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Toward a New Model for Securities Law Enforcement
Cristie L. Ford¹

“[A] SINGLE ENFORCEMENT ACTION HAS THE POTENTIAL TO EFFECT CHANGE ON AN ENORMOUS SCALE, CAUSING THE DEVELOPMENT OR ENHANCEMENT OF INTERNAL CONTROLS, SUPERVISORY PROCEDURES, AND COMPLIANCE FUNCTIONS AT HUNDREDS OF OTHER COMPANIES.”²

“THE SPECTER OF PROSECUTION CAN MOTIVATE CORPORATIONS TO CHANGE THEIR LONG-TERM BEHAVIOR”³

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²Former SEC Enforcement Director Stephen M. Cutler, Speech at 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004), <http://www.sec.gov/news/speech/spch042904smc.htm>.

³Barry W. Rashkover, Comment, *Reforming Corporations Through Prosecution: Perspectives from an SEC Enforcement Lawyer*, 89 CORNELL L. REV. 535, 536 (2004).

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The United States Securities and Exchange Commission (SEC or the Commission) expanded its mandate in recent years, in the wake of multiple scandals: its Enforcement Division (Enforcement) was no longer satisfied with punishing wrongdoing, but through the specter of prosecution intended to effect compliance change to internal controls, supervisory procedures, and compliance functions on an “enormous scale,” and to motivate “long-term” change in corporate behavior. In effect, the quotes from senior SEC officers with which this paper opens suggest that Enforcement has been aspiring to changing corporate culture.⁴ The SEC has not only emphasized the necessity of having a “culture of compliance,” but expressed awareness of and concern for companies’ “moral DNA.”⁵

Enforcement’s approach to this goal has been characterized, above all, by increasingly massive monetary penalties levied against firms—that is, against public companies and regulated entities.⁶ Under Chairman William H. Donaldson, who resigned in June of this year, the SEC initiated enforcement actions against more organizations and imposed more and larger civil penalties than at any time in its seven-decade history.⁷ These extraordinary fines were combined with a published SEC protocol that allowed firms to bid for leniency in settlements, in exchange for cooperating with Enforcement after apparent wrongdoing has been uncovered, and/or for having in place an internal compliance program.

Yet each of the SEC’s recent strategies—massive monetary sanctions and a settlement protocol that permits bargaining for leniency on the terms above—was inadequate if the goal was sincerely to motivate long-term change in firm behavior. First, monetary penalties do not address the thornier problems of institutional culture except in the most accidental way. While optimal penalties (to the extent that optimality can be identified) may deter companies from engaging in open and clearly law-violating conduct,

⁴A similar observation could be made about criminal securities law enforcement, but that must be the subject of another paper. Michael Chertoff, Former Assistant Attorney General, Criminal Division, Department of Justice, has reportedly expressed the view that criminal prosecution, also, can be “a spur for institutional reform.” Michael Chertoff, Speech at the ABA Criminal Justice Section’s 17th Annual National Institute on White Collar Crime, (Mar. 2003), as recorded by John Gibeaut, *Junior G-Men: Corporate Lawyers Worry That They’re Doing the Government’s Bidding While Doing Internal Investigations*, 89-JUN A.B.A. J. 46 (June 2003). See also *infra* note 11.

⁵See *infra* notes 58-60 and accompanying text.

⁶I use the terms “organizations” and “firms” to refer collectively to public companies and other regulated entities subject to the SEC’s enforcement jurisdiction. For clarity’s sake, I periodically employ terms such as “corporate governance” or “corporate citizen,” but I mean those terms to apply to regulated entities as well.

⁷See *infra* notes 26-38 and accompanying text.

they are unpredictable as a tool for effecting ambitious cultural change. Because deterrence effects are inscrutable, massive deterrence looks like the last resort of the regulator who has given up trying to identify, or address, root causes of social and economic problems in any more systematic way. This is not to say that deterrence-based mechanisms may not be useful in effecting widespread reforms; only that they are insufficient on their own, and potentially unwieldy.

Second, the SEC's settlement protocol, called the "Framework for Cooperation,"⁸ does not advance and may even undermine the stated goal of promoting good corporate governance. Specifically, it is not the case that either of the Framework's criteria—having in place a compliance program, and/or cooperating with Enforcement *ex post*—is a reliable indicator of good corporate citizenship. In fact, for the worst offenders, cooperating with authorities can be a mechanism for scapegoating individuals and avoiding organizational responsibility. Extending leniency to firms that have a compliance program in place can mean in practice that formulaic and facial compliance indicia substitute for evidence that a real "culture of compliance" exists.

If the SEC is serious about spurring institutional reform, it will need enforcement tools that are better suited to its purpose. Interestingly, during Chairman Donaldson's era, Enforcement also roughed out the promising beginnings of a new, or resurgent, model in what I call the "Reform Undertaking." Under a Reform Undertaking arrangement, SEC Enforcement and the firm enter into a settlement agreement relating to an action that Enforcement has initiated for violation of the securities laws. One term of the settlement agreement is that the firm shall retain, at its own expense, an independent third party monitor (the "Third Party") to oversee its compliance processes and procedures for a period of time after the settlement has been concluded.⁹ The Reform Undertaking model has

⁸*See infra* Part 2.

⁹The Reform Undertaking shares key features with another innovation in federal criminal prosecution: the organizational Deferred Prosecution Agreement. Like the Reform Undertaking, the typical Deferred Prosecution Agreement requires firms to adopt internal controls designed to deter potential violations of firm policies and procedures, and to cooperate with an independent third party monitor who will report at intervals to the Department of Justice. Failure to abide by the terms satisfactorily over the span of the deferral results in prosecution. *See, e.g.*, Press Release, Department of Justice, America Online Charged with Aiding and Abetting Securities Fraud; Prosecution Deferred for Two Years (Dec. 15, 2004), <http://www.fbi.gov/dojpressrel/pressrel04/aolrelease121504.htm>; Deferred Prosecution Agreement, *United States v. Computer Associates Int'l, Inc.*, Cr. No. 04-837 (E.D.N.Y. Sept. 22, 2004), http://www.ca.com/about/dpa/def_pros_agreement.pdf; Press Release, Department of Justice, PNC ICLC Corp. Enters Into Deferred Prosecution Agreement with the United States (June 2, 2003), http://www.usdoj.gov/opa/pr/2003/June/03_crm_329.htm. The Department of Justice also incorporated auditing mechanisms and structural changes to its Enron-related settlements

important advantages over more traditional settlement approaches in that it uncouples the acute enforcement action from the specifics of reform measures, thereby reducing some of the pressure toward strategic action. It goes beyond a pure deterrence model and tries to investigate “corporate culture,” by making firm actors agents of their own change, in a way that it is more transparent and accountable than the existing Framework for Cooperation approach.

Some things are likely to change under new SEC Chairman Christopher Cox. For example, he is likely to discontinue the substantial monetary penalties levied against organizations that became controversial in the last months of Chairman Donaldson’s tenure.¹⁰ On the other hand, the published SEC protocol mentioned above, which allows firms to bid for leniency, is likely to persist since the philosophy underlying it—that firms should be rewarded for cooperating with Enforcement and for having internal compliance programs in place—has not been seriously questioned. We should also expect the Reform Undertaking model, as an alternative to heavy monetary fines, to increase in currency under Chairman Cox. Chairman Cox is generally understood to be a strong ally of business community interests, which have opposed what they perceive as overzealous regulation under Chairman Donaldson.¹¹ The Reform Undertaking model is theoretically consistent with a more decentralized, industry-driven regulatory agenda.

Less obvious but just as important is that, when properly implemented, the Reform Undertaking model may contain the power, unanticipated by advocates of industry-driven regulation, to effect verifiable positive change to a firm’s culture, institutions, and long-term behavior. This paper explores and then extrapolates from the Reform Undertaking, informed in part by “new governance” or “experimentalist” theory,¹² to sketch the directions in which the Reform Undertaking must go if it is to have a real chance of effecting such change. By relating SEC Enforcement

with CIBC and Merrill Lynch. Letter from Leslie R. Caldwell, Director, Enron Task Force, Department of Justice, to Gary Naftalis, Esq. (Dec. 22, 2003), <http://www.usdoj.gov/dag/cftf/chargingdocs/cibcagreement.pdf>; Letter from Leslie R. Caldwell, Director, Enron Task Force, Department of Justice, to Robert S. Morvillo, Esq. and Charles Stillman, Esq. (Sept. 17, 2003), http://www.usdoj.gov/dag/cftf/chargingdocs/merrill_lynchagreement.pdf. See also *Off the Hook: Deferred Prosecution Agreements on the Rise*, 48 CORP. CRIME REP. 1, (Dec. 10, 2004). While Deferred Prosecution Agreements work on a similar model and deserve their own analysis, they are beyond the scope of this paper.

¹⁰See Deborah Solomon & John D. McKinnon, *Off the Beat: Donaldson Ends an SEC Tenure Marked by Active Regulation*, WALL ST. J., June 2, 2005, at A1. See also *infra* note 27 (for criticism that the SEC’s implementation of Sarbanes-Oxley Act § 404 imposed extraordinary costs on business without corresponding benefit).

¹¹*Id.*

¹²See *infra* notes 62-74 and accompanying text.

practices to New Governance, I am connecting promising on-the-ground developments that may be proceeding ad hoc, without guiding principle, to a relevant theoretical conversation. I argue for four things above all: the need for the Reform Undertaking to be built around a participatory firm process; the need for Third Parties to be accountable for their methodology and results within firms' Reform Undertakings; the need for the SEC to develop the information-gathering capacity to credibly evaluate Reform Undertakings' success; and the need to provide consistent incentives to Enforcement personnel.

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

This paper proceeds in five parts. Part One describes the limitations of the SEC's deterrence-based strategy in meeting the agency's stated intention of spurring institutional reform, and suggests that a New Governance-style approach may be better suited to the task. It also identifies challenges, relative to other New Governance initiatives, arising from the securities laws' enforcement-driven and settlement-oriented environment. Part Two describes problems with the second component part of the SEC's strategy, the Framework for Cooperation, which permits firms to bid for leniency in exchange for having in place facial indicia of compliance, and/or for cooperating with Enforcement ex post. Part Three describes and provides examples of the new settlement approach that I call the Reform Undertaking. This Part sets out the Reform Undertaking's advantages over either pure deterrence-based mechanisms or Framework for Cooperation-based settlements. Part Four identifies the shortcomings of the

Reform Undertaking in its current iteration, and points to the four additional elements it needs to be a more thoroughgoing and theoretically coherent approach. The final Part imagines a New Governance-inflected approach to enforcement conduct, which leverages its strengths as a hybrid enforcement-oriented experimentalist form.

1. Corporate Governance and Deterrence-Based Response

Scope Concerns

This paper starts from a position that should be uncontroversial by now: that industries, companies, and organizations have cultures of their own; that culture affects how those organizations behave; and that certain kinds of cultural attributes can cause organizations to behave in law-violating ways.¹³ I do not attempt, nor is it necessary to completely define “firm culture,” except to note that some organizations can be characterized by an “insiders’ culture,” which rewards in-group loyalty at the expense of the best interests of “outsiders,” such as general shareholders or the public. Loyalty may take the form of keeping confidences, or making contributions to in-group members’ income or market share by means that would be criticized were they widely known. For example, in the securities industry, investment advisors may fail to tell mutual fund shareholders about excessive fees or “shelf space” commissions;¹⁴ audit firms may fail to tell an audit client’s shareholders about conflicts of interest that could compromise the independence of an audit;¹⁵ or investment banks may fail to tell the public that the research analysis they produce has a remuneratory relationship to banking business, before and after initial public offerings.¹⁶

¹³See, e.g., JAMES W. COLEMAN, *THE CRIMINAL ELITE* (1989); KIP SCHLEGEL, *JUST DESERTS FOR CORPORATE CRIMINALS* (1990); Lynne L. Dallas, *A Preliminary Inquiry into the Responsibility of Corporations and Their Officers and Directors for Corporate Climate: The Psychology of Enron’s Demise*, 35 *RUTGERS L. J.* 1, 10-45 (2003) (canvassing sociolegal literature on the relationship between social environment and individual ethical conduct). Firms, especially the worst actors, may also be very dysfunctional in the manner described in MAX H. BAZERMAN & MICHAEL D. WATKINS, *PREDICTABLE SURPRISES: THE DISASTERS YOU SHOULD HAVE SEEN COMING AND HOW TO PREVENT THEM* 95-119 (2004). The recommendations that follow apply equally there.

¹⁴Richard C. Schoenstein et al., *Investigations of Mutual Fund Industry Still Gathering Steam*, *N.Y.L.J.*, Mar. 8, 2004, at 9.

¹⁵See, e.g., *In re Ernst & Young LLP*, Initial Decision Release No. 249 (Apr. 16, 2004), <http://www.sec.gov/litigation/aljdec/id249bpm.htm>; Final Order, Securities Act Release No. 8413 (April 26, 2004), <http://www.sec.gov/litigation/aljdec/33-8413.htm> [hereinafter Ernst & Young]; Cassell Bryan-Low, *Did Ties That Bind Also Blind KPMG?*, *WALL ST. J.*, June 18, 2003, at C1; Floyd Norris, *Andersen Told To Split Audits and Consulting*, *N.Y. TIMES*, Mar. 12, 2002, at C1.

¹⁶Documents relating to the Global Research Analyst Settlement are collected at <http://www.sec.gov/spotlight/globalsettlement.htm>.

Cultures are not monolithic, and they have as much to do with situation and human psychology as with some notion of firm “character.” But regardless of their provenance, the norms, customs, and rituals that arise in tight-knit communities may create a compelling moral world for those in it.¹⁷ Insiders’ ethical perceptions of conduct are shaped by the actions of those around them, normalizing and even ratcheting up law-violating conduct and marginalizing dissenters.¹⁸ In an extreme form, an “insiders’ culture” may disdain and try to circumvent inconvenient, externally imposed regulations on issues ranging from employment discrimination, to revenue recognition, to toxic waste disposal. Insiders’ cultures put in place, intentionally or accretively (through situational pressures or escalation of commitment), structures and relationships that maintain the culture’s opacity. Such public-harming cultures can exist notwithstanding governance processes and compliance mechanisms that look exemplary on paper. A classic example of this phenomenon is Enron, whose Board of Directors voted to waive that company’s state-of-the-art conflict of interest rules to allow CFO Andrew Fastow to make self-dealing transactions.¹⁹ WorldCom also adhered to “‘checklists’ of recommended ‘best practices.’”²⁰

Although all organizations have cultures, and even some degree of “insider culture,” let me be clear about the firms that are of primary concern. They are those firms that Ian Ayres and John Braithwaite, in their seminal work *Responsive Regulation*, would put at or near the top of the “enforcement pyramid”—those firms that attract the greatest enforcement resources because other, lesser attempts at regulation have failed.²¹ These

¹⁷See Robert Cover, *Nomos and Narrative*, in *NARRATIVE, VIOLENCE, AND THE LAW: THE ESSAYS OF ROBERT COVER* 95, 103-113, 138-144 (Martha Minow et al. eds., 1992).

¹⁸See EDWIN H. SUTHERLAND, *WHITE COLLAR CRIME: THE UNCUT VERSION* 240 (1983) (discussing how criminal behavior is learned in association with those who define such criminal behavior favorably and in isolation from those who define it unfavorably); Kenneth D. Butterfield et al., *Moral Awareness in Business Organizations: Influences of Issue-Related and Social Context Factors*, 53 *HUM. REL.* 981, 999-1001 (2000) (empirical study of impact of perceived social consensus on ethical decisionmaking). This provides a strong theoretical justification for conspiracy laws: even where a conspiracy did not successfully complete a criminal act, conspiracy itself is a crime because collective action emboldens individual wrongdoers. Neal Kumar Katyar, *Conspiracy Theory*, 112 *YALE L. J.* 1307 (2003).

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

²⁰Richard C. Breeden, *Restoring Trust: Report to the Hon. Jed S. Rakoff, United States District Court for the Southern District of New York, On Corporate Governance for the Future of MCI* 20, 25 (Aug. 2003), <http://www.sec.gov/spotlight/worldcom/wcomreport0803.pdf>.

²¹Ayres and Braithwaite describe a regulatory structure in which enforcers have an escalating scale of enforcement options at their disposal. The majority of firms, at the broad base of the pyramid, stay in compliance with little resource expenditure by enforcers. As firm

are the same firms whose conduct attracts (or should attract) the largest monetary sanctions, in settlements based on serious allegations of fraud or something close to it,²² where the degree of harm resulting from the alleged violations is significant. Often, they are recidivists, even if past violations are not identical to the current one. There is reason to believe (regardless of what the firm claims) that the firm suffers from pervasive cultural or ethical problems that are likely to persist beyond the immediate enforcement action, but these are not utterly criminal enterprises. My preoccupation, then, is what Christopher Stone once described as “that group of firms, impossible to identify in advance, whose behavior in the face of realistically achievable penalty levels will remain inadequately modified.”²³ These are the “worst actors.”

I argue below for a remedy that is more interventionist than existing remedies, and that will impose additional costs on worst actor firms. The firms are required to engage in a protracted remedial exercise in which they define and apply standards-based (as opposed to narrower rule-based) notions of good governance to their own operations. Readers may reasonably counter that additional regulatory costs should not be imposed on firms without some indication that the project’s benefits would outweigh its costs. A complete response to this challenge is beyond this paper’s scope, but three points are relevant. First, interventionist remedies would not be appropriate all the way down the enforcement pyramid.²⁴ I am talking about a relatively small subset of firms. Second, and just as crucially, this paper argues for a standards-based approach in the *remedial enforcement* context. The cost of post-enforcement standards-based remedies should compare favorably to the cost of prophylactic standards-based requirements, such as the controversial provisions in section 404 of the Sarbanes-Oxley Act that require public companies to report on the adequacy of their internal financial controls.²⁵ Third, any cost/benefit analysis should factor in not only the

noncompliance escalates, enforcers can escalate deterrence, reserving the most severe sanctions for the small number of very serious cases. See IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION* 35-41 (1992). The enforcement pyramid’s effectiveness depends very much on Enforcement’s ability to collect and interpret valid data on firm cooperation.

