businesses overpaying, but they also are installing compliance programs that will likely fail to prevent future violations of law.

C. Theories of the Firm

State-imposed corporate governance is inconsistent with current theories of the firm, whether one's model of the firm is derived from the "nexus of contracts,"[259] "transaction cost economics,"[260] or "property rights"[261] theories.[262] Under all of these theories, corporate governance is understood as contractual, subject to a background of mandatory terms supplied by statute or judicial precedent. Compliance amounts to the extrafirm imposition of intrafirm governance. It therefore does not fit with any of the current theoretical accounts of the firm.

If anything, compliance flips the intuition underlying mainstream theories of the firm. Most of these theories proceed from Coase's realization concerning the incompleteness of contracts in an ongoing

257. *Id.* at 490 ("[B]ad cars drive out the good because they sell at the same price as good cars.").

258. *Id.* at 489 ("[M]ost cars traded will be the 'lemons,' and good cars may not be traded at all.").

259. EASTERBROOK & FISCHEL, *supra* note 184, at 8-12.

260. "Transaction cost" theories of the firm account for the development of the firm as a result of these costs. WILLIAMSON, *supra* note 146, at 17-18.

261. "Property rights" theories of the firm take incomplete contracts as a starting point, but also emphasize the importance of allocating to the residual claimant control rights to the physical or intangible assets at the center of the firm. *See generally* Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990).

262. The agency cost problem that has centrally occupied mainstream corporate law scholarship for generations can be made to fit alongside each of these theories of the firm. *See* Jensen & Meckling, *supra* note 217, at 305-06.

business enterprise.[263] Parties in an ongoing business relationship are unable to specify all contingencies that may arise in their contractual relations over time. The result is the creation of the firm, whose role is to mediate contractual incompleteness through structures of authority and background principles of fiduciary duty.[264] In light of these principles, perhaps the best way to conceptualize compliance and distinguish it from other structures of regulation is to portray it as a similar response to the problem of incompleteness.[265] Because it is impossible for regulators to specify all contingencies that could lead to evasion or violation of regulatory rules or to articulate every step a firm must take to prevent a violation, they therefore impose on firms compliance departments whose fundamental role is to mediate regulatory demands in light of the ongoing conduct of the business. In other words, compliance is to the incompleteness of regulatory specificity as governance is to the incompleteness of the investment contract.

Although this parallel may suggest a theory of compliance, it does not succeed in fitting that account within corporate law theory. As noted above, all mainstream theories of the firm are limited in scope to the constituent entities of the firm—that is, the contractual counterparties of the business. Compliance responds to a transaction cost of the government, not of the firm's contractual counterparties. In spite of the parallel, in other words, compliance remains an exogenous imposition, not an endogenous element of firm governance. This begs the theoretical question of what gives the government the authority to intervene in the firm through compliance.

An answer to this question might be that the state's right to intervene in corporate affairs comes from the role of the sovereign in granting the corporate charter, an argument that goes back to the origins of the corporate form in Britain.[266] Having granted a corporate charter, the king retained the right to exercise a considerable

263. *See generally* Coase, *supra* note 6.

264. *See* Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1629-30 (2001).

265. *See* AYRES & BRAITHWAITE, *supra* note 9, at 103 (citing Coase as a source of inspiration in analyzing "enforced self-regulation as a form of subcontracting regulatory functions to private actors").

266. *See* 2 WILLIAM BLACKSTONE, COMMENTARIES *472 (explaining that "in England, the king's consent is absolutely necessary" to charter a corporation).

degree of control over corporate affairs.[267] Once the United States separated from Britain, U.S. states assumed the authority to grant corporate charters.[268] Perhaps compliance is a later-day manifestation of the sovereign right, having granted the firm its charter, to intervene in corporate affairs.[269]

However, U.S. law long ago rejected the claim that the power to grant charters gives states an inherent right to intervene in corporate affairs. In the famous *Dartmouth College* case of 1819, the U.S. Supreme Court held that the state of New Hampshire could not take control of the college by altering its charter to transfer the appointment of trustees to the state.[270] In spite of having formally created the corporation, the state could not treat it as a mere instrumentality of state power. The corporation, Justice Marshall wrote, "does not share in the civil government of the country, unless that be the purpose for which it was created."[271] The corporation exists, instead, to represent the interests stated in the charter and is protected from state interference by the Contracts Clause of the Constitution.[272]

An alternative basis for the government's interventions in compliance can be found in the "real entity" theory, a late nineteenth-century theory exported from Germany to England and the United States as a basis for the legal rights of business organizations.[273] In the early to mid-twentieth century, the real entity theory "helped

267. *See* RON HARRIS, INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION 64-65 (2000).

