A SYSTEMS THEORY OF COMPLIANCE LAW

David Orozco*

ABSTRACT

Compliance law theory is incomplete and in a conceptually disconnected state. This article seeks to offer clarification to this seemingly disparate yet growing and vitally important area of legal practice and scholarship. A robust theory of compliance that seeks to better explain and predict compliance-related outcomes is introduced through compliance systems theory. The systems theory of compliance conceptualizes the various actors, institutions and relations that impact compliance practices. Currently, compliance is viewed as a process and this yields inadequate explanatory and predictive power. The behavior and practices of each conceptualized unit in the compliance system, comprising regulators, firms, executives and inter-organizational structures are analyzed in reference to two major forces acting at each level: economic and non-economic institutional forces. These forces impact each unit and help explain compliance-related behavior across all levels within the system. This descriptive theoretical analysis in turn, yields insights and prescriptive recommendations that will help improve compliance law, theory and practice.

Part I discusses compliance in practice and compliance law. This section details the struggle of compliance law to stand as its own field in light of scholarly critiques to define it otherwise. This section also provides a model for evaluating compliance law under the current limited process-based viewpoint. Part II offers a structural-realist view of compliance practice and law. This section details a compliance case study involving MF Global to reinforce the complex realities of the subject. From this vantage point, compliance law and practice are regarded as complex, multi-actor and interconnected aspects of a general system. Part III introduces the systems theory of compliance and advances arguments to support why this theoretical

* Associate Professor of Legal Studies, Florida State University College of Business. The author is deeply indebted to the following colleagues who provided feedback on earlier drafts of the manuscript: Miriam Baer, Robert Bird, Todd Haugh, Jeremy Kress, Gideon Mark, Susan Marsnik, Jennifer Pacella, Stephen Park, Lydie Pierre Louis, Josephine Sandler Nelson and David Zaring. Any errors and omissions are solely mine.

model offers robust explanatory and predictive power. Part IV offers a prescriptive legal and policy analysis.

INTRODUCTION

Compliance law is under-theorized.[1] As a result, scholarly analysis of compliance fails to provide generalizable principles and the writings on the topic, mirroring the state of the law, tend to be focused on discrete topics that view compliance as a reactionary process driven by regulation and external forces such as politics.[2] The practice of compliance, likewise, follows this fragmented and process-driven approach.[3] This article will examine these shortcomings and offers a systems theory of compliance law and practice that integrates, in a novel way, research from the fields of corporate governance, behavioral ethics, transaction cost economics, administrative law and regulatory arbitrage. The article begins with a descriptive account

1. *See* Sean J. Griffith, *Corporate Governance in an Era of Compliance*, 57 WM. & MARY L. REV. 2075, 2081 (2016) (commenting how compliance law is undertheorized).

2. *See infra* section I.B.; Veronica Root, *Coordinating Compliance Incentives*, 102 CORNELL L. REV. 1003, 1010 (2017) (stating that "[t]here is no formal statute or regulation that requires firms to engage in comprehensive compliance efforts. Instead, there are specific statutory and regulatory admonishments that require firms within certain industries to implement discrete compliance programs."). Some scholars focus on the internal aspects of compliance within firms. *See* Donald C. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 939 (2017) (articulating a framework that characterizes the important components of compliance programs within firms); Veronica Root, *The Compliance Process*, 94 IND. L.J. 203, 219–27 (2019) (distilling a four-stage compliance process that utilizes process frame analysis); Veronica Root, *Complex Compliance Investigations*, COLUM. L. REV. (forthcoming) (focusing "on the detection and investigative stages [of compliance] and the continuum between them. [Also, demonstrating that] many recent compliance failures within organizations might have been avoided if more robust processes—meaning the actions, practices, and routines that firms can employ to communicate and analyze information—had been in place to ensure investigations were conducted in a manner that allowed the firm to analyze information from diverse areas within the firm."); Todd Haugh, *Nudging Corporate Compliance*, 54 AM. BUS. L.J. 683–741 (2017) (providing a detailed analysis of the role behavioral ethics as a form of nudging in corporate compliance). As Professor Haugh states "[i]n many ways, then, achieving the goals of corporate compliance is dependent on the behavior of individual officers, managers, and employees within the corporation." *Id.* at 704; other scholars focus their attention on compliance as an aspect of corporate governance. *See* Jennifer Arlen, *Removing Prosecutors from the Boardroom: Limiting Prosecutorial Discretion to Impose Structural Reforms*, *in* PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT 62–86 (Anthony S. Barkow & Rachel E. Barkow eds., 2011) (highlighting scholarship in criminal law acting as a reactionary force in relation to corporate conduct); Lawrence A. Cunningham, *Deferred Prosecutions and Corporate Governance: An Integrated Approach to Investigation and Reform*, 66 FLA. L. REV. 1, 15 (2014) (citing an example of academic work focused on prosecutorial actions concerning corporate governance).