²²*E.g.*, Securities Exchange Act § 15(c), 15 U.S.C. § 78o-5 (2004).

²³Christopher Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 *YALE L. J.* 1, 28 (1980).

²⁴The whole purpose of the regulatory pyramid is to allocate scarce enforcement resources toward the worst offenders, and to avoid the chilling effect of over-regulating law-abiding firms. See AYRES & BRAITHWAITE, *supra* note 21, at 35-41; see also EUGENE BARDACH & ROBERT KAGAN, *GOING BY THE BOOK: THE PROBLEM OF REGULATORY UNREASONABLENESS* (1982) (arguing that regulatory strategy based mostly on punishment fosters resistance within regulated firms).

²⁵See Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262. Whether or not such certification requirements are a necessary part of the regulatory scheme, their costs can be significant. See, *e.g.*, John Thain, *Sarbanes-Oxley: Is the Price Too High?* WALL. ST. J.,

immediate cost outlay the Reform Undertaking represents, but also the substantial long-term costs the status quo imposes on consumer confidence and firm viability.

Responding to the opposite challenge, this is not a marginal project even if only a few firms are involved. Worst-acting firms should attract scrutiny because they are responsible for disproportionate social costs. Understanding the full range of reasons why certain firm cultures bring forth repeated law-violating conduct also sheds light on firm culture generally. Moreover, the problem of the worst actor sheds light on the effectiveness of the securities law regime as a whole. In evaluating outcomes, regulatory policymakers may be tempted to focus on “gold star” companies whose success proves the wisdom of the regulators’ approach. A focus on enforcement blunts that tendency. It keeps us realistic—not only with respect to proposals that may be credulous about firms’ bona fides generally, but also with respect to proposals that underscrutinize firm functionality in the name of an ostensibly tough (but actually limited) deterrence approach. Limitations of method in spurring reform among worst actors can be a telltale for a more general limitation of method.

Relying on Massive Deterrence

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

Under Chairman Donaldson, the SEC’s approach to the recent crisis was to step up prosecutions, including prosecutions against organizations, and to impose massive monetary fines on individuals, regulated entities, and public companies.²⁶ The presumption was that “any serious violation of the

May 27, 2004, at A20; Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance With Law*, 2002 COLUM. BUS. L. REV. 71 (2002); Stone, *supra* note 23, at 36-45 (distinguishing between the substantial cost of standard-based directives when applied broadly, as opposed to their most circumscribed cost in the retrospective remedial situation). On the distinction between rules and standards, see Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976).

²⁶In 2003, the Division of Enforcement filed 679 enforcement actions, more than in any previous year. See William H. Donaldson, Remarks to the Practising Law Institute (Mar. 5, 2004), <http://www.sec.gov/speech/spch030504whd.htm>. According to Commissioner Harvey Goldschmid, statistics show an approximate 40 percent increase in enforcement cases brought by the Commission between fiscal years 2001 and 2004. See Richard Hill, *Goldschmid: Companies Should Not Let SEC Enforcement Hinder Their Creativity*, 36 Sec. Reg. & L. Rep. (BNA) 2203 (Dec. 13, 2004). Stephen Cutler has observed that his Enforcement Division imposed 15 penalties over \$50 million between early 2003 and fall 2004, including many of the highest penalties ever obtained in SEC enforcement actions. Stephen M. Cutler,

federal securities laws should be penalized with a monetary sanction.”²⁷ The Enforcement Division has filed an unprecedented number of actions, especially against organizations, in the last two years.²⁸ The quantum of the penalties is also unprecedented: consider the WorldCom settlement,²⁹ the global research analyst settlement,³⁰ the Enron-related financial services firm settlements,³¹ the market timing and late trading mutual fund company settlements,³² or those with public companies such as Quest

Speech: The Themes of Sarbanes-Oxley as Reflected in the Commission’s Enforcement Program (Sept. 20, 2004), <http://www.sec.gov/news/speech/spch092004smc.htm>.

²⁷Cutler, *supra* note 2.

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

²⁹SEC v. WorldCom, Inc., 273 F.Supp.2d 431 (S.D.N.Y. 2003) (imposing a \$2.25 billion penalty, satisfied post-bankruptcy at \$750 million).

³⁰Not including disgorgement, civil penalties against the ten firms in their settlements with the SEC, NASD, NYSE and states amounted to \$487.5 million, with the lead taken by Citigroup at \$150 million. Press Release, SEC et al., Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), <http://sec.gov/news/press/2003-54.htm>.

³¹The SEC levied a total of \$197.5 million in civil penalties, alongside substantial disgorgement orders, against Merrill Lynch, Citigroup, JPMorgan Chase, and CIBC. *See In re Merrill Lynch & Co.*, Litigation Release No. 18038 (Mar. 17, 2003), <http://sec.gov/litigation/litreleases/lr18038.htm>; *In re Citigroup, Inc.*, Exchange Act Release No. 48230 (July 28, 2003), <http://sec.gov/litigation/admin/34-48230.htm>; SEC Charges J.P. Morgan Chase In Connection With Enron's Accounting Fraud, Litigation Release No. 18252 (July 28, 2003), <http://sec.gov/litigation/litreleases/lr18252.htm>; SEC Charges Canadian Imperial Bank of Commerce and Three Executives With Aiding and Abetting Enron's Accounting Fraud, Litigation Release No. 18517 (Dec. 25, 2003), <http://sec.gov/litigation/litreleases/lr18517.htm>.

³²*See e.g.*, *In re Invesco Funds Group, Inc.*, Investment Company Act Release No. 26629 (Oct. 8, 2004) (\$110 million penalty), <http://www.sec.gov/litigation/admin/34-50506.htm>; *In re Alliance Capital Management, L.P.*, Investment Advisors Act Release No. 2205A (Jan. 15, 2004) (\$100 million penalty), <http://www.sec.gov/litigation/admin/ia-2205a.htm>; *In re Massachusetts Financial Services Co.*, Investment Advisors Act Release No. 2213 (Feb. 5, 2004) (\$50 million), <http://www.sec.gov/litigation/admin/ia-2213.htm>; *In re Pilgrim Baxter & Associates, Ltd.*, Investment Advisors Act Release No. 2251 (June 21, 2004) (\$50 million), <http://www.sec.gov/litigation/admin/ia-2251.htm>; *In re Putnam Investment Management, LLC*, Investment Advisors Act Release No. 2226 (Apr. 8, 2004) (\$50 million),

Communications,³³ Royal Dutch Shell,³⁴ and Bristol-Myers.³⁵ The SEC also supported a still-pending congressional initiative to increase the penalties it may levy, which the SEC has described as “an important step in achieving the desired deterrent effect under the securities laws.”³⁶

Former SEC Director of Enforcement Stephen Cutler described the era’s approach as “an evolution, if not a revolution, in thinking.”³⁷ The nature of the (r)evolution requires some elaboration. In the speech quoted at the beginning of this paper, he explained the shift toward levying massive civil fines against organizations, as well as individuals, in terms that suggest the view that general deterrence can lead to profound, industry-wide change:

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

... When the Commission obtains a penalty against an entity, it provides a powerful incentive for companies in the same or similar industries to take steps to *prevent and*

<http://www.sec.gov/litigation/admin/ia-2226.htm>; *In re Janus Capital Management LLC*, Investment Advisors Act Release No. 2277 (Aug. 18, 2004) (\$50 million), <http://www.sec.gov/litigation/admin/ia-2277.htm>. These numbers do not include restitution damages. Some of these firms were also made subject to Reform Undertakings; *see infra* note 142.

³³Qwest Communications consented to disgorge \$1 and pay a civil penalty of \$250 million, the entire amount of which is to be disbursed to investors pursuant to Sarbanes-Oxley’s Fair Fund provisions. *See SEC v. Qwest Communications Int’l Inc.*, Litigation Release No. 18936 (Oct. 21, 2004), <http://www.sec.gov/litigation/litreleases/lr18936.htm>; *see also* Sarbanes-Oxley Act of 2002 § 308, 15 U.S.C. § 7246.

³⁴The company consented to the entry of a federal court judgment, pursuant to section 21(d) of the Exchange Act, to disgorge \$1 and pay a \$120 million civil penalty. In a related administrative proceeding, Royal Dutch Shell undertook to “to spend \$5 million in the development and implementation of a comprehensive internal compliance program under the direction and oversight of [its] Legal Director.” *In re Royal Dutch Petroleum Company*, Exchange Act Release No. 50233 (Aug. 24, 2004), <http://www.sec.gov/litigation/admin/34-50233.pdf>. *See also* Securities Exchange Act of 1934 § 21, 15 U.S.C. § 78u.

³⁵Bristol-Myers consented to pay a \$100 million fine and to disgorge \$50 million. *SEC v. Bristol-Myers Squibb Company*, Litigation Release No. 18820 (Aug. 4, 2004), <http://www.sec.gov/litigation/litreleases/lr18820.htm>.

³⁶Stephen M. Cutler, Testimony Concerning The Securities Fraud Deterrence and Investor Restitution Act before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services (June 5, 2003), <http://www.sec.gov/news/testimony/060503tssmc.htm>. Commissioner Glassman is one of the SEC Commissioners to have expressed reservations about the SEC’s trend toward large civil penalties levied against organizations, rather than individuals. *See, e.g.*, Cynthia A. Glassman, Remarks at the 13th Annual Public Fund Boards Forum: The Challenges of Striking a Regulatory Balance (Dec. 6, 2004), <http://www.sec.gov/news/speech/spch120604cag.htm>.

³⁷Cutler, *supra* note 2.

address comparable misconduct within their own walls. Thus, a single enforcement action has the potential to effect change on an enormous scale, causing the development or enhancement of internal controls, supervisory procedures, and compliance functions at hundreds of other companies.

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

The claim that Enforcement can “effect change on an enormous scale” suggests a larger systemic role than Enforcement historically has claimed.³⁹ It also suggests a more nuanced awareness of the role of organizational culture than one associates with the traditional, conduct-preoccupied approach to deterrence. On closer reading, however, the Cutler approach does not stray far from utilitarianism. The reference to “culture” notwithstanding, the approach is still one that is built on a static understanding of the firm as proverbial “bad man,” which will only change its culture to the extent that doing so is in its financial interest.⁴⁰ The assumption is that optimally-calibrated punishment increases the cost of violating the law, and thereby changes the firm’s calculation of the advantages of doing so.⁴¹ Indeed, such a response does not signify a *cultural* change at all; only an acknowledgement that rational firms must learn how to *look* as though they care about culture, because it is in their pecuniary interest to adopt that public stance. Reform-through-sanctions sets up incentives for firms to do nothing more than avoid more sanctions. Strategies for avoiding regulatory sanctions are not necessarily coterminous

³⁸*Id.* (emphasis added). Mr. Cutler’s view on the role of monetary penalties as *punishment*, when imposed on organizations, comes out less clearly in this speech. He refers to civil fines as “fundamentally a punitive measure intended to enhance deterrence of securities laws violations,” and says that their ratcheting up is “driven by two goals: increased accountability [for past wrongdoing] and enhanced deterrence.” It is unclear whether Mr. Cutler intended to distinguish between organizational and individual liability with respect to the punitive aspect. In any event, he views enterprise liability as operating alongside, not in lieu of, individual liability and “gatekeeper” oversight.

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

⁴⁰*See* Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457 (1897).

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

with strategies for identifying root causes and problems, and working to fix them.⁴²

I do not disagree that the *in terrorem* effect of large but not arbitrary monetary sanctions may directly force important changes in the daily operations of some rational and self-interested firms. As such, this kind of deterrent may be a sensible, if partial, response to firm wrongdoing, and one may hope that it does not fall completely out of favor when dealing with the most egregious cases.⁴³ Recent sociolegal work has suggested new ways in which “old school” deterrence mechanisms may reinforce good governance and promote law-abiding behavior in less linear ways, as well. This is the case for even the least transformative and most mechanical punitive forms—monetary sanctions, for example—*so long as* Enforcement’s investigatory procedures and processes are generally believed to be fair, its decisions reasonable and factually supported, and its conduct demonstrably even-handed.⁴⁴ Consider that the enforcement of law, like law itself, serves an expressive purpose.⁴⁵ Firms seek the legitimacy that legal approval confers, not only for culturally expressive reasons but also in part because that legitimacy can confer tangible benefits, including currency with other industry actors.⁴⁶ Again, insofar as regulator conduct is perceived to be credible and proportional, enforcement action can stigmatize businesses vis-à-vis the public and other companies with whom they wish to do business.⁴⁷

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

⁴³See *infra*, Part 5. I leave to one side the empirical studies suggesting that deterrent mechanisms do not prevent firms, or the individuals operating in them, from violating the law. See, e.g., SALLY S. SIMPSON, CORPORATE CRIME, LAW, AND SOCIAL CONTROL 40 (2002); SCHLEGEL, *supra* note 13. My claim is only that some firms may be directly motivated by the fear of sanctions, and that sanctions may also have indirect effects as discussed above.

⁴⁴Making the same point in the broader criminal context based on psychological studies is TOM R. TYLER, WHY PEOPLE OBEY THE LAW (1990).

⁴⁵See Cass Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996); Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349, 362-65 (1997).

⁴⁶Scholarship on the interaction of law and norms is extensive. E.g., Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253 (1999) (arguing that corporate actors are motivated less by the desire to avoid liability than by the joint effect of social norms, and the correlative prospect of financial gain in the market); Mark C. Suchman, *Managing Legitimacy: Strategic and Institutional Approaches*, 20 ACAD. MGMT. REV. 571 (1995) (arguing that law shapes organizational conduct not only because of law’s cultural weight, but also because organizational legitimacy is pragmatically linked to benefits and penalties); Cass Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903 (1996).

⁴⁷See generally Dan M. Kahan, *What Do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591 (1996) (arguing in favor of “shaming” over incarceration with respect to “white collar” criminals); Avitai Aviram, *Regulation by Networks*, 2003 BRIGHAM YOUNG U. L. REV. 1179 (2003) (describing “network effects” as a mechanism for private ordering and self-regulation); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997) (arguing that that Delaware corporate law, as

Enforcement action can also serve an error correction function, in that it provides an additional set of standards (redundant in places and/or reflecting different priorities), which helps to reduce wrongdoing arising from simple managerial distraction.⁴⁸

Enforcement can also resolve collective action problems where new, socially desirable norms are just taking hold.⁴⁹ For example, an industry's standard practice may violate the securities laws but be so entrenched, and perhaps competitively advantageous, that no individual industry actor is likely to reject the practice unilaterally. Legal sanctions can influence this type of industry norm. Especially relevant to industries with such entrenched practices is the fact that a well-designed and fairly administered enforcement system can help perpetuate an environment where each actor believes that other actors are complying with rules—a belief that positively correlates with voluntary compliance.⁵⁰ Even the worst performers will not want to be the “last ones out of the pool” if they have the impression that norms are changing within their subgroup.

Keeping the “big stick” of massive sanctions in reserve can also buttress other Enforcement demands, including perhaps the demand that a firm engage in additional, explicitly forward-looking remedial steps such as the Reform Undertaking discussed below.⁵¹ There is nothing necessarily inconsistent between forward-looking and retrospective Enforcement sanctions operating together. Whether particular forms or conceptions of

interpreted by courts, is best understood as attempts to create social norms for senior managers, directors and the lawyers who advise them).

⁴⁸See John T. Scholz & Wayne B. Gray, *OSHA Enforcement and Workplace Injuries: A Behavioral Approach to Risk Assessment*, 3 J. RISK & UNCERTAINTY 283, 303 (1990) (analyzing results of six year empirical study of 6,842 manufacturing plants).

⁴⁹See, e.g., Sunstein, *supra* note 46, at 968; Amitai Aviram, *A Paradox of Spontaneous Formation: The Evolution of Private Legal Systems*, 22 YALE L. & POL. REV. 1 (2004); Clayton Gillette, *The Lock-In Effect of Norms*, 78 B.U. L. REV. 813, 832-35 (1998).

⁵⁰See John T. Scholz, *Enforcement Policy and Corporate Misconduct: The Changing Perspective of Deterrence Theory*, 60 LAW & CONTEMP. PROBS. 253, 261-65 (1997) (according to Scholz, the belief that others are complying with mutually advantageous rules correlates more closely with individual firm compliance than do other factors, such as the size of the penalty for violation, which would be more important under a pure deterrence model. Enforcement action can bolster incentives to cooperate voluntarily. Scholz argues that the support function of public enforcement is enhanced where criminal sanctions are limited to egregious cases; enforcement procedures are perceived to be fair; substantive rules are perceived to be adequate and legitimate; Enforcement targets ‘bad apples’ and gives greater deference to compliant firms; and where Enforcement strengthens and encourages private enforcement systems (e.g., trade associations)). See also the “tit-for-tat” literature: ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* (1984); AYRES & BRAITHWAITE, *supra* note 21, at 20-27.

⁵¹See AYRES & BRAITHWAITE, *supra* note 21, at 39.

deterrence, as implemented, undermine a deeper corporate governance project is part of the subject examined here.⁵²

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

Without attention to the underlying cultural reasons for the wrongdoing, one risks sending the message that facial compliance alone can avoid sanctions and confer legitimacy on firm conduct. In the process, one reduces the scope for more profound, endogenous cultural change. What a reform-through-massive-sanctions approach signals, more than anything, is

⁵²See *infra*, Part 5.

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

⁵⁴See, e.g., Mark Suchman & Lauren Edelman, *Legal Rational Myths: The New Institutionalism and the Law and Society Tradition*, 21 LAW & SOC. INQUIRY 903, 910-11, 914-15 (1996) (arguing that both the “rational” and “normative” camps in sociolegal literature overvalue conscious reasoning in accounts of why people obey the law); BAZERMAN & WATKINS, *supra* note 13, at 95-119 (describing organizational failures in processing information and reacting to it).