268. Unlike the British monarch, U.S. states freely granted corporate charters to for-profit enterprises. *See* JOSEPH K. ANGELL & SAMUEL AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE 38 (Boston, Little, Brown & Co. 2d ed. 1843) ("In no country have corporations been multiplied to so great an extent, as in our own.... There is scarcely an individual of respectable character in our community, who is not a member of, at least, one private company or society which is incorporated.... Acts of incorporation are moreover continually solicited at every session of the legislature.").

269. It is worth noting that, under this theory, the right would belong to the states, not the federal government.

270. Trs. of Dartmouth Coll. v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).

271. *Id.* at 636.

272. *Id.* at 654 ("[T]he body corporate, as possessing the whole legal and equitable interest, and completely representing the donors, for the purpose of executing the trust, has rights which are protected by the constitution.").

273. The real entity theory is identified principally with German legal academic Otto von Gierke, whose influence spread through the work of Frederic William Maitland and Ernst Frend. *See* Gelter, *supra* note 227, at 665-66 (discussing Gierke's influence).

strengthen limited liability and the business judgment rule, and may have been partially responsible for the introduction of a corporate income tax regime, which treated corporations as separate taxable entities."[274] Most importantly, the theory supported treating the corporation as a person for purposes of criminal law.[275] A great leap is not required to go from prosecuting corporations as though they were real people to seeking to "rehabilitate" them through compliance.[276]

The real entity theory is now rejected by mainstream corporate law theory.[277] Of course, this does not mean that it is wrong, but it does mean that compliance is seriously undertheorized. Compliance is the place where conceptions of the firm held by scholars and practitioners of criminal law encounter those held by scholars and practitioners of corporate law. At present those two conceptions are incompatible, suggesting the need either for a reconceptualization of corporate law theory or, alternatively, a correction in the way the government approaches compliance. The next Part sketches an approach to the latter, while leaving open the former as perhaps the more interesting possibility.

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274. Martin Petrin, *Reconceptualizing the Theory of the Firm: From Nature to Function*, 118 PENN ST. L. REV. 1, 12 (2013) (footnotes omitted).

275. Mark M. Hager, *Bodies Politic: The Progressive History of Organizational "Real Entity" Theory*, 50 U. PITT. L. REV. 575, 585, 588 (1989) ("Gierke established the understanding that the real entity theory was pro-liability while the fiction theory was anti-liability.").

276. *See generally* Miriam H. Baer, *Organizational Liability and the Tension Between Corporate and Criminal Law*, 19 J.L. & POL'Y 1, 10 (2010) ("Sometimes the government's proposed rehabilitation has little to do with eliminating criminal conduct at the individual level, but instead seeks the implementation of questionable governance provisions."); *see also* GARRETT, *supra* note 9, at 47 ("Prosecutors say a central goal is to rehabilitate corporations, to try to help make them better and more ethical."); Peter Spivack & Sujit Raman, *Regulating the "New Regulators": Current Trends in Deferred Prosecution Agreements*, 45 AM. CRIM. L. REV. 159, 161 (2008) ("In a post-Enron world, DOJ officials appear to believe that the principal role of corporate criminal enforcement is to reform corrupt corporate cultures—that is, to effect widespread structural reform.").

277. In the words of former Chancellor Allen:

> The dominant legal academic view does not describe the corporation as a social institution. Rather, the corporation is seen as the market writ small, a web of ongoing contracts (explicit or implicit) between various real persons. The notion that corporations are "persons" is seen as a weak and unimportant fiction.

William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993).

IV. REFORMING THE REFORMS

Corporate compliance with the law is plainly a social good. However, the current structure of compliance, as the last Part has shown, is more ambiguously so. How might the situation be improved? This Part offers two alternatives. First, end the government's role as the architect of compliance, allowing firms to adopt compliance programs (or not) on the basis of efficiency concerns alone while still holding them accountable for violations of substantive law. Second, increase the transparency of the compliance function on an ongoing basis through periodic disclosures in securities law filings. The Sections that follow explore each of these alternatives.