3. *See* PRICEWATERHOUSECOOPERS, STATE OF COMPLIANCE STUDY 2016 - LAYING A STRATEGIC FOUNDATION FOR STRONG COMPLIANCE RISK MANAGEMENT 11 (2016), https://www.pwc.se/sv/pdf-reports/state-of-compliance-study-2016.pdf [https://perma.cc/366X-9U2S] (displaying a compliance framework that is broken down into different elements to accomplish different strategies).

of the systems theory of compliance law and ends with the normative implications derived from the theoretical analysis. The systems theory is useful insofar as it provides explanatory and predictive power that is currently lacking in compliance theory.

This article introduces a systems theory of compliance law. A generalized theory of compliance law is necessary since the demands on organizations to invest in their compliance functions have been rapidly increasing during the past two decades, as are the risks associated with failing to meet those demands.[4] The fact is that compliance has, within a relatively short period of time, occupied a central position within regulatory and corporate law matters.[5]

Take the example of Facebook, which has faced existential threats directly related to compliance law. In 2018, a major compliance-related threat to that company occurred when the political consultancy firm Cambridge Analytica was granted unauthorized access to millions of Facebook users' personal data.[6] The fallout from that scandal resulted in the public's loss of trust in the company, congressional hearings, increased regulatory oversight and lawsuits.[7]

Yet another major compliance-related challenge arose at Facebook

---

4. DELOITTE, MEETING COMPLIANCE CHALLENGES: LEVERAGING THE VALUE OF OUTSOURCING 1, 3 (2013), https://www2.deloitte.com/us/en/pages/regulatory/articles/managed-regulatory-compliance-services.html [https://perma.cc/A5UJ-UTDJ].

5. *See* Root, *Coordinating Compliance Incentives*, *supra* note 2, at 1004 (stating that "[c]ompliance is king, and its subjects—regulators, prosecutors, courts, corporations, and academics—are quick to tout its power and potential for good"); Griffith, *supra* note 1, at 2077 (identifying how "American corporations have witnessed the dawn of a new era: the era of compliance").

6. *See* Kartikay Mehrotra & Aoife White, *Facebook Faces Lawsuit for Data Breach Affecting Nearly 30 Million Users*, INS. J. (June 24, 2019), https://www.insurancejournal.com/news/national/2019/06/24/530247.htm [https://perma.cc/LMJ8-X6ED] (stating that "[t]he company's disclosure in September that hackers exploited several software bugs to obtain login access to accounts was tagged as Facebook's worst security breach ever").