⁵⁵See Paul J. DiMaggio & Walter W. Powell, *Expanding the Scope of Institutional Analysis*, in THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS 63, 67-68, 79 (Walter Powell & Paul DiMaggio, eds., 1991).

the regulator's inability to imagine remedies that can respond directly to the culture-based problems that the regulator itself has identified. Reform-through-sanctions offloads to the firm, without benefit of regulator support or institutional learning, the task of identifying organizational problems and identifying solutions. The firms this paper is most interested in affecting are those with the most dysfunctional and/or intransigent cultures—precisely the same ones that will not, or are not able to, reorient their own cultures in the hoped-for ways through penalty imposition alone. Deterrence may effect change in some situations, but it is not guaranteed to do so. All of this might be acceptable if it were unavoidable, but it is possible to do better, within existing structures and regulatory resource constraints. In the case of the worst actors, for whom deterrence has proven to be an insufficient driver, regulators and the public need not settle for this sort of wishful, black-box⁵⁶ approach to problems of culture.

Strikingly, the other trend in recent SEC rhetoric (only accidentally served by the trend toward massive deterrence) has been a recognition that institutional culture matters because it generates law-abiding and law-violating conduct, meaning that sanctions against individuals only are incomplete as a response to recent corporate and financial sector scandals.⁵⁷ To be sure, the SEC recognizes that good corporate culture is the sine qua non of good corporate citizenship. Former SEC Chairman Donaldson's ambitions were wider than seeing compliance programs put in place, or even ensuring a law-abiding tone at the top. He stated that his goal was to “enhance and improve corporate governance to help restore the moral DNA of entities throughout the U.S. economy.”⁵⁸ Lori Richards, Director of the SEC Office of Compliance Inspections and Examinations, frequently refers to the notion of a “culture of compliance.”⁵⁹ Mr. Cutler spoke at length

⁵⁶See CHRISTOPHER STONE, WHERE THE LAW ENDS 121 (1975). In Stone's language, my proposal is “interventionist,” to be distinguished from the “black box” approach. See also Stone, *supra* note 23, at 28.

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

⁵⁸Donaldson, *supra* note 26.

⁵⁹See, e.g., Lori A. Richards, Speech: The Culture of Compliance (Apr. 23, 2003), available at <http://www.sec.gov/news/speech/spch042303lar.htm> (last visited May 12, 2005) (articulating the principles of a “culture of compliance”).

about the elements of a law-abiding culture.⁶⁰ There is a correlation, too, between the new focus on organizations, and the new language of cultural reform. This wide-lens approach is new in securities enforcement, although it is reminiscent of the kinds of institutional reform-minded remedies familiar from public law.⁶¹ It remains to be seen whether it will persist under Chairman Cox, but public perception of the systemic nature of recent scandals certainly suggests a compelling need to continue to speak to those concerns.

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

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

⁶⁰See Stephen M. Cutler, Speech: Tone at the Top: Getting it Right (Dec. 3, 2004), *available at* <http://www.sec.gov/news/speech/spch120304smc.htm> (last visited May 12, 2005) (“Cultivating a culture of compliance requires a sustainable effort. A one-time push is not enough. . . . don’t fall victim to a checklist mentality.”); Stephen M. Cutler, Remarks before the 2004 Investment Company Institute Securities Law Developments Conference (Dec. 6, 2004), *available at* <http://www.sec.gov/news/speech/spch120604smc.htm> (last visited May 12, 2005) (describing the “three Ps” of place, people, and process required to avoid another round of scandals).

⁶¹See *infra* note 62.

Administrative Enforcement and Institutional Reform

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

Almost three decades ago, Abram Chayes described an emerging dichotomy between traditional conceptions of adjudication, and an emerging judicial role in public law litigation.⁶² In traditional adjudication, the suit involves only the private parties before the court. It is self-contained and party-initiated. A dispassionate judge identifies the private right at issue based on doctrinal analysis and retrospective fact inquiry. She imposes relief, understood as compensation for the past violation of an identifiable existing right. By contrast, in public law litigation, the debate is more about the vindication of broader statutory or constitutional policies. The lawsuit is not self-contained. The judge must manage complex trial situations involving not just the parties to the dispute, but also the many and shifting parties not before the court who may nevertheless be affected by the suit's outcome. Fact inquiry is predictive. Through a combination of party negotiation and continuing judicial involvement, the judge fashions relief that is ad hoc, ongoing, and prospective. As such, judges can become change agents under whose management specific cases can have far-reaching effects—not just for their deterrent value, but because the relief fashioned focuses squarely on institutional reform.

The public law adjudicatory model pulls away from traditional adversarialism in favor of participatory, forward-looking, non-adversarial methods. Lately, this problem solving approach has become one theme in an emerging school of thought known as “new governance,” or “experimentalism.”⁶³ This approach identifies ongoing deliberation as both

⁶²See Abram Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281 (1976). For two important theoretical elaborations on the deliberative public law litigation model, see Susan P. Sturm, *A Normative Theory of Public Law Remedies*, 79 GEO. L.J. 1355, 1365–76 (1991) (developing a deliberative model for remedial decisionmaking); and Charles F. Sabel & William H. Simon, *Destabilization Rights: How Public Law Litigation Succeeds*, 117 HARV. L. REV. 1016 (2004) (using case study narratives to illustrate a theoretical model of structural reform through public law litigation).

⁶³I am glossing over noteworthy distinctions in speaking of experimentalism and New Governance together. Other terms for similar approaches include “reflexive law,” “responsive regulation,” and “network governance.” New Governance has emerged as a global term to refer to this set of approaches. Within it, experimentalism (an approach associated with, among others, Charles Sabel, Michael Dorf, Bradley Karkkainen, James Liebman, and William H. Simon) may be distinctive for its Deweyan pragmatist arguments in favor of decentralized decisionmaking in the service of broader social goals, and for the comprehensiveness of its description of the “rolling best practices rulemaking” needed to track progress toward those goals. Susan Sturm shares the emphases on pragmatism,

the most legitimate, and most effective, mechanism for making decisions in complex organizational structures. The deliberation is accomplished by decentralized, broadly participatory stakeholder groups that can access local knowledge and context-specific understandings of a situation. Decisionmaking within the groups is buttressed by explicit reason-giving, based on reference to identified norms rather than pure exchange. A centralized information-gathering body aggregates experience and permits comparative learning. It is a “learning by doing” structure, meaning that groups continually revise both ends and their own process through their participation in it. Transparency and accountability, including accountability for adhering to non-negotiable participatory norms, are reinforced by the centralized comparative data analysis function.⁶⁴

In spite of worries about courts’ capacity and legitimacy in working larger institutional reform,⁶⁵ the new methods show promise. Civil rights advocates, using public law litigation, have had some significant successes in “destabilizing” failing institutions and reforming practices in areas such as public school administration, mental health institutions, prison management, responses to systemic police abuse, public housing,⁶⁶ and health care provision.⁶⁷ Novel court structures have also emerged as part of the recognition that complex social problems are not always best resolved in a (stereotypically) atomistic and adversarial environment.⁶⁸

Beyond court action, and operating very much across the traditional public law/private law divide, New Governance theorists are also reorienting conversation about employment discrimination,⁶⁹ environmental

demonstrably reasoned decisionmaking practices, and centralized comparative learning, *but see* Susan Sturm, *Second Generation Employment Discrimination: A Structural Approach*, 101 COLUM. L. REV. 458, 555 (2001). For a conversation about the current state of play, *see generally* Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004); and Bradley C. Karkkainen, “New Governance” in *Legal Thought and In the World: Some Splitting as Antidote to Overzealous Lumping*, 89 MINN. L. REV. 471 (2004).

⁶⁴*See* Sturm, *supra* note 62, at 1427-1444; Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267, 345-56 (1998).

⁶⁵*See* Sabel & Simon, *supra* note 62, at 1017-19.

⁶⁶*See* Sabel & Simon, *supra* note 62, at 1022-53. Unlike Chayes, Sabel & Simon do not believe the new public law litigation techniques signal a break with the older adjudicative model. *Id.* at 1056-62.

⁶⁷*See* Louise G. Trubek, *Public Interest Lawyers and New Governance: Advocating for Healthcare*, 2002 WIS. L. REV. 575 (2002).

⁶⁸*See generally* Michael C. Dorf & Charles F. Sabel, *Drug Treatment Courts and Experimentalist Government*, 53 VAND. L. REV. 831 (2000); Michael C. Dorf & Jeffrey A. Fagan, *Problem-Solving Courts: From Innovation to Institutionalization*, 40 AM. CRIM. L. REV. 1501 (2003). Michael C. Dorf, *Legal Indeterminacy and Institutional Design*, 78 N.Y.U. L. REV. 875, 936-953 (2003).

⁶⁹*See generally* Sturm, *supra* note 63.

regulation,⁷⁰ public school administration,⁷¹ international labor standards,⁷² and regulation generally.⁷³ The most provocative proposals argue for the application of deliberative, pragmatic “democratic experimentalist” methods to constitutional law and jurisprudence.⁷⁴ What makes the model attractive in securities law enforcement is not only its willingness to address head-on (albeit through incremental means) the challenge of reforming complex institutions, but also its somewhat unexpected success across a wide range of other, apparently intractable, problems.

The Unique Enforcement Environment

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

⁷⁰See Eric W. Orts, *Reflexive Environmental Law*, 89 NW. U. L. REV. 1227 (1995); Bradley C. Karkkainen, *Information as Environmental Regulation: TRI and Performance Benchmarking, Precursor to a New Paradigm?*, 89 GEO. L.J. 257 (2000); Bradley C. Karkkainen, *Toward a Smarter NEPA: Monitoring and Managing Environmental Performance*, 102 COLUM. L. REV. 903 (2002).

⁷¹See James S. Liebman & Charles F. Sabel, *A Public Laboratory Dewey Barely Imagined: The Emerging Model of School Governance and Legal Reform*, 28 N.Y.U. REV. L. & SOC. CHANGE 183 (2003).

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

⁷³See Jody Freeman, *Collaborative Governance in the Administrative State*, 45 UCLA L. REV. 1 (1997); and, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543 (2000); Richard B. Stewart, *Administrative Law in the Twenty-First Century*, 78 N.Y.U. L. REV. 437 (2003).

⁷⁴See generally Dorf & Sabel, *supra* note 64; Brandon L. Garrett & James S. Liebman, *Experimentalist Equal Protection*, 22 YALE L. & POL’Y REV. 261 (2004); Michael C. Dorf, *Legal Indeterminacy and Institutional Design*, 78 N.Y.U. L. REV. 875 (2003); Cristie L. Ford, *In Search of the Qualitative Clear Majority: Democratic Experimentalism and the Quebec Secession Reference*, 39 ALBERTA L. REV. 511 (2001); JEAN L. COHEN, REGULATING INTIMACY: A NEW LEGAL PARADIGM (2002) (preferring the term “reflexive law” and not necessarily aligning herself explicitly with democratic experimentalism).

⁷⁵But see MALCOLM SPARROW, THE REGULATORY CRAFT: CONTROLLING RISKS, SOLVING PROBLEMS, AND MANAGING COMPLIANCE (2000) (identifying changes in internal enforcement approaches, from customer service- and process-oriented to problem solving, in the mid to late 1990s).

prospective approaches, to the benefit of both enforcement and corporate governance reform.⁷⁶

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

Settlements provide obvious resource conservation benefits, but they impose a cost in terms of lost transparency. Firms settling regulatory actions can keep aspects of their internal wrongdoing out of the public eye by resolving matters before full-blown trial. They can be expected to leverage their greater knowledge of what went wrong, and to try to settle before all the facts emerge, precisely to avoid a more thorough investigation. This reduces public, regulatory, and judicial learning about violation patterns more generally. In fact, firms can resolve matters with prosecutors before even the (overworked) prosecutors have a complete sense of the depth of the problem. Because of their informational advantage, firms can also assess the likely penalty range better than enforcement can. Settlement can even be a way for firms themselves to avoid facing the pervasiveness of their corporate governance problems. Sanctions meted out in settlements may therefore be poorly suited to responding to the most serious problems. At the aggregate level, as well, the opacity can make enforcement's forceful "culture of compliance" message seem less convincing. Individuals, including those leading organizations, are more likely to abide by rules they perceive as legitimate and procedurally fair.⁷⁷ Therefore, enforcement mechanisms that are not transparent may lack demonstrable credibility, which in turn may undermine tendencies toward law-abiding behavior. As discussed below,⁷⁸ given SEC Enforcement's settlement framework, onlookers may be right to be cynical about whether broader corporate governance priorities are being advanced behind the concealing curtain of settlement.

The second key difference here is that Enforcement staff, not courts, are the primary arbiters of these settlements. As change agents, the enforcement arms of administrative regulators are much understudied. Enforcement in particular has not garnered much attention from New Governance theorists. This may be because the enforcement process has been seen, rightly or wrongly, to have become fossilized into an old-fashioned prosecutorial form based on retrospective and blame-oriented

⁷⁶See *infra*, Part 5.

⁷⁷See TOM R. TYLER, WHY PEOPLE OBEY THE LAW (1990).

⁷⁸*Infra* Part 2.

decisionmaking.⁷⁹ Perhaps, because they have been able to offload systemic impact questions to the regulatory arms of their agencies, enforcement divisions have not been pushed toward a more public-regarding stance to the degree that courts have.

Having enforcement personnel focus on broader systemic reform has implications. To begin with, relative to regulators, the enforcer's task is retrospective and blame-oriented, not prospective and reform-oriented. The liability model on which enforcement/prosecution is based serves a legitimate social function in signaling public norms, and those norms affect the conduct of other actors. While blame is only one kind of possible deterrence, its shaming effects can provide a coercive "stick," external to the regulatory process, to reinforce law-abiding behavior.⁸⁰ At the same time, blame-ascribing models tend to be better suited to individuals than to organizations. Blame-oriented models struggle with how to respond to the corporate form, although the basic intuition—that blame allocation is an important part of a regulatory system—has not been dislodged.⁸¹

Enforcement action provides a mechanism by which the firm, and the larger market, can digest and move beyond acute instances of wrongdoing. It serves a legitimate purpose in achieving closure, which reduces downward pressure on stock valuation (to the benefit of current shareholders), allows the firm to emerge intact as a productive business entity and employer, and prevents an escalation into a larger industry or

⁷⁹According to Sparrow, this is how proponents of former President Clinton's customer-oriented National Performance Review regulatory model (an early and incomplete, but still noteworthy, New Governance form) viewed the enforcement function. See SPARROW, *supra* note 75, at 49-64.

⁸⁰See *infra* notes 218-222 and accompanying text (comparing shaming/blaming punishments to the information-forcing coercive mechanism imagined in experimentalist regulation).

⁸¹For interesting recent comments on the normative problems with allocating blame and criminal liability for corporations, see generally Gilbert Geis & Joseph F.C. DiMento, *Empirical Evidence and the Legal Doctrine of Corporate Criminal Liability*, 29 AM. J. CRIM. L. 341 (2002); SIMPSON, *supra* note 43; William H. Simon, *Toyota Jurisprudence*, in GRAÏNNE DE BURCA & JOANNE SCOTT, EDS., *NEW GOVERNANCE AND CONSTITUTIONALISM IN EUROPE AND THE U.S.* (forthcoming 2005) (manuscript at 9-11, on file with author). A bibliography covering both legal and social science resources from the late 19th century through early 2001 is Joseph F.C. DiMento et al., *Corporate Criminal Liability: A Bibliography*, 28 W. ST. U. L. REV. 1 (2000-2001). Causation and individual intent can also be hard to prove within complex organizational contexts. *Contra* JOHN BRAITHWAITE, *CORPORATE CRIME IN THE PHARMACEUTICAL INDUSTRY* (1984) (arguing that on the whole, corporate wrongdoing is pursued for organizational, not individual, ends). For a theory of organizational jurisprudence arguing that forward-looking regulation is appropriate when adjudicating controversies involving organizations such as large corporations (and that retrospective, individualistic arbitration is appropriate when adjudicating controversies involving individuals), see MEIR DAN-COHEN, *RIGHTS, PERSONS, AND ORGANIZATIONS: A LEGAL THEORY FOR BUREAUCRATIC SOCIETY* (1986).

market crisis.⁸² If the goal is to spur institutional reform, however, the downsides to this closure orientation are twofold. First, within the process, the closure-oriented model seems incapable of making space for the kinds of deep and broad, time-intensive and often difficult self-examinations that a real cultural shift would require.⁸³ On the contrary, the focus on closure is likely to stimulate end-game strategic responses from firms. The most one could hope for would be compliance with externally imposed rules, meant to channel firm action within certain bounds. Second, at the institutional level, the fact that enforcement actions are time-limited means there may be no aggregation of institutional knowledge about governance problems. Enforcers as a group may not get better at predicting problems, identifying risk factors, or developing workable remedies over time.⁸⁴

Similarly, the Enforcement-firm relationship is not geared toward ongoing, trusting collaboration. Like prosecutors, Enforcement's relationship with firms being investigated will, by definition, be adversarial and suspicious. This is not to say that they want to see firms harmed. Individual Enforcement staff may be agnostic on the overall goodwill of market actors, or they may believe that every firm will do anything it can get away with, or they may believe that most firms act responsibly and their job is to weed out the "bad apples." Yet in all cases they are institutionally charged with remaining suspicious of their actual targets and skeptical about unsubstantiated promises. If they were not, we would be concerned about agency capture.

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

⁸²I am not speaking of that exceedingly rare firm that is so "rotten" that the only course must be to shut it down. See *infra* notes 213-216 and accompanying text.

⁸³On the difference in institutional culture between government lawyers and social scientists such as economists (in terms of lawyers' preference for circumscribed sets of provable facts over broader systemic analysis), see JAMES Q. WILSON, BUREAUCRACY 61-61 (1989).