A. Government Exit

Getting the government out of the compliance business would prevent core corporate governance functions from being designed in an opaque process by a largely unaccountable agent with no expertise in organizational design and no ability to measure effectiveness.[278] Government exit from compliance would *not* mean exit from enforcement. If the government got out of the business of corporate reform, it would still have the power to enforce the law to its fullest extent. It would still be able to impose massive penalties. And it would still have the power to settle and to give credit for cooperation.[279] It simply could not insist upon compliance reforms.[280]

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278. *See supra* Part III.B; *see also* Jennifer Arlen, *Removing Prosecutors from the Boardroom: Limiting Prosecutorial Discretion to Impose Structural Reforms*, *in* PROSECUTORS IN THE BOARDROOM, *supra* note 4, at 62, 63 (arguing that "prosecutors should not impose structural reforms on nonindicted corporations").

279. There are good reasons for recognizing cooperation as a mitigating factor. *See* Arlen, *supra* note 20, at 859; Arlen & Kraakman, *supra* note 22, at 746-47. Retaining a role for cooperation would likely mean retaining at least those parts of the contemporary compliance function that are essential to support cooperation—notably, monitoring and internal investigations—but not in a form mandated by the enforcement agent.

280. *See* David M. Uhlmann, *Deferred Prosecution and Non-Prosecution Agreements and the Erosion of Corporate Criminal Liability*, 72 MD. L. REV. 1295, 1302 (2013) (arguing that the use of DPAs and NPAs limits the deterrent value of law enforcement, eliminates the social condemnation of criminal wrongdoing, and undermines the rule of law).

How would firms react to this change? Would corporations suddenly shut down their compliance departments?

Corporations have strong incentives to comply with the law even without the government telling them exactly how to do it.[281] And insofar as compliance programs contain elements that are an efficient means of producing compliance with the law, firms would maintain at least those. But they would likely jettison aspects of compliance programs that could not be shown to produce compliance in a cost-effective manner. In other words, if it were wholly owned by firms, compliance would be subject to firms' internal cost-benefit calculations, and firms would likely "engage in compliance if the cost of sanctions with compliance is less than or equal to the cost of sanctions without compliance."[282]

As long as corporate governance is seen as the product of a bargain between managers and shareholders ultimately aimed at wealth maximization, this is a desirable outcome. Even without a hand in the design of compliance programs, the government retains the size of the sanction (and the prospect of criminal liability) as an extremely powerful tool in preventing corporate wrongdoing.[283] If corporate misconduct is insufficiently deterred by current sanctions levels, the government should increase them, thereby changing the subject firm's present value calculation.[284] Once misconduct is no longer value-maximizing from the firm's point of view, an efficiency-based compliance program will be no less (and perhaps more) serious about detecting and deterring corporate misconduct than a program designed by the government.

The salutary effects of this arrangement are pragmatic as well as theoretical. Once firms own compliance, they will seek better and cheaper ways of channeling organizational behavior. They will experiment, moving away from the core elements that have served as the basis of compliance since the drafting of the Sentencing

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281. *But see* Arlen & Kahan, *supra* note 8 (defending intervention through DPAs/NPAs when "policing agency costs" suggest that the firm does not have the proper incentive to comply with the law).

282. Geoffrey P. Miller, *An Economic Analysis of Effective Compliance Programs*, *in* RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING, *supra* note 93.

283. *See* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 185 (1968); A. Mitchell Polinsky & Steven Shavell, *Enforcement Costs and the Optimal Magnitude and Probability of Fines*, 35 J.L. & ECON. 133, 133-36 (1992).

284. *See* Polinsky & Shavell, *supra* note 283, at 133-36.

Guidelines.[285] For example, if investing in culture or technology appears to be a better strategy for inducing compliance than hiring hundreds or thousands of staff to perform "Know Your Customer" due diligence, firms will try it.[286] Likewise firms may seek to adapt their compliance programs to emerging literature that suggests compliance programs organized around sanctions and monitoring may be less effective (and more expensive) than systems organized around procedural fairness, consent, and deference.[287] Experimentation leads to innovation and, perhaps, more effective compliance structures.[288] Moreover, once firms begin to experiment, there will be greater heterogeneity of compliance structures and greater opportunity for the capital market to make distinctions on this basis, provided, however, that there is greater transparency in compliance—an issue taken up in the next Section.

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285. *See supra* notes 27-28 and accompanying text.

286. As the CCO of a major financial institution remarked:

> I'm not sure what the return on investment is on hiring thousands and thousands of new graduates to look at account opening documents. We might be better off hiring thousands and thousands of technologists who could actually figure out how to find the money launderer, or the person who's engaging in misconduct. We haven't gone that way in large part because most of these settlements have resulted in people staffing up.... [Staffing up is easier than figuring out] how to find potential misconduct and stop it.

Compliance Symposium Panel, *supra* note 70.