7. Regulatory oversight increasingly involves regulatory agencies pursuing civil remedies and working in conjunction with criminal prosecutors. *See* Todd Haugh, *The Criminalization of Compliance*, 92 NOTRE DAME L. REV. 1215, 1221 (2017) (discussing how corporate compliance is becoming increasingly criminalized); Order Granting in Part and Denying in Part Motion to Dismiss at 17, Echavarria v. Facebook, Inc., No. 3:18-cv-05982 (N.D. Cal. June 21, 2019) (denying Facebook's motion to dismiss because, according to U.S. District Judge William Alsup, "[f]rom a policy standpoint, to hold that Facebook has no duty of care here 'would create perverse incentives for businesses who profit off the use of consumers' personal data to turn a blind eye and ignore known security risks'"); Tony Romm, *FTC Votes to Approve $5 Billion Settlement with Facebook in Privacy Probe*, WASH. POST (July 12, 2019), https://www.washingtonpost.com/technology/2019/07/12/ftc-votes-approve-billion-settlement-with-facebook-privacy-probe/?noredirect=on&utm_term=.5ee8252e5046 (referencing Facebook's settlement in light of the Privacy Probe).

when it announced plans to introduce its own cryptocurrency called Libra.[8] The fate of this ambitious and potentially transformative project will largely rest on the company's ability to comply with a whole host of financial regulations that can potentially derail this undertaking.[9] Facebook, however, is not alone in its continuous struggle to adequately address compliance-related issues. Companies large and small and across virtually every sector face compliance-related threats and opportunities of varying degrees and scale.[10]

In the wake of headline-generating corporate scandals, a body of compliance-related law has emerged with attendant statutes, regulations, judicial precedent and norms of behavior.[11] Scholars have increasingly commented on the subject of compliance.[12] Thriving associations such as the Society of Corporate Compliance and Ethics service professionals who practice compliance across various areas.[13] Academic institutions likewise have taken an interest in the subject and a growing number offer courses or programs related to compliance law.[14]

---

8. Clare Duffy, *Facebook Wants to Make Cryptocurrency Mainstream. Here's How*, CNN (June 19, 2019), https://www.cnn.com/2019/06/18/tech/facebook-libra-cryptocurrency/index.html [https://perma.cc/83RB-F35X].

9. Christopher Carbone, *Facebook Says Cryptocurrency Libra Won't Happen Without 'Full Government Approval' Amid Broad Resistance*, FOX NEWS (July 16, 2019), https://www.foxnews.com/tech/facebook-cryptocurrency-libra-wont-happen-without-full-government-approval [https://perma.cc/UL9B-RGB8].

10. *See* Root, *The Compliance Process*, *supra* note 2, at 209 (noting that "[t]oday's organizations are responsible for ensuring proper compliance in many different areas").

11. *Id.* at 214.

12. D. Daniel Sokol, *Teaching Compliance*, 84 U. CIN. L. REV. 399, 399 (2016); *see* Geoffrey Parsons Miller, *Compliance: Past, Present and Future*, 48 U. TOL. L. REV. 437, 438 (2017) (highlighting scholarship on compliance); Robert C. Bird & Stephen Kim Park, *Organic Corporate Governance*, 59 B.C. L. REV. 21, 44–45 (2018) (stating that "[t]he influence of the compliance function on corporate decision-making has become so significant that it has prompted legal scholars to declare compliance 'the new corporate governance' and 'a universal corporate governance activity'"). Also, the shift toward greater compliance-related activities within organizations may be due to heightened levels of corporate criminal liability and enforcement. This liability regime has shifted to one that is duty-based and dependent on the effectiveness of corporate compliance programs in response to the Federal Organizational Sentencing Guidelines that incentivize such programs. *See* Cunningham, *supra* note 2, at 15 (describing the shift towards a duty-based approach to liability after the implementation of the Federal Organizational Sentencing Guidelines).

13. SOC'Y OF CORP. COMPLIANCE ETHICS & HEALTH CARE COMPLIANCE ASS'N, 2017 ANNUAL REPORT 4 (2017), https://assets.corporatecompliance.org/Portals/1/PDF/AboutSCCE/scce-hcca-2018-annual-report.pdf [https://perma.cc/MVT3-Z9RL].