⁸⁴See also HERMAN GOLDSTEIN, PROBLEM-ORIENTED POLICING (1990) (arguing, in the police context, that rather than merely trying to solve crimes after they are committed, the police should study crime patterns in order to identify underlying conditions that stimulate the commission of crimes, and then move proactively to eliminate them).

expert staffers would have to develop context-appropriate responses that were as pervasive and elastic as the culture they seek to supplant.

Even without trying to effect large-scale cultural changes, Enforcement resources are stretched to an almost unmanageable degree. Enforcement settles the vast majority of its actions, not only for all the usual settlement reasons but also because it could not effectively prosecute them all. Certainly, it could not prosecute all the cases it is investigating at any one time, but the point goes further: it takes enormous resources to get to the bottom of the kinds of large and complex securities cases that are being brought routinely in recent years.⁸⁵ According to one report from mid-2002, SEC Enforcement was so overwhelmed that “evidence rooms on the 8th and 9th floors of the SEC’s downtown Washington headquarters [were] so full that boxes of subpoenaed documents [were] stacked in hallways,” and Mr. Cutler himself admitted that his staff was “stretched to the limit.”⁸⁶ The SEC Enforcement model—perhaps like the prosecutorial model generally—was not designed to conduct the kinds of massive document reviews, factual investigations, and informational analysis needed to understand the myriad facets of a particular act of firm wrongdoing, let alone to fashion systemic solutions to cultural problems.

Nor do I think that increasing Enforcement resources to allow staffers to undertake “deep” scrutiny is the solution. Enforcement staff should not be transformed into corporate governance consultants. Recent

⁸⁵Enforcement subpoenas and requests for documents in the post-Enron era tend to be broadly worded and to compel vast swaths of data including general business documents, email and instant messaging records, and financial and account systems information. See, e.g., Barry B. Burr, *First time: Consultants under the gun with SEC probe; ‘Pay-to-play’ allegations spur sweeping, detailed investigation*, 32 PENSIONS & INV. 1 (Jan. 12, 2004). For one leading East Coast document management firm, the average regulatory document production project involves about 100,000 documents. At the upper end, the firm has processed more than 3 million documents, resulting in about 10 million pages, in a single case. It has produced 250,000 documents – in excess of one million pages – to a law firm in a single day. E-mail from Jay McNally, CEO, Ibis Consulting, Inc., to Cristie Ford (June 13, 2005) (on file with author). Of course, after being individually reviewed by lawyers, those documents are produced to regulators at a distinctly more human pace. Nevertheless, Enforcement is ill-equipped to handle this kind of volume, provided to them at first instance (per their request and in keeping with the firm’s work product privilege) as a largely undifferentiated mass of data. As New York Attorney General Eliot Spitzer’s office has shown, even small teams of enforcers may be able to bring firms to the settlement table. See Richard Thomson, *America’s Celebrity Prosecutors: Chasing the white collar crooks puts top lawyers on the glory trail*, EVENING STANDARD (U.K.), June 13, 2003, at 42 (noting Spitzer’s investigation of stock analysts involved hundreds of thousands of documents and emails and was handled by only four lawyers); Michael Schroeder, *Stock Analysis: States’ Wall Street Probes Bog Down*, WALL ST. J., Sept. 13, 2002, at C5. This does not necessarily imply that those enforcers have a comprehensive picture of the information produced to them.

⁸⁶Michael Schroeder & Greg Ip, *Imperfect Guardian: SEC Faces Hurdles Beyond Low Budget In Stopping Fraud*, WALL ST. J., July 19, 2002, at A1.

increases in the SEC's budget allocation from Congress,⁸⁷ and a recent push to make the SEC more technically adept at handling the information it does receive,⁸⁸ only tinker around the edges of a fundamental mismatch between institutional design and information volume.⁸⁹ One can scarcely imagine how an agency facing this kind of information burden could assume additional responsibility for understanding and working to resolve pervasive cultural problems among firms being investigated. If the goal is nothing more than to resolve cases as expeditiously as possible, Enforcement can make significant progress through individual interviews or depositions and a sufficient number of key documents. But one can understand why, aspirational proclamations aside, Enforcement staff might take a deterrence-based approach to trying to further institutional reform. Irrespective of any faith in that approach, they are not in a position to do much more.

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

⁸⁷See SEC, 2004-2009 Strategic Plan, 22, 27 (Aug. 5, 2004), available at <http://www.sec.gov/about/secstratplan0409.pdf> (last visited May 12, 2005) (showing that over the last several years, the SEC's Congressional budget allocation has increased significantly, growing from \$514 million in fiscal 2002 to \$811.5 in fiscal 2004); Anna Wilde Mathews et al., *The Bush Budget Proposal: FDA, FCC Get Rare Boosts, While SEC Funding Is Stable*, WALL ST. J., Feb. 5, 2005, at A14 (reporting President Bush has requested \$863 million for the SEC in fiscal 2006, up only slightly from the fiscal 2005 figure of \$857 million).

⁸⁸See SEC, 2004-2009 Strategic Plan, *supra* note 87, at 32-33, 48-50 (announcing new staff training initiatives and new or expanded automated information management tools).

⁸⁹I am speaking primarily of Enforcement, but even in the normal regulatory course, the SEC is expected to manage an enormous information volume. See Schroeder & Ip, *supra* note 86; see also "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs," Report of the Staff to the Senate Committee on Governmental Affairs (Oct. 8, 2002), available at http://www.senate.gov/~gov_affairs/100702watchdogsreport.pdf (last visited May 12, 2005).

⁹⁰The term refers to resolutions that may be good enough in the circumstances (i.e., wherein goals are somewhere between "satisfied" and "sacrificed,"), but that are not optimal. HERBERT A. SIMON, MODELS OF MAN (1957).

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

The other alternative, the Reform Undertaking model,⁹¹ recognizes that Enforcement’s purpose is not to get to the root of a systemic corporate governance problem on its own, even if those are the problems that it needs to address. Nevertheless, it constitutes the Enforcement action as an intervention that is far more engaged than the one contemplated by deterrence alone. The Reform Undertaking model involves an independent third party consultant to help the organization address its own governance problems, over a longer period of time, and after the immediate enforcement action has been provisionally resolved. In this way, Reform Undertakings uncouple the catalyst-for-reform of the enforcement action from the specifics of reform measures. This reduces some of the pressure toward strategic action, and if properly implemented can create an environment more conducive to fostering meaningful positive culture change.

2. Problems With the Framework for Cooperation

The discussion in Part One, above, describes the limitations of the Donaldson-era SEC’s deterrence-based strategy in meeting the agency’s stated intention of spurring institutional reform, and suggests that a New Governance-style approach may be better suited to the task. It identifies some challenges, relative to other New Governance initiatives, arising from

⁹¹See *Infra* Part 3 (explaining the Reform Undertaking model as one that uses enforcement to further, but not to define or manage, more profound institutional reform).

the Enforcement-driven and settlement-oriented environment. I return to those below, and make recommendations for a incorporating a version of New Governance problem solving into real-life enforcement.⁹² However, deterrence is only half the picture. Enforcement has stated that certain “core factors” influence the decision as to quantum of penalty, or even whether to impose a penalty at all. The factor that often proves decisive in their analysis is the extent of a violator’s cooperation, as measured by the standards set forth in the [Framework for Cooperation].⁹³ The Framework for Cooperation effectively sets out the indicia that a firm must demonstrate to obtain leniency from Enforcement. It is an integral part of the nontransparent settlement dance described above, and its structure and rationale should be of concern to those aspiring to foster improved corporate governance standards through SEC Enforcement action.

The SEC Framework for Cooperation

On October 23, 2001, as part of an Exchange Act Section 21(a) Report, the Commission released a “Framework for Evaluating Cooperation in Exercising Prosecutorial Discretion.”⁹⁴ Like the United States Sentencing Commission’s 1991 Organizational Sentencing Guidelines on which it was loosely modeled, the Framework for Cooperation settlement approach can be boiled down to two basic requirements. In order to obtain leniency, the firm must demonstrate (1) that it has in place compliance mechanisms designed to prevent and detect violations of law within the firm (“credit-for-compliance”), and (2) that it has cooperated with authorities after apparent wrongdoing has been uncovered (“credit-for-cooperation”).⁹⁵ As a practical

⁹²See *Infra* Part 5 (concluding that a coherent hybridity between experimentalism and securities law enforcement structures can, and should, exist).

⁹³See Cutler, *supra* note 2 (highlighting that cooperation is the third and often the decisive one of three core factors). The first two are the type of violation committed (i.e., fraud or non-fraud, although non-fraud cases can also attract monetary penalties), and the degree of harm resulting from the violations as measured by harm to investors, effect on market capitalization, and/or harm to public trust and confidence. I fold these factors into my definition of the “worst actors,” above.

⁹⁴See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969, (Oct. 23, 2001) [hereinafter the Framework for Cooperation], at <http://www.sec.gov/litigation/investreport/34-44969.htm> (explaining that the word “prosecution” here refers to SEC Staff attorneys working in the Enforcement Division); Comm. on Fed. Reg. of Sec., *Report of the Task Force on Exchange Act Section 21(a) Written Statements*, 59 BUS. LAW. 531 (2004) (outlining the recent history of the use of the Section 21(a) Report).

⁹⁵U.S. SENTENCING GUIDELINES MANUAL § 8A1.1 et seq. (2004). The Organizational Sentencing Guidelines imposed a mandatory sentencing calculus on federal court judges dealing with corporate and white collar crime. Those guidelines remain, at a minimum, persuasive in the wake of the Supreme Court’s rulings on the constitutionality of federal individual sentencing guidelines, in *U.S. v. Booker*, 125 S.Ct. 738 (2005). See also United

matter, the Framework for Cooperation provides Enforcement with a shortcut that allows it to avoid sorting through all the intricacies of the complex and information-heavy investigations it brings. In the process, though, it has the potential to undermine efforts toward corporate governance reform.

According to the Press Release accompanying the Framework, a firm's cooperation with SEC Enforcement staff will be measured along four broad measures.⁹⁶ They are: (1) Self-policing prior to the discovery of the misconduct, including establishing effective compliance procedures and an appropriate tone at the top; (2) Self-reporting of misconduct when it is discovered, including conducting a thorough review of the nature, extent, origins and consequences of the misconduct, as well as promptly, completely, and effectively disclosing the misconduct to the public, to regulators, and to self-regulators; (3) Remediation, including dismissing or appropriately disciplining wrongdoers, modifying and improving internal controls and procedures to prevent recurrence of the misconduct, and appropriately compensating those adversely affected; and (4) Cooperation with law enforcement authorities, including providing the Commission staff with all information relevant to the underlying violations and the company's remedial efforts.⁹⁷

The Framework's structure and language show the influence of SEC Enforcement culture and imperatives. It lists 13 criteria for Enforcement

States Sentencing Commission, *Report of the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines* (Oct. 7, 2003), at <http://www.uscc.gov/corp/advgrprpt/advgrprpt.htm>; John R. Steer, *Changing Organizational Behavior – The Federal Sentencing Guidelines Experiment Begins to Bear Fruit*, 1317 PLI / CORP 113, 115-26 (2002). Federal criminal prosecutors have also used the Guidelines as an informal roadmap for cases involving business organizations. See also Memorandum from Deputy Attorney General Eric H. Holder, Jr., to All Component Heads and United States Attorneys, *Bringing Criminal Charges Against Corporations* (June 16, 1999), <http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html>; Memorandum from Deputy Attorney General Larry D. Thompson to Heads of Department Components, United States Attorneys, *Principles of Federal Prosecution of Business Organizations* (Jan. 20, 2003), http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm (recognizing that federal criminal prosecutors have also used the Guidelines as an informal roadmap for cases involving business organizations). The Framework, the Organizational Sentencing Guidelines, and their other progeny also ask whether the firm has appropriately compensated those adversely affected by the alleged wrongdoing. This important criterion is not directly relevant to this analysis of firm culture and pathologies in regulatory settlements, but remediation requirements could certainly be a component of a True Reform Undertaking structure; see *infra*, Part 5.

⁹⁶Press Release, SEC, *SEC Issues Report of Investigation and Statement Setting Forth Framework for Evaluating Cooperation in Exercising Prosecutorial Discretion* (Oct. 23, 2001), at <http://www.sec.gov/news/headlines/prosdiscretion.htm> (asserting that credit for cooperation may range from no enforcement action at all, to bringing reduced charges).

⁹⁷See *id.*

staffers to consider in determining whether, and how much, to credit self-policing, self-reporting, remediation, and cooperation. Relative to the Organizational Sentencing Guidelines, which attempt to articulate general standards against which to measure a firm's compliance program,⁹⁸ the purpose of the Framework for Cooperation is to specify in clear terms how firms can obtain leniency. For this reason, the Framework's language is prescriptive—almost forensic—and focused on the acute wrongdoing instance rather than on broader corporate governance indicia.

The only way to convey the Framework's tenor is to quote the relevant criteria in full. The eight criteria relevant to this discussion⁹⁹ are divided along the following lines: three evaluate prior conditions and good governance mechanisms in the firm; four evaluate the firm's response to the wrongdoing; and one specifically addresses the firm's cooperation with Staff. The three criteria that evaluate prior conditions and/or good governance ask:

2. How did the misconduct arise? Is it the result of pressure placed on employees to achieve specific results, or a tone of lawlessness set by those in control of the company? What

⁹⁸The Organizational Sentencing Guidelines have been compared to the United States Constitution, in that they contain “simple statements of general principles that permit its [sic] application to varied and changing circumstances.” Judge Diana E. Murphy, *The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics*, 1291 P.L.I./CORP 97, 110 (Feb 2002). Thus, the Guidelines' definition of “an effective program to prevent and detect violations of law” is intended to evolve based on best practices and ongoing learning within the firm about its own risk factors and vulnerabilities. The Guidelines do not define such an “effective program,” except to say that it is a program that has been “reasonably designed, implemented, and enforced so that it generally will be effective in preventing and detecting criminal conduct.” While the precise actions necessary for an “effective program” depend upon a number of factors, the likelihood that certain offenses may occur because of the nature of a firm's business is relevant. The “hallmark” of such a program is that “the organization exercised due diligence in seeking to prevent and detect criminal conduct by its employees and other agents.” Words such as “effective,” “reasonable,” and “due diligence” signal a degree of discretion in deciding what constitutes a good compliance program. The definition of “due diligence” itself is general and contains many open and subjective words. See, e.g., U.S. SENTENCING GUIDELINES MANUAL § 8A1.2, cmt. n.3(k) et seq. (2004). Of course, the Guidelines are hardly an improvement over the Framework to the extent that they require judges and/or prosecutors to evaluate firms' compliance systems, just as the Framework requires Enforcement staff to do it.

⁹⁹The other five criteria speak more to the allocation of scarce Enforcement resources. Four criteria assess severity of conduct and magnitude of harm, and go to proportionality of punishment-versus-crime, rather than to leniency per se. Framework for Cooperation, *supra* note 94, at criteria 1, 3, 4, and 5. The final criterion asks whether the company is “the same company in which the misconduct occurred, or [whether it has] changed through a merger or bankruptcy reorganization.” *Id.* at criterion 13. While these are all valid considerations, they are concerned with the cost-benefit analysis of pursuing Enforcement action against certain firms, rather than with cooperation, compliance, or culture. See *supra* notes 24-25 and accompanying text.

compliance procedures were in place to prevent the misconduct now uncovered? Why did those procedures fail to stop or inhibit the wrongful conduct?¹⁰⁰

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

12. What assurances are there that the conduct is unlikely to recur? Did the company adopt and ensure enforcement of new and more effective internal controls and procedures designed to prevent a recurrence of the misconduct? Did the company provide our staff with sufficient information for it to evaluate the company's measures to correct the situation and ensure that the conduct does not recur?¹⁰¹

The four criteria that evaluate the firm's response in the period *after* wrongdoing has been alleged are concerned with compliance, but also with damage control. They ask:

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

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

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

¹⁰⁰Recent Commission speeches make it clear that after-the-fact cleanup exercises are no substitute for pre-existing good governance practices. According to Commissioner Cynthia Glassman, "if you are looking for leniency you had better be able to show that you cared about preventing corporate misconduct before you discover that it occurred." Commissioner Cynthia A. Glassman, Speech: Sarbanes-Oxley and the Idea of 'Good' Governance (Sept. 27, 2002) at <http://www.sec.gov/news/speech/spch586.htm>.

¹⁰¹See Framework for Cooperation, *supra* note 94, at criteria 2, 6, and 12.

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

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

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

The cooperation criterion is the most immediately alarming for those concerned with due process, safeguarding the attorney client privilege, and an adversarial process permitting zealous defense of clients. The Framework makes it clear that SEC Enforcement expects value-added firm participation in its investigation, not just prompt and adequate responses to Enforcement demands. In other words, along with making documents and witnesses available, the firm is expected to identify possible violations and evidence proactively; to produce a thorough and probing written report and make it available to Enforcement; and to bring information that Enforcement might not otherwise have uncovered to its attention.¹⁰⁴

While the credit-for-cooperation requirements raise the most pressing concerns, on further reflection the credit-for-compliance

¹⁰²See Framework for Cooperation, *supra* note 94, at criteria 7-10.

¹⁰³See Framework for Cooperation, *supra* note 94, at criterion 11.

¹⁰⁴In the criminal context, a similar provision has caused anxiety for at least one observer, who notes that some practitioners think the government is "laz[y]" and "hitch[ing] a free ride" on defense counsel's work. Gibeaut, *supra* note 6, at 49.