287. *See, e.g.*, Todd Haugh, Criminalized Compliance (unpublished manuscript) (arguing that current approaches to compliance fail because they import the delegitimizing features of criminal law); Tom R. Tyler, *Psychology and the Deterrence of Corporate Crime*, *in* RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING, *supra* note 93 (reviewing empirical evidence showing consent-based models of compliance are superior to coercion-based models). Parallel arguments have been made in other areas of law. *See, e.g*, Anthony V. Alfieri, *The Fall of Legal Ethics and the Rise of Risk Management*, 94 GEO. L. J. 1909 (2006) (describing and critiquing the import of risk management norms in the regulation of the legal profession); Russell G. Pearce & Eli Wald, *Rethinking Lawyer Regulation: How A Relational Approach Would Improve Professional Rules and Roles*, 2012 MICH. ST. L. REV. 513 (critiquing the command-and-control model of professional conduct regulation and advocating instead for a relationship-based approach organized around broad principles).

288. *See* Roberta Romano, *For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture* 7 (Yale Law & Econ. Research Paper No. 452, 2013), http://ssrn.com/abstract=2127749 [https://perma.cc/7DSC-53G8] (arguing that regulatory experimentation "would generate information and formalize an ongoing testing of assumptions in the search for better regulatory solutions"); *see also* Sean J. Griffith, *Substituted Compliance and Systemic Risk: How to Make a Global Market in Derivatives Regulation*, 98 MINN. L. REV. 1291, 1358-59 (2014) (advancing arguments for regulatory diversity in the context of derivative regulation).

B. Increased Transparency of the Compliance Function

Because outright government exit from the regulation of compliance may seem unlikely, it is worth considering alternative approaches to reform. Toward this end, some commentators have recently suggested greater judicial scrutiny at settlement.[289] Though there is evidence that at least some judges have signaled discomfort with the use of DPAs/NPAs in corporate prosecutions, there is little evidence that greater involvement of the judiciary could improve the resulting compliance reforms. Judges commenting on the resolution of enforcement actions have tended to criticize the government for failing to hold individuals accountable or for failing to extract more in fines.[290] They have tended not to focus on the efficacy of compliance reforms. Indeed, judges are as ill-equipped to assess the quality of settlement reforms as the prosecutors are in imposing them, perhaps even more so.[291]

289. *See, e.g.*, GARRETT, *supra* note 9, at 282 (advocating putting greater control over the DPA process in the hands of a judge serving the public interest); Cunningham, *supra* note 8, at 50 (advocating greater judicial scrutiny of prosecutorial rationales).

290. These include Judge Rakoff's refusal to approve the SEC's November 2011 settlement with Citigroup and Judge Gleeson's imposition of ongoing oversight of the reforms in the DOJ's December 2012 settlement with HSBC. *See* Peter J. Henning, *Behind Rakoff's Rejection of Citigroup Settlement*, N.Y. TIMES: DEALBOOK (Nov. 28, 2011, 5:14 PM), http://dealbook.nytimes.com/2011/11/28/behind-judge-rakoffs-rejection-of-s-e-c-citigroup-settlement/?_r=1 [https://perma.cc/XYQ9-UZXU] (discussing *SEC v. Citigroup Global Markets*); Christie Smythe, *HSBC Judge Approves $1.9B Drug-Money Laundering Accord*, BLOOMBERG (July 3, 2013), http://www.bloomberg.com/news/articles/2013-07-02/hsbc-judge-approves-1-9b-drug-money-laundering-accord [https://perma.cc/DX4R-HZLK] (discussing *United States v. HSBC Bank USA, N.A.*); *see also* United States v. Fokker Servs. B.V., 79 F. Supp. 3d 160 (D.D.C. 2015) (holding that the DPA was too lenient in light of the charged conduct), *appeal filed*, No. 15-3016 (D.C. Cir. Feb. 23, 2015), *and* No. 15-3017 (D.C. Cir. Mar. 10, 2015) (DOJ appeal from a trial judge's rejection of a settlement as too lenient).