14. *See, e.g.*, Sokol, *supra* note 12, at 399–400 (noting the "supply side response" of law schools to the increased hiring of lawyers in the compliance field, including the development of compliance certificates or degrees); Mikhail Reider-Gordon & Elena Helmer, *Training the Next Generation of Anti-Corruption Enforcers: International Anti-Corruption Curriculum in U.S. Law Schools*, 14 J. INT'L BUS. & L. 169, 179 (2015) (discussing the efforts of several law

The expected result is that an improved understanding of the forces that influence compliance law will result in better-informed policy and practice. This, in turn, matters since compliance failures exact a significant toll on society.[15] Many small-magnitude compliance failures point to a general weakness in the deterrent aspects of the law. Larger compliance failures create systemic risks and reactionary policy adjustments that often result in suboptimal regulation for an entire industry.[16] Compliance failures have real costs and cause damage to property, the environment, trust in the marketplace and in some cases individual autonomy and safety.[17]

This work also contributes to a growing scholarly debate about the appropriate levels of expenditures in compliance and its intrusion into corporate governance affairs. Prominent scholars question the need and efficacy of compliance-related activities and the use of regulatory enforcement tools such as deferred prosecution agreements that intrude into internal corporate governance matters.[18] The systems theory of compliance described in this article addresses many of these important questions and offers several prescriptions. For example, an insight gained from the systems theory is that regulatory and enforcement actions are best tailored by weighing economic and institutional forces that impact the interrelated practices of regulators, firms, executives and inter-organizational structures.

As described below, the current state of compliance law is a mélange of disparate and unrelated state and federal laws, regulations and precedent

---

schools in creating compliance-based curriculum); Julie DiMauro, *U.S. Compliance Education Expands as Demand Increases*, REUTERS (Dec. 3, 2014), http://blogs.reuters.com/financial-regulatory-forum/2014/12/03/u-s-compliance-education-expands-as-demand-increases-part-one-law-schools/ [https://perma.cc/C5MH-FMFW] (discussing the efforts of law schools to develop compliance curricula in response to the increased employment in this sector).

15. *See* Root, *The Compliance Process*, *supra* note 2, at 210 (discussing the negative consequences of compliance failures).

16. *See* Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77, 89 (2003) (explaining that legislation following a crash can harm executive officers and firms that are risk-seeking rather than risk-averse); Roberta Romano, *The Sarbanes–Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1587–90 (2005) (noting that Sarbanes–Oxley created differing burdens on smaller firms compared with larger firms).

17. British Petroleum's oil spill in the Gulf of Mexico, Volkswagen's emission regulations cheating scandal and the fraudulent opening of fake bank accounts at Wells Fargo are just some of the more prominent recent examples of compliance failures with significant social costs.

18. *See* Jenifer Arlen & Marcel Kahan, *Corporate Governance Regulation Through Nonprosecution*, 84 CHI. L. REV. 323 (2017) (discussing the transformation in corporate criminal enforcement policy); Miriam H. Baer, *Insuring Corporate Crime*, 83 IND. L.J. 1036, 1036 (2008) (indicating that firms will over-invest in compliance to avoid formal criminal charges even if this practice is inefficient); Kimberly D. Krawiec, *Organization Misconduct: Beyond the Principal-Agent Model*, 32 FLA. ST. U. L. REV. 571, 591–96 (2005) (questioning whether compliance programs are effective at all).

related to a dizzying array of topics.[19] Scholars, however, argue that compliance law merits its own separate classification as a discipline.[20] In some ways, the debate is similar to the claims made about cyberlaw when this topical area exhibited rapid growth during the early days of the Internet. Many thought cyberlaw would stand as its own discipline whereas others argued it lacked the requisite level of general unifying principles.[21] As discussed below, compliance law will thrive as a discipline if it is positioned within a general theory, such as the systems theory.

The article proceeds as follows. Part I discusses compliance in practice and what is called compliance law. This section details the struggle of compliance law to stand as its own field in light of scholarly critiques to define it otherwise. This section also provides a model for evaluating compliance law under the current limited viewpoint. Part II offers a structural-realist view of compliance practice and law. This section details a compliance case study involving MF Global to reinforce the complex realities of the subject. From this vantage point, compliance law and practice are regarded as complex, multi-actor and interconnected aspects of a general system. Part III introduces the systems theory of compliance and advances arguments to support why this theoretical model offers robust explanatory and predictive power. Part IV offers a prescriptive analysis. After this section, the article concludes.