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

“Cynical Happy-Talk”: The Problem with Credit-for-Compliance

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

The obvious temptation (or obvious, at least, to those familiar with the history of command-and-control regulation in this country) is to define the essentialized “effective compliance program” to a high gloss of certainty, even at the cost of being optimally effective from a long term risk management or good governance perspective. Enforcement staff could try to evaluate firm compliance according to a checklist, rather than in a flexible or empirically based way.¹⁰⁵ Checklists are simpler to work with, and

¹⁰⁵The similarity with discredited command-and-control administrative mechanisms, the stereotypical example of which requires regulated entities to meet detailed and rigid, learning-resistant process criteria, is striking. It brings to mind the literature on bounded rationality suggesting that, when confronted with overwhelming complexity, people tend to rely on cognitive shortcuts such as heuristics and schema as a way of managing the universe of possibilities. See, e.g., Amos Tversky & Daniel Kahneman, Judgment Under Uncertainty: Heuristics and Biases, DANIEL KAHNEMAN ET AL., EDS., JUDGMENT UNDER UNCERTAINTY 3

provide a degree of clarity for both firm and overworked Enforcement staffer. However, rigid, anticipatory rules have limited range for compelling systemic scrutiny or good behavior. For example, contemporary compliance scholarship considers having an independent board of directors to be a crucial step in safeguarding shareholders and the public against managerial self-interest.¹⁰⁶ The presence of a code of ethics is also an important component.¹⁰⁷ Yet, in an empirical study of 221 large- and medium-sized U.S. corporations, James Westphal found that changes in board structure that increase the board's independence from management are associated with higher levels of CEO ingratiation and persuasion behavior toward board members, and that such influence behaviors offset the effect of increased structural board independence.¹⁰⁸ Corporate codes of ethics have also been criticized as being ineffective.¹⁰⁹ Relying on shallow tests for

(1982); Jeffrey Rachlinski & Cynthia Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549 (2002) (applying a cognitive model to regulatory design). As Troy Paredes has noted, people make bad decisions when the volume of information increases, and they are forced to apply simpler analytical tools. See Troy A. Paredes, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 WASH. U. L. Q. 417, 434-43 (2003) (discussing investors' "information overload" and mandatory disclosure system in securities laws).

¹⁰⁶The Sarbanes-Oxley Act of 2002 and related new self regulatory organization rules emphasize the importance of a strong and independent board of directors, with certain committees of the board either a majority or completely comprised of independent directors. The Act creates extensive protections for Audit Committees in particular, including the requirement that Audit Committee members be independent of the company, and that at least one member of the Audit Committee be a "financial expert." See Sarbanes-Oxley Act of 2002 § 407, 15 U.S.C. § 7265. The Act gives the Audit Committee sole responsibility for appointing, compensating and supervising auditors, and requires the Audit Committee to set up internal procedures for receiving and reacting to complaints concerning accounting, internal control, or auditing matters, including establishing a mechanism for handling confidential, anonymous concerns of employees. See Sarbanes-Oxley Act § 301, 15 U.S.C. § 78j-1. See also Self Regulatory Organizations, Exchange Act Release No. 48745, 68 Fed. Reg. 64,154, 64,157-59, 64,161-64 (Nov. 4, 2003), available at <http://www.sec.gov/rules/sro/34-48745.htm>.

¹⁰⁷See Sarbanes-Oxley Act of 2002 § 406(c), 15 U.S.C. § 7265 (defining the code of ethics as among other things, honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships); see also Self Regulatory Organizations, 68 Fed. Reg. 64,159, 64,164 (Nov. 12, 2003) (explaining the code of business conduct and ethics).

¹⁰⁸See James D. Westphal, *Board Games: How CEOs Adapt to Increases in Structural Board Independence from Management*, 43 ADMIN. SCI. Q. 511, 529-532 (1998) (explaining, for instance, that increases in structural board independence lead to larger subsequent increases in CEO compensation by increasing the level of CEO interpersonal influence behavior).

¹⁰⁹See John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. COLO. L. REV. 57, 120-21 (2005) (citing the Enron's Board of Directors actions in waiving company code of ethics so that Enron's CFO could participate in the LJM-related party transactions, conflict of interest notwithstanding); see also Note, *The Good, The Bad, and Their Compliance Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 HARV. L. REV. 2123 (2003) (asserting that a corporate code of ethics is only as good as the directors and officers responsible for implementing it).

board independence, then, fails to account for the undoubtedly nuanced relationship between board independence and good corporate citizenship.¹¹⁰ Part of the problem is that procedural *outputs* (e.g., internal reports generated, number of compliance officers on staff, the installation of a 24-hour anonymous whistleblower hotline, etc.) are easier to measure than high level compliance *outcomes*. In fact, relatively easy-to-measure outputs are even likely to receive more attention than hard-to-measure outputs.¹¹¹ One can understand how observers might be cynical as to whether prototypical compliance programs do more than provide lip service to governance norms.

Interestingly enough, this is not what the Framework for Cooperation does. It avoids overspecification (historically, a regulator's tic) in favor of *no* specification (that is, the largely unfettered discretion of the criminal prosecutor). The Framework asks only what compliance measures were in place at the firm, and why they failed. But recall the impossible information volume that Enforcement must handle, the inscrutability (to Enforcement) of "effective compliance," and the Framework's emphasis on proactive firm cooperation. In real life, the Framework's credit-for-compliance provision only opens the door for the firm to convince staffers that its compliance structures were meaningful, and that the reasons for failure were specific and unlikely to be repeated. The typical medium for making this kind of pitch is the Wells Submission, a carefully crafted written brief the firm submits in support of its position as Enforcement's initial investigation draws to a close.¹¹² A firm will virtually never say that deep cultural problems caused its law violations, and that those conditions persist. Enforcement will rarely have the informational arsenal to counter that claim in specific terms.

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

¹¹¹WILSON, *supra* note 83, at 161-62. The problem is most severe in the most dysfunctional firms, where the absence of easy-to-read signals from inside – e.g., calls to the whistleblower hotline – may mask a more pervasive problem.

¹¹²Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations, Securities Act Release No. 5310 (Sept. 22, 1972). See 17 C.F.R. § 202.5(c) (2005) (providing that persons who become involved in preliminary or formal investigations may, on their own initiative, submit a written statement to the Commission setting forth their interests and position in regard to the subject matter of the investigation). See also *In re Initial Public Offering Sec. Litig.*, 2004 WL 60290 at *1 (S.D.N.Y. Jan. 12, 2004) (providing a brief history of the Wells submission process); Joshua A. Naftalis, Note, "Wells Submissions" to the SEC as Offers of Settlement under Federal Rule of Evidence 408 and their Protection from Third-Party Discovery, 102 COLUM. L. REV. 1912, 1912-26 (2002) (describing generally Wells Submissions).

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

Thus, according to Laufer, many large firms come to think of compliance and even corporate ethics as matters of risk management – what Citigroup CEO Charles Price calls “cynical happy-talk.”¹¹⁵ Compliance serves an insurance function against zealous prosecutorial action, and firms purchase only the amount of compliance required to shift liability away from the firm.¹¹⁶ It would not be in their interest to purchase too-effective compliance structures that uncovered wrongdoing that otherwise would have lain undiscovered, so firms may be tempted to follow compliance requirements in a minimal, even cynical, way.¹¹⁷ Because the Framework does not explicitly require that compliance programs continually improve, they become a ceiling instead of a floor. Ironically, then, Laufer suggests

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

¹¹⁴See *id.* at 1407-11 (citing commentators who note that ethics codes are poorly integrated into firm culture).

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

¹¹⁶See Laufer, *supra* note 113, at 1382-1402 (explaining that prescriptive steps for due diligence afford firms protections from criminal investigations, indictments, conviction, and fines); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L. J. 857, 859-62 (1984) (asserting that employee indemnification agreements tend to limit the degree to which blame-shifting to employees actually results in pecuniary savings for the firm); cf. Stone, *supra* note 23, at 47-56 (arguing at 56 that employee indemnification can be a “ruse a firm can devise to take care of its good soldiers”). The SEC takes the position that indemnification for securities law violations is void as a matter of public policy; see Regulation S-K, 17 C.F.R. § 229.512(h)(3) (2005).

¹¹⁷See Laufer, *supra* note 113; Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEG. STUD. 833 (1994).

that the “good corporate citizenship” movement may actually generate moral hazards that undermine corporate governance objectives.¹¹⁸

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

The Problem with Credit-for-Cooperation

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

¹¹⁸See Laufer, *supra* note 113, at 1405-19. Laufer does not see a way out of the moral hazard and the problem of “cosmetic compliance” until prosecutors/enforcers and firms share a consistent understanding of what an “effective” compliance system entails, and a workable metric for evaluating compliance systems. *Supra* at 1419-20. See also Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 80 WASH. U. L. Q. 487, 491-92, 510-16 (2003) (arguing that placing excessive importance on compliance structures raises dangers of underenforcement and social waste).

¹¹⁹Lucent Corporation was fined \$25 million recently for failing to cooperate in an investigation. According to Associate Director of Enforcement Paul Berger, the case “sends a message about cooperation during an investigation.” Press Release, SEC, Lucent Settles SEC Enforcement Action Charging the Company with \$1.1 Billion Accounting Fraud (May 17, 2004), available at <http://www.sec.gov/news/press/2004-67.htm>. Other firms that have been fined for failing to cooperate include Xerox, Dynegy, Banc of America Securities, and AIG. See Press Release, SEC, Xerox Settles SEC Enforcement Action Charging Company with Fraud (Apr. 11, 2002), available at <http://www.sec.gov/news/press/2002-52.txt> (imposing a then-unprecedented \$10 million penalty reflecting, in part, a sanction for the company’s lack of full cooperation in the investigation); *In re* Dynegy, Inc., Exchange Act Release No. 46537 (Sept. 25, 2002), available at <http://www.sec.gov/litigation/litreleases/lr17744.htm> (imposing a \$3 million penalty due to the Commission’s dissatisfaction with Dynegy’s lack of full cooperation); *In re* Banc of America Securities LLC, Exchange Act Release No. 49386 (Mar. 10, 2004), available at <http://www.sec.gov/litigation/admin/34-49386.htm> (imposing a \$10 million civil penalty for BAS’s alleged failure to meet the Commission’s reasonable document requests, and emphasizing the “overriding importance” of broker-dealer compliance with requests of

According to Mr. Cutler, “the Commission is placing a greater emphasis than ever before on assessing and weighing cooperation when making charging and sanctioning decisions.”¹²⁰

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

regulatory authorities during investigations); Press Release, SEC, SEC Charges American International Group and Others in Brightpoint Securities Fraud (Sept. 11, 2003), *available at* <http://www.sec.gov/news/press/2003-111.htm> (imposing a \$10 million civil penalty relating to “AIG’s participation in the Brightpoint fraud, as well as misconduct by AIG during the Commission’s investigation”).

¹²⁰Stephen M. Cutler, Remarks Before the District of Columbia Bar Association (Feb. 11, 2004), *available at* <http://www.sec.gov/news/speech/spch021104smc.htm>. Cases in which corporate cooperation has explicitly led to reduced sanctions include SEC v. Giesecke, Litigation Release No. 17745 (Sept. 25, 2002), *available at* <http://www.sec.gov/litigation/litreleases/lr17745.htm> (declining to bring any enforcement action against Homestore, Inc. because of its “swift, extensive and extraordinary cooperation in the Commission’s investigation”); *In re* Rite-Aid Corp., Exchange Act Release No. 46099 (June 21, 2002), *available at* <http://www.sec.gov/litigation/admin/34-46099.htm> (considering the value of Rite Aid’s cooperation in determining the appropriate resolution of this matter); Alliance Capital Management, *supra* note 32; *In re* Gateway, Inc., Securities Act Release No. 8838 (Nov. 13, 2003), *available at* <http://www.sec.gov/litigation/admin/33-8338.htm> (stating that the Commission has considered Gateway’s cooperative undertakings in deciding to accept Gateway’s offer).

¹²¹With apologies to Lord Denning: Crabb v. Arun District Council [1976] Ch. 179, 187 (U.K.) (“there are estoppel and estoppel”).

¹²²Cooperation between investigator and subject was not the norm, at least in the criminal context, before the Organizational Sentencing Guidelines were implemented. As one observer noted in 1985, because white collar criminal investigations often went on for substantial periods of time, “information control” – i.e., “keeping documents away from and preventing clients and witnesses from talking to government investigators, prosecutors, and judges” – was central to at least some counsels’ defense strategy. See KENNETH MANN, DEFENDING WHITE COLLAR CRIME: A PORTRAIT OF ATTORNEYS AT WORK, 6-8 (1985). In case one is left with the impression that only defendants were perceived to be “hiding the ball,” *see, e.g.*, U.S. v. Liquid Sugars, Inc., 158 F.R.D. 466, 471 n.4 (E.D.Cal. 1994); United States v. Houlihan, 937 F. Supp. 65, 69 (D. Mass. 1996) (stating that criminal discovery is not, nor should it be, the game of hide the ball, as the stakes are too high for both sides). The dates of these cases demonstrate, of course, that “hide the ball” behavior did not end with the Organizational Sentencing Guidelines’ promulgation in 1991.

Credit-for-cooperation schemes of any sort can be problematic,¹²³ but my concern is primarily the “flipping” kind of cooperation. Seen through a darker lens, the cooperation condition can imply a quiet agreement between a firm and its regulator, in which the firm acquires leniency in exchange for assisting Enforcement staff to make a case against another Enforcement target.¹²⁴ Especially given the obstacles they face in making retrospective sense of the document universe, and the theoretical and practical problems involved in attaching blame to a complex corporate form,¹²⁵ enforcers might be expected to welcome cooperation where it furthers the enforcement action in question. This is, especially true if the action includes sanctions against a high-profile individual. Ever-increasing standards of cooperation can become a substitute for good corporate citizenship.

The information that emerges from such a process may be suspect, like all information coming from a self-interested informant.¹²⁶ Cooperation is an effective enforcement tool because it cuts through volumes of information through which Enforcement staff themselves do not have the resources to wade. The problem is that cooperation cuts through volumes of documents in unverifiable ways. Moreover, the “cut” is generally performed by a party that has a stake in the investigation’s outcome, and that normally has greater financial, human, and information-management resources than any other party. Recall the value-added cooperation the SEC demands under the Framework for Cooperation. Because “cooperation” means not only producing documents and making witnesses available but also assisting the SEC’s understanding of the case, the firm has the ability to

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

¹²⁴*See* William S. Laufer, *Corporate Prosecution, Cooperation, and the Trading of Favors*, 87 IOWA L. REV. 643 (2002); Phyllis Diamond, *Special Report: SEC Demand for ‘Cooperation’ Seen Raising Due Process Concerns*, 36 Sec. Reg. & L. Rep. (BNA) 1070 (June 14, 2004).

¹²⁵*See supra* note 81.

¹²⁶Criminal prosecutors have known this for a long time. *See, e.g.*, Graham Hughes, *Agreements for Cooperation in Criminal Cases*, 45 VAND. L. REV. 1 (1992); Ellen Yaroshesky, *Cooperation with Federal Prosecutors: Experiences of Truth Telling and Embellishment*, 68 FORDHAM L. REV. 917 (1999) (arguing that there are no studies that examine the manner in which cooperators work with prosecutors and the extent to which prosecutors can determine whether cooperators are truthful).

shape and frame the evidence, potentially even before the SEC has developed its own impressions of it.¹²⁷

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

Moreover, to the extent that Enforcement conduct is not transparent, credible, and characterized by due process, it undermines efforts to promote good governance within regulated companies. SEC Administrative Releases shed little light on the nuts and bolts of how firm cooperation contributed to

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

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

¹²⁹See Laufer, *supra* note 124, at 648-650, 659-660.

¹³⁰The powerful effect of prestige-related incentives on prosecutors to bring and resolve cases is one of the points made by James S. Liebman, *The Overproduction of Death*, 100 COLUM. L. REV. 2030, 2078-2101 (2000). According to Liebman, the pressure on law enforcement and prosecutors to “solve the crime and punish the perpetrator, harshly,” combined with the fact that capital murder cases can often be hard to solve because of the absence of certain kinds of key evidence, can lead to cutting corners in investigations.

¹³¹See Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571 (1998) (on the “hindsight bias”); Zivi Kunda, *The Case for Motivated Reasoning*, 108 PSYCHOL. BULL. 480 (1990) (on “motivated inference”).

any particular enforcement outcome. Settlement releases are pre-negotiated between firm and Enforcement, and generally provide only boilerplate language to the effect that the Staff had considered the firm's cooperation in its settlement decision.¹³² Worse yet, Enforcement staff themselves may not be in a position to verify that the firm's cooperation provided anything more than potentially shotgun information implicating individuals.

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

3. Reform Undertakings as Enforcement Innovation

Whether or not by conscious design, recent SEC actions are showing the first indications of a new, or newly rediscovered,¹³⁴ approach to

¹³²See, e.g., *In re* Corpro Companies, Inc., Litigation Release No. 18547 (Jan. 16, 2004), (where injunction issued, but "the Commission considered that Corpro undertook remedial actions and substantial cooperation with Commission staff"), available at <http://www.sec.gov/litigation/litreleases/lr18547.htm>; *In re* Performance Food Group Company, Exchange Act Release No. 49243 (Feb. 13, 2004) ("the Commission considered remedial acts promptly undertaken by PFG and cooperation afforded the Commission staff"), available at <http://www.sec.gov/litigation/admin/34-49243.htm>; *In re* Citigroup, Inc., Exchange Act Release No. 48230 (July 28, 2003) (it was "considered that Citigroup had cooperated with the Commission's investigation in a timely and comprehensive manner, including production of witnesses and documents without delay, responsiveness to other requests for information, and timely efforts to resolve this matter."), available at <http://www.sec.gov/litigation/admin/34-48230.htm>.

¹³³See Laufer, *supra* note 124, at 653, 657. There is some evidence to indicate that the most harmful white collar crimes are those which are most "organizationally complex." See, e.g., DAVID WEISBRUD, STANTON WHEELER ET AL., CRIMES OF THE MIDDLE CLASSES: WHITE-COLLAR OFFENDERS IN THE FEDERAL COURTS 183-85 (1991).

¹³⁴The SEC has employed "creative" relief, including requiring firms to make an undertaking to retain an independent consultant or committee to conduct some kind of review, at least since the 1970s. Comm. on Fed. Reg. of Sec., *Report of the Task Force on SEC Settlements*, 47 BUS. LAW. 1083, 1128-31 (1992); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET, 463-64, 541, 616-19 (3rd ed. 2003); STONE, *supra* note 56, at 185-86. According to

enforcement settlements. This approach responds to worries about facial compliance, scapegoating, institutional capacity, and the limitations of deterrence in effecting thoroughgoing reform to corporate governance. This is the “Reform Undertaking” previously referred to in this paper.