291. Judges have no opportunity to develop a sense to what works and what does not in compliance. Most compliance settlements never come before them. *See* Greenblum, *supra* note 43, at 1869-70 ("The decision to defer is generally not subject to judicial review unless an applicable statute provides otherwise. For instance, the U.S. Code does not provide judicial review for federal deferral decisions. As to offenders seeking to challenge the prosecutor's discretion in pursuing prosecution at the close of the deferral period, federal courts have intervened only insofar as the deferral agreement represents a contract with enforceable terms."). And the compliance settlements that do end up before a judge lack any adversarial element, leading to severe information asymmetry on the part of the judge faced with approving the settlement. *See generally In re* Trulia, Inc. Stockholder Litig., 129 A.3d 884, 893 (Del. Ch. 2016) (noting that, in the context of approving class action settlements, the parties are no longer adversarial, and the court "receives briefs and affidavits… extolling the value

A more promising regulatory strategy might therefore be to focus not on the substance of compliance reform but rather on the transparency of the compliance function. Focusing on disclosure rather than substance parallels the regulatory strategy of securities law more generally, the aim of which is simply to provide the necessary information for the capital market to make distinctions between firms.[292] Disclosure of compliance details would enable professionals to study and understand those compliance mechanisms that work and those that do not. It would also enable market professionals to distinguish between firms according to the quality of their compliance functions. If they invested accordingly, the capital market itself incentivizes firms to improve their compliance function. The government could make this happen by adopting a rule, administered by the SEC, requiring public companies to disclose compliance details.

Mandatory compliance disclosure would focus on structural details, such as how compliance is organized, what its relationship is with business units, and other control functions such as risk and internal audit, which risks are allocated to compliance and how compliance assigns personnel and technological resources to manage those risks, whether and how compliance is involved in strategic business decisions, the authority and expectations of compliance officers in the event of conflict, how escalation and reporting structures work, and whether and to what degree compliance influences executive compensation. These program details could be categorized and compared according to indicators of effectiveness, such as reported incidents of misconduct, government investigations, and sanctions paid. Alternatively or in addition, companies could be required to disclose standardized data on the performance of their own programs, allowing quantitative metrics to be compared more directly across a set of firms.[293] Currently no company voluntarily discloses this information.[294] Moreover, federal securities law, which

of the [settlement] and advocating for approval of the proposed settlement, but rarely receives any submissions expressing an opposing viewpoint").

292. *See supra* Part II.B.2.

293. Performance data could focus on quantitative metrics such as how often a compliance program is audited and how it scores, how quickly a program clears concerns raised either by employees or technological tools, training completion rates and how quickly the company reaches training targets, and how well employees score on training assessments.

294. The absence of voluntary disclosure does not automatically imply that the information

forces public companies to disclose a vast amount of information, does not mandate any compliance disclosures. It should.[295]

Mandatory compliance disclosures would trigger the release of information that companies already possess. Many companies track program effectiveness. Those that do not are in possession of the information and could compile it. The information is not competitively sensitive. It does not include business plans or strategies that could give competitors an advantage. Or, in the event that a required compliance disclosure did hint at competitively sensitive information, companies could apply to the SEC for an exemption from the disclosure item.

Disclosure would produce substantial benefits. First, disclosure of compliance details would allow interested parties—compliance officers, policymakers, and enforcers—to learn what actually works in compliance. Claims to effectiveness would be empirically informed rather than anecdotal. Compliance programs would work better as less effective structures lost currency, resulting in more effective detection and deterrence of corporate misconduct. Second, the disclosure of compliance details would enable capital market participants to distinguish between compliance programs at different companies. Investors, recognizing that better compliance means less risk of loss, would be willing to pay a premium for firms with better compliance.[296] This, in turn, leads to a virtuous circle wherein the share-price premium serves as a further incentive to adopt strong compliance functions, leading to less downside risk, less misconduct, and higher share prices.

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is of no use. Firms' failure to release useful information may be explained by free-rider effects, first-mover disadvantages, and the absence of a standard format to enable investors to process the information. *See* EASTERBROOK & FISCHEL, *supra* note 184, at 300-04.

295. It may also be possible for an industry association to compile this information, perhaps on an anonymous basis, by agreement of its members. But without standardization and a means of preventing holdouts, private data collection seems a second-best solution to a regulatory mandate.

296. Losses here are understood to include not only fines and other legal sanctions, but also losses generated by the misconduct itself—for example, the losses generated by "rogue traders" undetected by poor compliance programs. *See generally* Mark N. Wexler, *Financial Edgework and the Persistence of Rogue Traders*, 115 BUS. & SOC'Y REV. 1, 3-7 (2010) (historical overview of the "rogue trader" phenomenon).

CONCLUSION

This Article has argued that compliance is a governance function that is incompatible with contemporary corporate theory. The inconsistencies between theory and practice exposed by compliance present an opportunity to rethink theories of the firm and to reconsider dormant debates. This Article seeks to start the conversation, calling on scholars across specialties, along with practitioners and policymakers, to engage on the critical issues of theory and practice raised by the contemporary compliance function.