I. COMPLIANCE LAW AND PRACTICE

To develop a robust theory of compliance law, it is important to conceptually define and disentangle the law of compliance from compliance practice, which has been defined as "the processes by which an organization seeks to ensure that employees and other constituents conform to applicable norms—which can include either the requirements of laws or regulations or

19. The compliance literature mainly focuses on federal law. Yet, state law is vital and parallels federal law in substance and structure. The theory proffered here applies equally to federal and state compliance issues.

20. *See* Robert C. Bird & Stephen Kim Park, *Turning Corporate Compliance into Competitive Advantage*, 19 U. PA. J. BUS. L. 285, 338 (2017) (noting that a "growing array of regulatory mandates and modes of regulatory enforcement" has contributed to compliance as a significant area of focus for legal and business activity and academic and industry-related interest); Jennifer M. Pacella, *The Regulation of Lawyers in Compliance* (Kelley Sch. of Bus., Res. Paper No. 19-37, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3430093 [https://perma.cc/J425-G5CL] (analyzing the role of lawyers in compliance functions and proposing reforms to current regulatory models).

21. *See* Joseph H. Sommer, *Against Cyberlaw*, 15 BERKELEY TECH. L.J. 1145, 1149 (2000) (arguing that cyberlaw is not its own body of law but rather reflects preexisting legal issues).

the internal rules of the organization."[22] This section offers a delineation of these two areas and then offers a model to illustrate how compliance law is currently assessed, albeit in a fairly crude manner, through a reactionary-process viewpoint.

As alluded to above, compliance practice includes the norms, internal company regulations and policies, governance mechanisms, resources and personnel used by a firm to adhere to what the firm interprets is the appropriate response to existing laws and regulations. Compliance is, therefore, the firm's *practice* of compliance broadly construed. The law of compliance, however, includes the legislation, caselaw and administrative regulations that govern what the firm may or may not do, the mechanics of enforcement and prosecution and the penalties that may apply in the event of a violation. The systems theory of compliance law will address both aspects of compliance since the field cannot be properly understood without reference to each aspect of the system and their relation to one another.

A. Compliance as a Field of Research and Practice

Some scholars claim that compliance law is its own field and that its importance is growing.[23] The American Law Institute (ALI) recently promulgated a tentative draft of their *Principles of the Law of Compliance, Risk Management and Enforcement*.[24] The ALI's efforts are to be lauded as an important step to distill basic concepts related to the subject of compliance law, however the principles are mainly a distillation of best practices, not a cohesive theory that can effectively explain or predict a wide range of compliance-related behavior.[25]

Although it is impossible to dispute that the subject has attracted great interest, the arguments in favor of labeling compliance law as a distinct field

22. GEOFFREY P. MILLER, THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE 3 (2014). *See* Miriam H. Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 958 (2009) (defining compliance as a "system of policies and controls that organizations adopt to deter violations of law and to assure external authorities that they are taking steps to deter violations of law."); Griffith, *supra* note 1, at 2082 (defining compliance as "the set of internal processes used by firms to adapt behavior to applicable norms").

23. Miller, *supra* note 12, at 437 (stating that "[c]ompliance, once a virtually unknown topic, is coming of age as a field of legal practice, as a subject taught in law schools, and as a field of research and analysis by academics and thoughtful practitioners"). *See* Bird & Park, *supra* note 20 (discussing compliance law as a core concern for corporate governance); Pacella, *supra* note 20 (analyzing the role of lawyers in compliance functions and proposing reforms to current regulatory models).

24. PRINCIPLES OF THE LAW COMPLIANCE, RISK MANAGEMENT, AND ENFORCEMENT § 301 (AM. LAW INST., Tentative Draft No. 1, 2019).