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

Mr. Cutler, they were used especially pre-1984, when the SEC’s statutory power to impose substantial civil penalties was more limited. Cutler, *supra* note 2. Other precedents for interventionist enforcement remedies, outside the public law litigation context, include New York City’s response to organized crime in the late 1980s. See RONALD GOLDSTOCK ET AL., CORRUPTION AND RACKETEERING IN THE NEW YORK CITY CONSTRUCTION INDUSTRY: FINAL REPORT TO GOVERNOR MARIO M. CUOMO FROM THE NEW YORK STATE ORGANIZED CRIME TASK FORCE, 157-74 (1990).

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

¹³⁶See, e.g., Ernst & Young, *supra* note 15. Chief Administrative Law Judge Murray concluded, inter alia, that Ernst & Young’s stated reliance on a “culture of consulting” to avoid violating auditor independence rules was a “sham,” and that its business relationships with PeopleSoft LLP were “outrageous,” “improper,” and “blatant” in their violation of those rules. She noted that the Commission had tried on two previous occasions to bring Ernst & Young into compliance through litigation, and held that absent an explicit directive to cease and desist, the firm would likely commit future violations. Along with other penalties, Judge Murray ordered:

Ernst & Young LLP shall retain an independent consultant acceptable to the Commission, to work with Ernst & Young LLP to assure the Commission that Ernst & Young LLP’s leadership is committed to, and has implemented policies and

and a firm. When part of a settlement agreement, the Reform Undertaking tends to be accompanied by a cease-and-desist order¹³⁷ and by additional relief against either the firm or individuals including disgorgement or restitution, director and officer bars, the requirement that the firm develop or enhance existing compliance processes, and civil penalties. The Reform Undertaking appears as a settlement term to the general effect that the firm shall retain, at its own expense, an independent third party consultant (the “Third Party”). The Third Party’s role is to intervene in the firm, identify compliance failures and reasons for the alleged law violation, and report back to the SEC. While there is substantial variation in Undertakings’ specific terms, and especially in the language describing the scope and depth of the Third Party’s investigation, the Undertakings share certain core features. They include: (1) a focus on the firm, not individuals, with particular view to its compliance and corporate governance policies, practices, and procedures; (2) prospective, standards-based language, giving the Third Parties substantial discretion to interpret what constitutes a “reasonable” or “appropriate” remedial recommendation; (3) a presumptively final settlement with Enforcement, combined with provision for a relatively extended time period during which the Third Party conducts its review, sometimes further reinforced by subsequent periodic review; (4) provision for a written Third Party report; and (5) provisions to safeguard the Third Party’s independence.

In every case I am aware of in which a Reform Undertaking has been put into action, it has fallen short of being a textbook New Governance remedy in both drafting and execution. Part Four, below, sets out a model

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

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

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

Securities Act of 1933 § 8A, 15 U.S.C. § 77h-1(2000); Securities Exchange Act § 21C, 15 U.S.C. § 78u-3 (2000); Investment Company Act of 1940 § 9(f), 15 U.S.C. § 80a-9(f) (2000); Investment Advisors Act of 1940 § 203(k), 15 U.S.C. § 80b-3(k) (2000).

of a more complete “True Reform Undertaking,” as a remedial alternative that incorporates New Governance learning into the distinct Enforcement environment. However, even in its present form the Reform Undertaking represents a profound shift in enforcement philosophy. The first step, I suspect, must have been Enforcement staff’s willingness to address their own institutional limitations in an innovative way. Unlike the credit-for-compliance and credit-for-cooperation models, the Reform Undertaking model accepts that Enforcement itself is ill-suited to promote institutional reform, because it has neither the resources nor the appropriate culture. At the same time, in its best form the Reform Undertaking model provides a mechanism for identifying concrete steps the firm must take to reform its corporate governance as a condition of getting “out from under” Enforcement scrutiny. In other words, the Reform Undertaking parses the liability and remedial phases in dealing with a regulated firm. In its ideal form it uses the enforcement “stick” to spur, but not to define or manage, more profound institutional reform. It employs the concept of best practices, which is a Trojan horse for more thoroughgoing reform. Having committed to that standard, the firm is charged with ratcheting up its governance practices above mere industry standards, to match the best practices available on an ongoing basis. This process, in turns, ratchets up general corporate governance standards.¹³⁸

During his tenure as Northeast Region Associate Director, Barry Rashkover observed that the SEC now frequently defers to independent consultants to tailor specific reforms in the context of court-ordered undertakings.¹³⁹ Reform Undertakings also appear in settlement documents, sometimes jointly reached with other government bodies, such as the United States Attorney’s Office.¹⁴⁰ Perhaps unsurprisingly, the scope of an Undertaking reached through settlement (rather than adjudication) seems to be more broadly worded, and undertakings are becoming more detailed and sophisticated over time. Undertakings appear in settlements with private

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

¹³⁹See Rashkover, *supra* note 3, at 544.

¹⁴⁰These footnotes are not a comprehensive catalog of recent Reform Undertakings. *But see*, e.g., SEC v. Computer Associates International, Inc., Litigation Release No. 18891 (Sept. 22, 2004), available at <http://www.sec.gov/litigation/litreleases/lr18891.htm>. Computer Associates agreed, inter alia, to be subject to “[f]orward looking remedial relief, including, for at least 18 months, that Computer Associates will be subject to the review of an Independent Examiner, reporting to the SEC, the Justice Department and Computer Associates’ Board of Directors.” While New York Attorney General Spitzer has been a large player in recent securities law enforcement actions, to my knowledge his office has not played a role in fashioning the Reform Undertakings I describe here.

companies,¹⁴¹ investment advisors,¹⁴² specialist firms,¹⁴³ and self-regulatory organizations¹⁴⁴ (whose own governance practices have been under scrutiny lately).¹⁴⁵

¹⁴¹See, e.g., *In re* GE InVision, Inc., Exchange Act Release No. 51199 (Feb. 14, 2005), available at <http://www.sec.gov/litigation/admin/34-51199.htm>; *In re* Monsanto Company, Exchange Act Release No. 50978 (Jan. 6, 2005), available at <http://www.sec.gov/litigation/admin/34-50978.htm>; Bristol-Myers Squibb, *supra* note 35. The InVision and Monsanto releases relate to alleged violations of the Foreign Corrupt Practices Act, 15 U.S.C. § 78m et seq. (2004). The only information available online with respect to the scope of the Bristol-Myers Reform Undertaking is that the Third Party is “to review Bristol-Myers’ accounting practices and internal control systems and periodically assess the status of remedial actions undertaken or planned by the Company in those and other areas, such as financial reporting.”

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

¹⁴³Pursuant to its powers under Exchange Act sections 15(b)(4) and 21C, the SEC entered into similar arrangements with five large specialist firms in regard to allegations of “trading ahead” of customer orders. All five cease-and-desist orders were issued on March 30, 2004: *In re* Bear Wagner Specialists LLC, Exchange Act Release No. 49498, available at <http://www.sec.gov/litigation/admin/34-49498.htm>; *In re* Fleet Specialists, Inc., Exchange Act Release No. 49499, available at <http://www.sec.gov/litigation/admin/34-49499.htm>; *In re* LaBranche & Co. LLC, Exchange Act Release No. 49500, available at <http://www.sec.gov/litigation/admin/34-49500.htm>; *In re* Spear, Leeds & Kellogg LLC, Exchange Act Release No. 49501, available at <http://www.sec.gov/litigation/admin/34-49501.htm>; *In re* Van der Moolen Specialists USA, LLC, Exchange Act Release No. 49502,

The Reform Undertaking should be distinguished from centralized, one-off structural reorganization, such as characterized the 2003 Global Research Analyst Settlement.¹⁴⁶ However, as structural remedies and especially in terms of the loss of control the firm experiences, they are similar to what one might see in bankruptcy reorganization.¹⁴⁷ We should expect them to be unpopular with firms, not only for their indeterminacy and cost but because to some degree, the Reform Undertaking moves the loss of

available at <http://www.sec.gov/litigation/admin/34-49502.pdf>. The specialist settlements are similar to the Investment Company Act settlements above.

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

¹⁴⁵Self-Regulatory Organizations – Various Amendments; Proposed Rule, 69 Fed. Reg. 71,126 (Dec. 8, 2004) (to be codified at 17 C.F.R. Parts 240, 242, and 249), available at <http://www.sec.gov/rules/proposed/34-50699.pdf>; Regulation NMS; Proposed Rule, 69 Fed. Reg. 77424 (Dec. 27, 2004) (to be codified at 17 C.F.R. Parts 200, 201, 230, 240, 242, 249, and 270), available at <http://www.sec.gov/rules/proposed/34-50870fr.pdf>.

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

¹⁴⁷*See* Bankruptcy Code § 1106(a)(3), (4), 11 U.S.C. § 1106(a)(3), (4). For an intriguing analysis of the role of the Chief Restructuring Officer, see Douglas G. Baird & Robert K. Rasmussen, *When Good Managers Go Bad: Controlling the Agents of Enterprise* (unpublished manuscript presented at Columbia Law School on March 7, 2005, on file with Columbia Law School Center for Law and Economic Studies).

control further up in a dismal chronology of events.¹⁴⁸ On the other hand, behavioral psychology has taught us that people tend to overly discount the future in their calculations.¹⁴⁹ Thus, when one recalls that a large number of the firms publicly accused of massive frauds over the last few years have ended up in bankruptcy proceedings, the Reform Undertaking looks like a sensible intervention before the costs to all involved get even higher.

Comparative Advantages

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

To begin with, the Reform Undertaking handles the resource problem facing Enforcement. It is the thoughtful result of squarely facing the misfit between Enforcement's processes and its aspirations of spurring institutional reform. As discussed above, Enforcement will never be as well equipped to analyze detailed information on compliance structures as the settling firm itself would be. The Reform Undertaking does not require Enforcement staff to act as long term regulators or compliance specialists. It allows Enforcement teams to remain temporary, flexible, and non-bureaucratic. It matches tools to problems, rather than trying to shoehorn problems into existing tools.¹⁵⁰

Secondly, as a function of distinguishing the liability phase from the remedial phase,¹⁵¹ the Reform Undertaking substantially neutralizes the counterproductive elements of the adversarial stance. There will be little trust between Enforcement and firms that are being investigated. Firms often behave in a strategic end-game manner in that environment. It is a high stakes situation that promotes evasive, not collaborative, action. The Reform Undertaking relieves some of the immediate pressure by taking the full articulation of a remedy out of the hands of Enforcement staff, and putting it in the hands of an independent Third Party. Removing the Enforcement stick from direct view can create a space where the firm is free, at least in relative terms, to think about compliance creatively and autonomously, based on voluntary problem solving instead of rule-based

¹⁴⁸In Ernst & Young, *supra* note 15, the defendant firm argued that the requirement that it retain an independent third party consultant was an "outrageous" and punitive measure.

¹⁴⁹BAZERMAN & WATKINS, *supra* note 13, at 84-87.

¹⁵⁰This is not to say that there will not still be work for Enforcement to do in, e.g., choosing along which criteria firms should be subject to Reform Undertakings. See SPARROW, *supra* note 75, at 155-70. Nevertheless, these are not the same issues that arise from being confronted with impossible information volumes in an Enforcement division entirely structurally unsuited to handling it.

¹⁵¹Sabel & Simon, *supra* note 62, at 1051-57.

enforcement.¹⁵² Because it comes from the firm itself (in conjunction with Third Party action) and is not imposed from above, this method has a better chance of producing a sustainable and meaningful response. Relatedly, the Reform Undertaking reduces the pathologies associated with the short term orientation. A resolution that is substantially satisfactory to the market is achieved when settlement occurs, relieving pressure on Enforcement to resolve the matter through whatever means necessary, but the parties have a longer remedial timeframe within which to work out the details based on better information and contextual analysis.¹⁵³

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

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

¹⁵²Making the same point in a different context, see Sturm, *supra* note 63; Susan P. Sturm, *New Governance and the Architecture of Learning, Mobilization, and Accountability: Lessons from Gender Equity Regimes*, in *NEW GOVERNANCE AND CONSTITUTIONALISM*, *supra* note 81 (manuscript at 7-8, on file with author).

¹⁵³Reform Undertaking terms generally require third parties to produce a first report within 60 days of being retained, but their involvement with the firm tends to be longer: e.g., in Monsanto, *supra* note 141, the Third Party is retained for three years.

¹⁵⁴See Ernst & Young, *supra* note 15; and Chicago Stock Exchange, *supra* note 144 (discussing the existence of policies and procedures that can reasonably remedy violations).

Undertaking described in greater detail below does not raise the sorts of obvious due process concerns that credit-for-cooperation raises. It avoids both agency capture and backroom horse-trading, as Ayres and Braithwaite suggest the injection of a third party is likely to do.¹⁵⁵ This is important at the broader level as well. If other firms understand that they cannot “buy” their way out of Enforcement action through cooperation, and that Enforcement actions are credible, proportional, and factually justified, this shortcut to resolution-without-reform will be closed off. By removing from Enforcement’s hands the ability to reward companies, it neutralizes the fact that the firm’s and Enforcement’s short term interests in closure and even scapegoating may be aligned. Transparency produces accountability, and transparent Enforcement processes are more likely to create market structures more demonstrably worthy of investors’ confidence.

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

¹⁵⁵On “regulatory tripartism,” see AYRES & BRAITHWAITE, *supra* note 21, at 56-58.

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

¹⁵⁷An important predecessor—successful on its merits, though short-lived for separate legal reasons—was OSHA’s “Cooperative Compliance Program,” (CCP) created in 1997 and directed specifically at workplaces with the highest injury rates. The program was modeled on the award-winning “Maine 200” program, begun in 1993, which targeted the 200 companies in that state with the highest workers’ compensation rates (i.e., Maine’s worst actors). Companies opting into the program would establish a health and safety program in cooperation with OSHA, and in exchange would be dropped from OSHA’s regular inspection program. High-injury workplaces not opting into the program would be the subject of heightened inspections. In Maine, 65% of participating employers saw reductions in overall injury and illness rates, and over the first two years participating employers experienced a 47.3% decrease in compensable claims for worker’s compensation (as compared to 27% for all Maine employers). U.S. Food & Drug Administration, *Mini Case Study: “Maine Top 200” —OSHA Shifts its Focus From Regulations To Outcomes* (2000), at <http://www.fda.gov/cdrh/leveraging/03c.html>. The CPP’s underlying directive was vacated by the District of Columbia Circuit on the basis that OSHA’s issuance of its directive failed to comply with the notice-and-comment requirements of the Administrative Procedure Act. *Chamber of Commerce v. U.S. Department of Labor*, 174 F.3d 206, 213 (C.A.D.C. 1999). Since then, OSHA has reverted to rewarding good firms rather than educating/reforming the worst performers: information on its Voluntary Protection Program (VPP) is available at <http://www.osha.gov/dcsp/vpp/index.html>. As a case-specific remedial enforcement mechanism, the Reform Undertaking is not vulnerable to the same charge.

firms reinforces the system's credibility down the line. The marginal effect of change is also greater when dealing with the worst actors, which cause disproportionate damage. A focus on the worst actors provides a necessary counterweight to regulators' tendency to focus on the best performers, which may be celebrated because they reinforce the wisdom of the agency's policies.

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

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

¹⁵⁸Simon, *supra* note 81 at 25-28; Sabel & Simon, *supra* note 62, at 1054. *Contra, see* Dallas, *supra* note 13, at 6-8 (arguing in favor of individual Director and Officer liability for failure to address the existence of a "corporate climate that encourages and supports unethical and illegal behavior" in a firm).

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

4. Next Steps and Missing Pieces

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

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

The Intervention: Attributes of the Process

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

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

¹⁶¹Susan Sturm's work on addressing subtle cultural problems in complex social environments, such as workplaces, develops fine-grained insights into the specific challenges

point should be to leverage the organization's own internal vocabulary and norms to reorient the firm's perspectives on governance. No one said this would be easy in practice. On the contrary, there is no lack of empirical evidence suggesting that the reasons that organizations so often behave in myopic, rigid ways are deep-seated and not amenable to easy change.¹⁶²

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

of such projects and substantially informs the discussion that follows. *See, e.g.,* Sturm, *supra* note 62; Sturm, *supra* note 63; Sturm, *supra* note 152.

¹⁶²*See, e.g.,* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997), Sturm, *supra* note 63, at 468-79.

¹⁶³*See, e.g.,* John E. Tropman, MAKING MEETINGS WORK, 2D ED. (2003). The Harvard Law School Project on Negotiation maintains a resource clearinghouse on its website at <http://www.pon.harvard.edu/main/home/index.php3>.

¹⁶⁴All the Reform Undertakings identified *supra*, in Part 3, require the Third Party to produce a written report, and require that it be provided to the Commission.

¹⁶⁵*See* Sturm, *supra* note 62, at 1399-1403, 1411, 1434-36. There is more than one sort of reasoned decisionmaking. *See, e.g.,* Simon, *supra* note 81, at 19-22 (describing "root cause analysis").

¹⁶⁶Which outsiders should have access to the report is a difficult question. Limiting participation does limit debate and collective learning, and the results of the Undertaking would be of quite general interest. Nevertheless, I say that only the SEC and other Third Parties (either directly or through the SEC) should have access to the full reports, because of the extraordinary cost and chilling effect of making the specifics discoverable in shareholder or other litigation. Similar concerns have been raised with regard to the Organizational Sentencing Guidelines. *See* United States Sentencing Commission, *Report*, *supra* note 95, at 116-25. Existing Reform Undertakings make no provision for public dissemination of Third Party reports.