25. *Id.* at § 203 cmt. b. (indicating that "[a]ccordingly, the recommendations and standards set forth in these Principles are general statements of appropriate conduct").

are not fully developed. As mentioned earlier, the issue that faces compliance law appears at first blush to resemble the case of cyberlaw. The cyberlaw label was applied to various cases arising from the application of existing legal principles to novel circumstances brought about by web-based technologies.[26] A debate emerged whether cyberlaw existed as its own body of law or whether it was the application of pre-existing legal principles to new facts driven by new technologies.[27] The scholarly consensus is the latter because very few bodies of law are defined by technologies. The connections between law and technology are mediated by social practices and what is called cyberlaw mainly corresponds to the application of existing legal doctrines to accommodate new technical scenarios.[28]

Compliance law differs fundamentally from cyberlaw, however, since it is not driven by technology. Instead, compliance law is driven by the reality of heightened regulation across industries and the greater social demands for companies to observe legal and ethical conduct.[29] According to some scholars, this heightened level of regulation originates from various sources. Professor Daniel Sokol states:

> Compliance, however, means different things to different people within a company based on factors such as the industry sector and the particular level of actors within a firm. For some, compliance relates to only board level issues. For others it relates to senior managers, mid-level managers, or employees. Compliance risk may be a function of issues that any company faces (e.g., Sarbanes Oxley, Dodd-Frank, antitrust, Foreign Corrupt Practices Act (FCPA), data privacy, insider trading, auditing, and tax) or sector specific issues (e.g., financial services, health care).[30]

Professor Sokol's statement highlights a central problem facing the recognition of compliance law as a distinct field. That is, compliance law is conceptually muddled and comprised of legal doctrines that are disconnected and strung together by the need to satisfy heightened levels of regulation.[31]

---

26. *See* JONATHAN ROSENOER, CYBERLAW – THE LAW OF THE INTERNET (1997) (describing a resource that provides guidance on legal issues regarding the internet).

27. One infamously critical account equated Cyberlaw with the Law of the Horse. *See* Frank H. Easterbrook, *Cyberspace and the Law of the Horse*, U. CHI. LEGAL F. 207 (1996) (analyzing whether cyberspace and intellectual property are adequately covered by existing law).

28. Sommer, s*upra* note 21, at 1145.

29. *See, e.g.*, Teresa Meek, *In a Risky World, Chief Compliance Officers Move to Center Stage*, FORBES (May 31, 2017), https://www.forbes.com/sites/adp/2017/05/31/in-a-risky-world-chief-compliance-officers-move-to-center-stage/#5731c6935a3a [https://perma.cc/3N 9H-6EMC] (discussing how the "steady rise in regulations" has given way to Chief Compliance Officers playing crucial roles in companies and industries of all types).

30. Sokol, *supra* note 12, at 401–02.

31. *See* Root, *The Compliance Process*, *supra* note 2, at 244 (stating that "[t]he field of

Also, the increased emphasis on civic and corporate social responsibility has increased the need for firms to invest in sound governance practices and compliance.[32] This may reduce compliance as simply a derivative byproduct of separate processes external to the firm. According to Professor Sokol, the current state of teaching compliance reflects this epistemological problem and is "nothing other than dressed up versions of classes in white collar crime or regulation or lectures on latest case developments. . . ."[33]

The principal pedagogical writings in compliance law reflect the agglomerated and disconnected nature of the field. For example, the first general compliance law textbook covers such varying and unrelated topics as: information security, off-label drugs, FCPA, anti-money laundering and sexual harassment.[34] Another resource aimed for practitioners published by the American Bar Association similarly covers disparate topics such as: labor, the FCPA, Dodd-Frank/Sarbanes-Oxley financial regulation, health care, pharmaceutical, medical, and food products, product safety, environmental regulation, government contracts, nonprofit entities, privacy and data security.[35] Lacking a general framework or theory, compliance law and pedagogy struggle to be understood beyond the need to comply with various regulations that are situation-specific and that lack commonality.