Just as importantly, the process should be explicitly participatory. One might contrast a True Reform Undertaking with the WorldCom model, in which a central expert—albeit a very capable one—acted essentially alone to produce a series of guidelines to be implemented by the firm.¹⁶⁷ Mr. Breeden’s report is a sophisticated and thoughtful blueprint for revising corporate governance structures at WorldCom and beyond, but it was written with that high level purpose in mind—not with a view to creating a reflexive process within the firm. If the purpose is to spur thoroughgoing institutional reform, then a Third Party’s top-down solutions will not be a substitute for the firm’s own involvement. Imposed solutions are less likely to embed themselves, and a failure to come to terms with the organization’s collective history can create pathologies around information sharing and problem solving. As Mr. Cutler has said, law-abiding behavior is a product not only of structural governance mechanisms, but of all “three Ps”: people, process, and place (meaning external variables and causative factors).¹⁶⁸

Broad participation serves several purposes in this context. Its advantages over nonparticipatory processes are considerable. First, it increases the pool of information and contextual knowledge, thereby improving the discovery process. By contrast, the WorldCom model reflects a closed system, where a snapshot of information enters after which a one-time report from an outsider ensues.¹⁶⁹ Second, participation creates buy-in. It gives key players a basis for investing in the process and committing to its results. Third, participatory exercises are exercises in governance. They serve an educative function and actively demonstrate new ways of doing business, ideally while learning to speak realistically about those areas where firm culture or collective action played a role in permitting past wrongdoing.¹⁷⁰ By contrast, the expert-centric WorldCom

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

¹⁶⁸Cutler, Speech, Dec. 6, 2004, *supra* note 60. See also Diane Vaughan, Rational Choice, Situated Action, and the Social Control of Organizations, 32 LAW & SOC’Y REV. 23 (using a case study to illustrate that “a fully elaborated explanation of decisionmaking necessarily would merge structure, culture, and agency.”)

¹⁶⁹Cognitive psychological insights into experts’ tendencies toward overconfidence and “expert myopia” are also relevant here. See Rachlinski & Farina, *supra* note 105, at 558-61. See also Sturm, *supra* note 62, at 1419-21 (on limitations of “expert remedial formulation model”).

¹⁷⁰In a similar vein, see Sturm, *supra* note 62, at 1390-96. Sturm also argues that at the remedial stage, the conceptual restrictions imposed by legal doctrine during the liability phase are more limited. Thus, what keeps the process rational and legitimate is a different

model leaves little room for the firm to do its own learning during the Undertaking time frame, and the guidelines are not revisable through ongoing learning thereafter. Finally, in view of the “insiders’ culture” that underlies many securities law violations, broad top-to-bottom participation makes the process credible to enforcers, and to lower and mid-level firm employees.

The Third Party’s operational methodology should focus on problem solving, not just compliance. Relative to compliance, problem solving requires that a broader and more diverse set of actors be involved, across a longer timeline, using a different set of information-gathering and decisionmaking mechanisms.¹⁷¹ Success is measured not by adherence to a rigid checklist, but by whether the firm’s institutional capacity to identify, prevent, and redress wrongdoing is improved, and sustainably so. This is not to say that facially compliant or otherwise unsatisfactory accommodations will never be reached. However, they stand a better chance of being identified, scrutinized by reference to important governance values, and addressed through the True Reform Undertaking process.

Correlatively, the process should be flexible. It should be capable of learning from its (carefully documented) successes and failures, and adjusting accordingly. The Third Party should be willing to be creative about the means used to address firm pathologies, avoiding a priori preferences for particular approaches. The Third Party should take an incrementalist approach, breaking the problem into manageable pieces and tackling each one based on its specific attributes.¹⁷²

The firm’s general governance standards, then, are realized and reinforced by the firm’s own careful, unique experience with the True Reform Undertaking process itself.¹⁷³ This is no small point. Through this

discipline imposed by participation. Participation also realigns party interests, making possible agreements along unexpected lines. See Sturm, *The Promise of Participation*, 78 IOWA L. REV. 981, 1006 (1992).

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

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

¹⁷³Sturm, *supra* note 63, at 475 (“General rules, unless linked to local structures for their elaboration in context, provide inadequate direction to shape behavior”). The nexus between broad compliance standards and specific governance and accountability mechanisms, combined with the presence of a centralized clearinghouse to evaluate individual firms’

sort of participatory work, the True Reform Undertaking grows connections between the firm's own operations and problem solving practices, and broad and vague governance and compliance standards, in a way that has nothing to do with facial adherence to externally-imposed, rigid rules.¹⁷⁴ Overly-defined rules are never more than a proxy for more general standards; but overly-vague standards are only made real through their situational learning and careful testing in practice. Unlike traditional settlement arrangements, the True Reform Undertaking can make situational learning an integral part of Enforcement action.

Profile of the Third Party

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

My purpose here is only to sketch out the broad outlines of the Third Party's profile, to demonstrate the idea's applicability to securities law

success, provide the missing components to Krawiec's description of "network governance." See Krawiec, *supra* note 118 (arguing that open standards-based regulations create incomplete contracts within which parties can engage in strategic gap-filling).

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

¹⁷⁵The worry brings to mind recent suggestions that so-called "independent" research analysts, whose industry was given an enormous boost by the terms of the 2003 Global Research Analyst Settlement, may also have conflicts of interest. Ann Davis and Susanne Craig, *Analyze This: Research is Fuzzier than Ever*, WALL ST. J., Apr. 26, 2004, at C1.

enforcement.¹⁷⁶ The problem is not a simple one, and the next step must be to identify the attributes that prove to be most important in actual securities law enforcement practice. But to be effective, the Third Party will surely need four key attributes: credibility, independence, the right skill set, and accountability.

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

Second, the Third Party will have to be independent from the firm. This comprises both structural and psychological elements. Structural independence means that the Third Party should not be operating with a view to obtaining future business by currying the firm's favor.¹⁷⁹ The Third

¹⁷⁶For a compatible and more comprehensive description of the roles of various problem solvers in addressing systemic problems, see Sturm, *supra* note 63, at 522-37.

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

¹⁷⁸See Sturm, *supra* note 152, at 35-40 (describing the role of mediating actors in gender equity regimes).

¹⁷⁹Most Reform Undertaking provisions restrict the Third Party's ability to do business with the firm for a period of time after the Undertaking period is concluded. See, e.g., GE InVision, *supra* note 141; Monsanto, *supra* note 141; the Investment Advisor Act Undertakings, *supra* note 142 (requiring the Third Party to agree that for the duration of its retainer and for two years thereafter, neither it nor, subject to the Commission's consent, any firm with which it is affiliated shall "enter into any employment, consultant, attorney-client,

Party should also be able to rely on outside support, from the Commission, in the event of non-compliance. The firm itself must recognize that it cannot exit. It must know that facial compliance, “freezing out” the Third Party, or other dysfunctional behavior has a good chance of being spotted and will result in the direct reapplication of the SEC’s enforcement “stick”.¹⁸⁰ At the psychological level, the Third Party must have the courage to publicly repudiate the process, or report to the Commission, if she concludes that it is failing irredeemably.¹⁸¹ Here, Judge Rakoff’s approach in the WorldCom settlement was to engage an individual whose own considerable reputational capital served as a buttress against the firm pressures.¹⁸²

auditing or other professional relationship with InVision, its successor-in-interest . . . or any . . . present or former affiliates, directors, officers, employees, or agents acting in their capacity”). Existing Reform Undertakings also stipulate that the firm shall not have the ability to terminate the Third Party, and must cooperate with her investigation.

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

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

¹⁸²See Breeden, *supra* note 20.

Third, the Third Party will have to have a considerable range of skills, and a level of acceptability to all parties without being beholden to any. (The Third Party can and perhaps should be a team, not one individual.) The Third Party will have to have the ability to connect and facilitate dialogue across the firm hierarchy, and to manage large volumes of viva voce and paper or electronic information. She and her team will need a strong knowledge base in compliance and corporate governance principles, including issues of organizational structure and experience with culture. The ideal Third Party may or may not be a lawyer.¹⁸³ At the same time, she will have to be justice-regarding and able to take into account the power imbalances between, for example, management and the individuals that “followed orders” during the era of the law violations. The Third Party must be alive to the possibility that the firm’s directing minds may be tempted to scapegoat individuals. A “justice audit” should be part of the process. The Third Party, like the firm, is a potential abuser of individual due process rights.¹⁸⁴ Faced with the hurdles of trying to create change, the parties, Third Party included, could be tempted to satisfice for superficial compliance or less thorough reforms. The Third Party may also be tempted by over-rigid resolutions in situations where any progress, however superficial, seems better than deadlock.

For all these reasons, the Third Party must be accountable to the SEC. Her ultimate report should speak not only to recommendations for firm change, but also to the Third Party’s own methodology and independence. The Third Party cannot be the final arbiter of the success of her own recommendations.¹⁸⁵ There must be a mechanism to ensure that the

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

¹⁸⁴This is a topic for another paper, but one must recognize the serious resource inequalities between the firm, the individual, and the Third Party that will exist in the Reform Undertaking process. Richard Stewart has suggested that in the twenty-first century, new forms of administrative law will be developed to address the distinctive issues presented by the new network and economic incentive methods of regulation Formal legal procedures, backed by judicial review, will be targeted toward protecting private rights from particularized applications of regulatory power, although there may be renewed scope for tort law as well.

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

¹⁸⁵*See cf.* Sturm, *supra* note 62, at 1413 (arguing, in the context of courts, that such a dual role creates an appearance of unfairness, and prevents a full articulation of the normative

same satisficing that characterizes the pre-settlement Enforcement process does not characterize the True Reform Undertaking process. There should be no attorney-client privilege between firm and Third Party, since this promotes information hoarding and prevents comparative learning.¹⁸⁶ The Third Party's report should speak not only to areas where there was considerable success, but also to those inevitable areas where compromises were reached, or roadblocks were encountered. The information should be capable of being aggregated—it should be set out in a sufficiently organized form that others can learn from it, and the Commission can compare one result to another. At the same time, conscious attention should go to ensuring that there does not emerge a reporting “orthodoxy” that causes different firms to reach the same conclusions, not independently because they are good ideas, but rather through mimicry with a view to satisfying the Commission in the least intensive way. Third Parties are not expected to reinvent the wheel—quite the contrary—but they should be prepared to demonstrate that they have given independent thought to the particular place, processes, and people before them.

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

The Need for a Center

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

Thus, the True Reform Undertaking approach should be reinforced by the active presence of a centralized data clearinghouse: i.e., an information-gathering and learning structure that aggregates information on

reasons underlying the adoption of a particular remedy). In this respect, the fact that little public information has emerged on the SEC's response to Third Parties' final reports is worrying.

¹⁸⁶Appropriately, the more recent Reform Undertakings stipulate that there shall be no attorney-client relationship between firm and Third Party. *See, e.g., supra* notes 142, 143.

the progress being made in these worst cases.¹⁸⁷ Progress should be measured by reference to high-level impacts and outcomes, not just outputs.¹⁸⁸ The clearinghouse function also serves a social signaling purpose. Deterrence, on its own, sends a message of seriousness about corporate wrongdoing. However, having a clearinghouse that can evaluate success in changing corporate culture sends a much deeper message of seriousness, and makes it clear that facial compliance or other mechanisms for short-circuiting the change process will not be tolerated.

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

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

¹⁸⁸See WILSON, *supra* note 83, at 161-62. This is not to say that identifying convincing outcome indicators for intangibles like the “culture of compliance” will be easy. Tracking high-level impacts and outcomes is notoriously difficult, though not impossible. See SPARROW, *supra* note 75, at 109-22, 281-92 (giving real-world examples of agencies’ frustrations in attempting to make such measurements, and suggesting a strategy to solve problems). On the other hand, the difficulty of measuring such concepts does not change the fact that they are, in fact, the outcomes that need to be measured to determine a program’s success. Nor is the problem unique to the Reform Undertaking situation.

¹⁸⁹Because of its situation within the enforcement context, there will never be as much room in my model for parties’ own articulation of novel governance standards as there is in the most wide-ranging versions of experimentalism. See, e.g., Dorf & Sabel, *supra* note 64, at 404-07. Settling firms must be able to revise what constitutes “good governance,” and to

Crucially, a best practices regime (or “rolling best practices rulemaking”) forces better learning by firms. Without conscious, outcome-based analysis, institutional responses to the coercive Undertaking mechanism may produce imitative isomorphism between firms, based not on that firm’s internal investigation and considered response but rather on mimicry of other previously-approved compliance programs.¹⁹⁰ Because the relationship between rule and response is reciprocal, industry practices in Reform Undertakings can become the basis of enforced legal norms for subsequent firms for no better reason than that others have used them.¹⁹¹ The risk of “missing the mark” with any particular firm (and consequently, the risk of recidivism) increases to the extent that the received wisdom on how to navigate through the Reform Undertaking process, perhaps based on replicated industry standards and imperfect information about how a specific firm operates, misaligns the Undertaking response with root causes of wrongdoing. Institutional learning by regulators is curtailed, and regulatory thinking is constrained. By contrast, best practices standards are a continually evolving standard, which limits the parties’ ability to satisfice for facial compliance.¹⁹²

The SEC’s new Office of Risk Management, established in 2004, is the place for the clearinghouse function. Its staff is tasked with gathering and maintaining data on new trends and risks from a variety of sources, such as external experts, domestic and foreign agencies, surveys, focus groups, and other market data, including both buy-side and sell-side research. The Office of Risk Management also analyzes data to identify and assess new areas of concern across professions, companies, industries, and markets; and preparing assessments and forecasts on the agency’s risk environment.¹⁹³

make a case for trying out novel compliance mechanisms, but their proposals would have to meet the approval of the SEC so long as they were operating within the Reform Undertaking timeline. They would have to make their case quite compellingly, given their limited credibility in Enforcement eyes.

¹⁹⁰DiMaggio & Powell, *supra* note 55, at 66-67, 69-70.

¹⁹¹*See, e.g.,* Lauren Edelman, *Legal Environments and Organizational Governance: The Expansion of Due Process in the Workplace*, 95 AM. J. SOC. 1401 (1990) (arguing that industry elaborations on broad equal protection requirements become the basis for court-defined “industry standards,” constituting the statutory mandate for subsequent industry actors).

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

¹⁹³*See* William H. Donaldson, Testimony Concerning Regulatory Reforms To Protect Our Nation’s Mutual Fund Investors Before the Senate Committee on Banking, Housing and Urban Affairs (Nov. 18, 2003), at <http://www.sec.gov/news/testimony/ts111803whd.htm> (canvassing the components of the new “risk management initiative”). This discussion is also compatible with the SEC’s latest Strategic Plan, which focuses more explicitly on risk

The Office is an overarching body, not situated within Enforcement.¹⁹⁴ It is structured around “internal risk teams in a ‘bottom-up’ approach for each major program area.” The Office will coordinate those teams with a view to anticipation and early identification of potential problem areas, or illegal or questionable activities, across the securities industry.¹⁹⁵ The work of the Office of Risk Assessment is complemented by a Risk Management Committee, whose primary responsibility is to review the implications of identified risks and recommend an appropriate course of action.¹⁹⁶ The key challenge, as the risk management function defines itself, will be for it to actively develop rolling best practices rules as a basis for forcing accountability within the True Reform Undertaking process.

Ramifying Back to the Enforcer

As Jim Liebman observed in a different context, no one chose to create a prosecutorial system that seemingly rewards horse-trading and scapegoating, facial but meaningless compliance structures, and insensitivity to prosecutors’ inability to handle the massive volume of information they face.¹⁹⁷ In identifying the prospect of spurring institutional reform of firm

assessment and data analysis, and the quality of internal agency functioning, than any plan to date. According to the Plan, the information coming from the risk assessment process will also be used to make the SEC’s enforcement pyramid more informed and rational in its resource allocation:

[s]uch risk assessment techniques also will help the SEC focus its examination and disclosure review programs. In identifying firms and filings to examine, the Commission is shifting away from a “one size fits all” review cycle to new risk-based approaches that direct resources toward those firms, issuers, filings, or industries that most warrant review.

SEC 2004-09 Strategic Plan, *supra* note 87, at 25.

¹⁹⁴The clearinghouse should not be too closely tied to Enforcement. The SEC must be in a position to pronounce the success or failure of each Reform Undertaking, but involving Enforcement in data-gathering reintroduces inefficiencies. It also raises the risk that Enforcement will assume command-and-control style management of the processes, or will be unduly influenced by its own self interest in seeing the Reform Undertaking method work relative to other non-Enforcement initiatives.

¹⁹⁵See Press Release, SEC, Charles Fishkin Named Director of SEC’s New Office of Risk Assessment (July 1, 2004), available at <http://www.sec.gov/news/press/2004-92.htm> (describing the recently formed Office of Risk Assessment as responsible for managing and “coordinating risk assessment activities across the agency”).

¹⁹⁶See Donaldson, *supra* note 193.

¹⁹⁷See Liebman, *supra* note 130, at 2155-56. See also William J. Stuntz, *The Pathological Politics of Criminal Law*, 100 MICH. L. REV. 505, 523 (2001) (arguing that criminal law-as-written differs substantially from criminal law-as-enforced as a result of incentives for and politics between legislators, prosecutors, and judges, and warning that “the law’s messages are likely to be buried, swamped by local variation and hard-to-discern arrest patterns, by low-visibility guilty pleas and even lower-visibility decisions to decline prosecution”). MICHAEL LEVI, REGULATING FRAUD: WHITE-COLLAR CRIME AND THE CRIMINAL PROCESS (1987) (arguing that white collar criminal law and law enforcement in the United Kingdom is more the product of sporadic and irrational political forces than rational planning).

culture, and in recognizing its own institutional limitations in achieving that goal, SEC Enforcement may have succeeded above all in charting a path toward its own reform. Recent scandals across financial sectors, followed by Enforcement scrambling to demonstrate its own continued relevance to problems of culture, has brought the clear incapacity of Enforcement's processes into sharp relief and suggested new reformative possibilities. Seen this way, the SEC may only now be catching up with innovations in enforcement at other administrative agencies, where the utter failure of the command-and-control administrative model (not an issue in the disclosure-based securities regulation context) began to force change more than a decade ago.¹⁹⁸

Enforcement behavior, like prosecutorial behavior more generally, is a product of its own structure and processes, and that structure will create its own context-specific effects.¹⁹⁹ What an employer measures and rewards will have an effect on outcomes and employee behavior. Thus, Enforcement staff should be trained to identify key elements of a forward-looking, transparent, and accountable remedial scheme, to be distinguished from resolutions that achieve case closure at the expense of other values, including due process to individuals or broader corporate citizenship norms. Individual Enforcement staff should be rewarded to the extent that their own decisions are demonstrably as information-based and systemically justified

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

¹⁹⁹See Daniel Richman, Prosecutors and their Agents, Agents and their Prosecutors, 103 COLUM. L. REV. 749, 758-87 (2003) (pointing out that structural and administrative factors influence the exercise of prosecutorial discretion). The SEC's latest Strategic Plan is striking for its use of risk-analytical and outcome-oriented methods, especially by comparison to prior Strategic Plan documents. Compare SEC 2004-09 Strategic Plan, *supra* note 87, with SEC, 1999 Annual Performance Report/2001 Annual Performance Plan (February 2000), at <http://www.sec.gov/about/gpra1999-2000.shtml>. The earlier SEC document, although it outlines six “preliminary” high level outcomes, describes 1999 Performance almost entirely in terms of outputs (number of enforcement actions brought, number of financial statements reviewed, number of SRO rules reviewed, etc.), and does not take an overarching risk analysis approach.

as the good governance requirements they impose on firms.²⁰⁰ The same standards of credibility and transparency that characterize the True Reform Undertaking process should characterize problem solving at Enforcement.

Actually, reworking Enforcement staff incentives to reward transparency and demonstrably reasoned decision-making is the easy part. The larger challenge for Enforcement will be to imagine a global approach to securities law enforcement that remains healthily skeptical, liability-conscious and closure-permitting, yet shows greater responsiveness to the strictures under which real-world enforcement operates, and the magnitude of the challenge of spurring widespread institutional reform. New Governance theory offers a theoretical structure for making sense of the Reform Undertaking in both normative and efficiency-based terms. In return, the creative action of enforcement personnel in practice is a reminder to New Governance theorists not to underestimate either the necessity or the creative potential of the enforcement role.



Enforcement has its own purpose. It is not a court, a corporate governance consultant, or a rulemaking administrative body. This is not to say that, to the extent that Enforcement action can spur long term changes in firm behavior, we should fetishize the distinction between regulation and enforcement.²⁰¹ The challenge in regulation is to identify how each actor can leverage its unique qualities of place and purpose to permit learning and wise, context-specific, impact-aware problem solving. It requires the actor in question to understand the purposes it is trying to achieve, and to learn from its own experience.

²⁰⁰The SEC's latest Strategic Plan emphasizes the need to "sustain and improve organizational excellence." The Plan announces a new continuing education program, new performance measurement systems, and a new Pay for Performance system for individual employees. SEC 2004-09 Strategic Plan, *supra* note 87, at 26-27. The SEC should include credit for innovative solutions that circumvent organizational limitations in performance metrics. See also SPARROW, *supra* note 75, at 168 (recommending rewards for employees' successful problem solving efforts).

²⁰¹Consider Mr. Cutler's recent comments:

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

Stephen M. Cutler, Remarks, After The Sarbanes-Oxley Act: The Future of The Mandatory Disclosure System (Feb. 21, 2003), *in* 81 WASH. U. L. Q. 545, 552 (2003).

5. Toward a New Enforcement Model

Forward-looking, reform-oriented regulatory structures can and do function within traditional Enforcement structures. Understanding this hybridity requires some elaboration. Three points seem especially relevant.²⁰² First, one would not want to lose, through a novel enforcement approach, Enforcement’s unique structural advantages. Certain elements of the enforcement model—primarily the reliance on temporary, task-specific teams and context-specific remedies—give enforcers an edge over other regulators in devising good responses to problems among public companies and regulated entities. Second, one must be prepared to imagine that a flexible, learning-by-doing structure can exist embedded within a more traditional adversarial one. Finally, the advantages of nesting New Governance experimentation within coercion can be significant, because it allows Enforcement staff to rely on the full range of behavior-modifying mechanisms, from shaming through information-forcing experimentalist remedies.

Structural Advantages

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

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

Second, compared to mainstream regulators, enforcement teams are flexible and *temporary*. Law and practice have allowed them to operate relatively free of bureaucratic process obligations, and they are more likely to be immune to bureaucratic sclerosis: i.e., the accretive process and personnel commitments that make quick response capability difficult to

²⁰²My focus is on the Reform Undertaking as straddling device between New Governance and traditional enforcement models. Many other important elements of building a new enforcement model are beyond this paper’s scope—how Enforcement ought to nominate and select firms for Reform Undertakings, and how Enforcement should allocate resources to individual projects. *See generally* SPARROW, *supra* note 75, at 155-70 (describing components of a “problem solving infrastructure”).

maintain over time.²⁰³ Enforcement managers can choose the right people, internal and external, for the job at hand. They can disband the teams when the job is complete, and they can have a new team coalesce for the next round without fear of flouting internal agency protocols. To some degree, shifting team composition can prevent ingrained distrust from building up between parties, even where the temporary team members continue to come from a pool of Enforcement staff. Because of their one-case-at-a-time orientation, the remedies that temporary teams develop (staffers and firms in drafting Reform Undertaking terms, and Third Parties and firms in effectuating them) can be tailored to the facts at hand. Enforcement can experiment with multiple possible solutions at once, across short timelines, and try to force very discrete kinds of action in the hope of catalyzing a broader compliance cascade.

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

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

²⁰³ See Stewart, *supra* note 74, at 440-42, 446-48 (describing events resulting in regulatory process “fatigue” in recent decades).

Embedding New Governance

The conflict between firm welfare and investor protection is a mixed-motive situation.²⁰⁴ That is, over the long term, SEC Enforcement's interests and the firm's interests are neither purely cooperative nor purely competitive. By pulling the reformatory project away from the liability-oriented one, the Reform Undertaking creates a space within which the parties can transcend adversarial win/lose dichotomies and concentrate on specific, achievable steps that can serve both long term investor protection and long term firm flourishing. The Reform Undertaking, as introduced by SEC Enforcement, represents a significant new approach to securities law enforcement. It contradicts the stereotype of enforcement personnel as stuck in an outmoded, adversarial, almost actively anti-reformatory posture.²⁰⁵

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

²⁰⁴See generally RICHARD WALTON & ROBERT MCKERSIE, A BEHAVIORAL THEORY OF LABOR NEGOTIATIONS: AN ANALYSIS OF A SOCIAL INTERACTION SYSTEM (1965) (interpreting practices in labor-management negotiations in light of behavioral theory).

²⁰⁵See *supra* note 79. This is even more the case when speaking of criminal prosecutors' similar innovations. See *supra* notes 6, 11.

²⁰⁶It is a harder project to ramify the learning all the way back to Congress, which also promulgates broad prophylactic requirements.

be the outcome-oriented and industry-focused, decentralized leadership of Chairman Cox.²⁰⁷

The Reform Undertaking also serves as an optimistic counterexample to those who worry that adversarialism and entrenched interests inevitably consume or undermine fragile experimentalist processes.²⁰⁸ Relative to situations lower on the enforcement pyramid, enforcement is the least hospitable environment for New Governance solutions. Mutual trust between the parties is substantially lacking. Past efforts at voluntary compliance with law have demonstrably failed. The primary actors in this scenario—Enforcement staff on one hand, and firm on the other—are operating in a high-stakes, adversarial, potentially punitive environment. This is not a benign “laboratory for democracy,” and one party is in a position to impose sanctions on the other.²⁰⁹ Costs are clear, and high. Nevertheless, Enforcement staff, on its own initiative and operating in its adversarial stance, has sketched out a structure that gives the worst actors in its regulated universe an opportunity to transcend that acute adversarial situation, through a reformist experiment.

Remedial Agnosticism

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

²⁰⁷ One set of observers has commented on the striking way in which the current presidential administration, through its emphasis on decentralization and accountability in government programs, may have put into motion an unexpectedly vast re-evaluation of public responses to systemic problems, far beyond those programs’ intended mandate. They argue that, despite its many deficiencies, this may be the case with the No Child Left Behind Act in education. See James S. Liebman & Charles F. Sabel, *The Federal No Child Left Behind Act and the Post-Desegregation Civil Rights Agenda*, 81 N.C. L. REV. 1703 (2003).

²⁰⁸ See MARK TUSHNET, THE NEW CONSTITUTIONAL ORDER 168-72 (2003) (urging caution against, but nonetheless advocating, “democratic experimentalism” because of its nascent status, its unknown outcomes, and its questionable effectiveness); Tushnet, New Institutional Structures of Governance and American Political Development, in NEW GOVERNANCE AND CONSTITUTIONALISM, *supra* note 81 (manuscript at 18-20, on file with author) (observing that traditional national interest groups, such as teachers’ unions, may obstruct experimentalist programs).

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

²¹⁰ See Joshua Cohen & Charles Sabel, *Directly Deliberative Polyarchy*, 3 EUR. L. J. 313 (1997); Dorf & Sabel, *supra* note 64, at 336-39, 348-51.

I share the conviction that New Governance-style participatory problem solving processes are a most promising mechanism for spurring institutional reform. This does not mean that one should hope for a deeply effective process to emerge spontaneously. While New Governance puts actor agency at the core of its program, it is not a voluntary compliance model. Most New Governance theorists would agree that in the regulatory context, a coercive “stick” is essential to making an enforcement pyramid function.²¹¹ Significantly, this is a stick of a different kind than that presented by the fear of massive one-time monetary sanctions. It is information-forcing and participation-forcing over a longer period of time relative to a traditional enforcement action, and is directed at stimulating the kind of bottom-up change that is more likely to be sustained and self-reinforcing. When dealing with actors that require a “nudge” in the right direction, New Governance regulation (here, in the person of the Third Party) steps up inspections and sets comparative benchmarks to challenge the firm to face and respond to its own deficiencies in processes and outcomes.²¹² Firms can be expected to want less regulatory interference in their daily operations. Thus, in situations where something like an experimental system is up and running, one can theoretically give firms incentives to improve by stipulating that good behavior (in the form of demonstrated good practices and internal learning) leads to greater autonomy, and bad behavior leads to greater scrutiny. One may anticipate a cascade effect as a critical mass of firms in a particular industry begin to observe good practices, to share information, and to put in place mechanisms that allow them to self-reflect.

This paper’s concern is for what happens when the necessary mindset has not emerged and shows no signs of emerging among certain industry actors. In other words, the question is what happens when, even if the need to do something seems clear and urgent to outsiders or to some of the parties involved, other key parties are resistant and even hostile to

²¹¹See AYRES & BRAITHWAITE, *supra* note 21, at 35-41; John Braithwaite, *Institutionalizing Distrust, Enculturating Trust*, in TRUST AND GOVERNANCE 343, 356 (Valerie A. Braithwaite et al., eds., 1998) (); Karkkainen, *supra* note 159; Karkkainen, *supra* note 63, at 485-89 (rejecting a model of New Governance that obviates any need for “hardness” in the law); Sabel & Simon, *supra* note 62, at 1067 n.154 (recognizing that the threat of sanctions is a “key function . . . [in] forc[ing] to the table a party who otherwise might not be willing to negotiate at all”); Archon Fung et al., *The Political Economy of Transparency: What Makes Disclosure Policies Sustainable?* Institute for Government Innovation 41-42 (OPS 02-03), at <http://www.innovations.harvard.edu/research/papers/FGW.pdf> (asserting that enforcement is a central component of New Governance).

²¹²See Dorf & Sabel, *supra* note 64, at 336-39 (recognizing that “firms often turn to third parties to organize benchmarking”).

²¹³It makes sense to speak specifically of experimentalism in this section. Among New Governance approaches, experimentalism provides the most completely imagined description of incentive systems for ratcheting up best-practices learning among decentralized groups.

reform efforts.²¹⁴ Some firms and even some industries may be too pathological or dysfunctional, and their own stories about themselves too entrenched, to be pulled in through experimentalist incentives. A system that presumes a certain base level of capacity and bona fides among industry actors will find no initial purchase among the worst actors. New Governance theory would respond by shutting the intransigent firm down. The top end of the New Governance enforcement pyramid is the “penalty default.” It is a harsh result, suboptimal for all parties (including shareholders and employees), which operates as a default outcome in the event that Enforcement and firm fail to reach a satisfactory accommodation.²¹⁵ In practical terms, this means that SEC Enforcement retains the right and the means to destroy or shut down the noncompliant firm.²¹⁶ To function as intended, however, the default option must be credible. Enforcers must be willing, in extreme cases, to allow the default option to play itself out.²¹⁷

²¹⁴It is thought that new forms of experimentalist governance are most likely to emerge in circumstances where both ends and means are disputed, and yet there is a collective sense of urgency about the need to do something. Without knowing how frequently those conditions prevail, or how close to ideal conditions one must get before experimentalism starts to gain momentum, we can agree that those conditions are not obviously present in every situation that calls for institutional reform.

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

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

²¹⁷I am not suggesting that giving regulators the power to shut down noncompliant actors is unique to New Governance theory; far from it. I mean that the penalty default is an integral component of the enforcement pyramid structure that informs the New Governance approach to enforcement. In fact, even the idea of an enforcement pyramid has deep roots in securities regulation. As William Orville Douglas stated decades ago, government’s role in regulating finance was to “keep the shotgun . . . behind the door, loaded, well oiled, cleaned, ready for use but with the hope that it would never be used.” W.O. DOUGLAS, *DEMOCRACY AND FINANCE* 82 (James Allen ed., 1940).

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

In fact, prosecution in all its forms can focus the mind. A True Reform Undertaking, embedded within and buttressed by deterrent sanctions, shaming, selective business line shutdown,²¹⁹ individual liability, disgorgement or restitution, and any number of other enforcement options can be the bridge between the worst actor and the abyss. Shaming and blaming can serve a forward-looking purpose as well as a retrospective one.²²⁰ Public liability determinations, too, affect a firm's reputational

²¹⁸Some experimentalist work does envision spurring reform through graduated traditional sanctions. *E.g.*, Dorf & Sabel, *supra* note 68. Thus far, this avenue is underdeveloped. This project moves beyond the drug treatment court model in note 68 in the following ways: it is concerned with the actions of enforcement personnel, not a specialized but still arm's length court. As such it must address the complicated strategic environment of settlement, rather than picking up the narrative after the subject individual has already pled guilty. As well, problems of responsibility, causation, and remedy are substantially more complex for the regulator when addressing institutional culture rather than individual drug-related law violations. While the drug treatment court model focuses on the court as experimentalist organ, this project is preoccupied with spurring a decentralized experimentalist process within settling firms, producing a subsequent feedback effect on SEC Enforcement. The absence of a court structure at the center of this project makes it more challenging, contingent, and complex, but also more reflective of actual securities law enforcement practice.

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

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

capital. Network effects in business relations flow from and often reinforce the shaming effect of public sanction.²²¹ If firms believe that the adverse consequences for failing at the Reform Undertaking stage will be swift, significant, and certain, then even unreconstructed “old school” Enforcement action may get people moving.²²² Some of these options may be necessary, if insufficient, components of a comprehensive coercive reform-spurring process.

In this way the line between deterrence and reform generation blurs, reminding us of the danger of overdrawing that distinction. None of this undermines the promise of the New Governance approach: it does not say that sanctions work and New Governance is epiphenomenal. What it does say is that New Governance-inflected approaches to reforming firm culture can work, especially when reinforced by consequences for failure.²²³ While alternate sanctioning effects will impose some costs on the problem solving process, the only way to determine whether the costs are worth running is to set up a mechanism by which the SEC can monitor and evaluate the Reform Undertaking structure in practice. This brings us full circle. In focusing on reforming firm culture, and in taking the first steps toward incorporating New Governance style remedies into its approach, SEC Enforcement may have charted a path toward its own institutional reform.

Postscript: A Different Kind of Governance

This paper identifies some dangers of over-abstraction in discussing governance. Securities law enforcement is a system that attempts to protect investors and allocate responsibility for past wrongdoing, veined through with other values such as efficiency, retributivism, the search for political capital, and the market pressure toward closure. Moreover, *who* enforces the principles—be it courts, the actors themselves, or some third party—is at

expected to) operate as though history and liability were irrelevant. On the contrary, one of the key functions of the problem solving process will be to make sense of the organization’s collective history.

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

²²²Commissioner Glassman has said:

[T]here is no question that fear is a potent motivator. Therefore, if fear of an investigation or enforcement action motivates board directors and executives to make sure that their companies are complying with the spirit and the letter of the securities laws, that’s OK with me – just as long as the result is that people are encouraged to, and in fact, do the right thing.

Commissioner Cynthia A. Glassman, Speech at the Practitioner Law Institute: My Top 10 Observations as an SEC Commissioner (Mar. 5, 2004), *at*

<http://www.sec.gov/news/speech/spch030504cag.htm>.

²²³See also TOM R. TYLER & YUEN J. HUO, TRUST IN THE LAW: ENCOURAGING PUBLIC COOPERATION WITH THE POLICE AND COURTS (2002) (arguing that even while police compel obedience through the threat or use of force, they can also gain the cooperation of people with whom they deal if they behave in procedurally fair ways).

least as integral to how and whether it will work as is the theoretical distinction between New Governance and other methods. It is only likely to work where all parties believe that they will be accountable, through transparent processes, to a larger audience than they can control.

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

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

Even more significantly, in trying on the Reform Undertaking approach, SEC Enforcement has opened the door to further developing its own, unique expression of New Governance style learning in the particular enforcement universe within which it operates. In its best form, the powerful combination of enforcement and New Governance contains the potential to transform not only the way the SEC deals with the worst actors, but also the way it structures itself. These are exciting developments that will bear watching.