Another scholarly critique against compliance law as a separate field is that it is simply a narrow subset of corporate governance law, which is a well-developed and comprehensive area of law.[36] According to Professor Lawrence Cunningham, "[t]he subject of compliance is a narrow component of corporate governance. Its roots are anchored not so much in the corporate governance movement but in the concurrent intensification of organizational criminal liability."[37] A contrary viewpoint is that compliance has supplanted

compliance is an emerging one within legal scholarship, but the diversity of issues raised by compliance may make some wonder whether it truly is its own field"); Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 237 (2010) (noting that "the administrative state has increased substantially, and the amount of time lawyers devote to regulatory matters has grown apace").

32. *E.g.*, ROBERT A.G. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 74 (1991) (implying that in the current reality of corpocracy, there is a growing need for corporate accountability and sound governance).

33. Sokol, *supra* note 12, at 400.

34. MILLER, *supra* note 22.

35. ANDREW S. BOUTROS, T. MARCUS FUNK & JAMES T. O'REILLY, THE ABA COMPLIANCE OFFICER'S DESKBOOK (2016).

36. Corporate governance is defined by one scholar as: "'[t]he system of rules, practices and processes by which a company is directed and controlled.' It is a broad term applicable to any business organization. It encompasses a company's business purpose and the mechanisms used to achieve that business purpose." Cunningham, *supra* note 2, at 6 (quoting *Corporate Governance*, INVESTOPEDIA (Feb. 26, 2014), http://www.investopedia.com/te rms/c/corporategovemance.asp [https://perma.cc/W27C-5JPD].

37. Cunningham, *supra* note 2, at 14.

corporate governance and brought forth a new era of corporate governance.[38]

The first argument, however, fails to adequately describe compliance law since it fails to take into account the richness of the subject and the diversity of actors involved in compliance. These two aspects of compliance extend beyond the confines of corporate governance. For example, corporate governance is largely concerned with the agency costs that impact stockholders, fiduciaries and agents as well as the market and non-market mechanisms that economics, regulation, case law and private norms of behavior produce to increase or reduce agency costs.[39] As scholars have pointed out, however, compliance also relies on risk concepts, ethics and behavioral attributes that extend to individuals internal and external to the firm.[40] As will be demonstrated by the analysis and generalizations of the systems theory of compliance, compliance law is a cohesive and broader subject than corporate governance law.[41]

B. A Reactionary Process View of Compliance Law

In its current epistemic form, compliance law is viewed by scholars under what is labeled here as a reactionary process view of private behavior influenced by external regulation.[42] The current theoretical view of

38. Griffith, *supra* note 1, at 2106–14.

39. *See* ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932) (describing the agency costs that arises from the separation of control and ownership in corporations); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836 (2005) (advocating for increasing shareholder power in order to reduce agency costs).

40. Donald C. Langevoort, *Behavioral Ethics, Behavioral Compliance*, *in* RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING (Jennifer Arlen ed., 2018).

41. Corporate governance is a vital element of the systems theory of compliance law as discussed further below. *See infra* Section III.C.2. For example, designing internal compliance structures and incentives within the firm is heavily dependent on governance. *See* PRINCIPLES OF THE LAW COMPLIANCE, RISK MANAGEMENT, AND ENFORCEMENT § 3.01 (AM. LAW INST., Tentative Draft No. 1, 2019) (stating that "[f]or example, under a larger for-profit organization's compliance governance, a chief compliance officer may be responsible for designing the compliance program, a chief executive officer decides whether and how to direct its implementation, and the board of directors approves the implementation and periodically reviews the program's effectiveness").

42. *See* John C. Coffee, Jr., *The Political Economy of Dodd Frank: Why Financial Reform Tends to Be Frustrated and Systematic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1028–29 (2012) (discussing how government intervention in corporate affairs is the result of legislation that follows in the wake of a scandal or a perceived market failure). Professor Veronica Root has offered some generalizable aspects of the compliance process as it occurs within organizations. Her process model advances our understanding of how compliance works within organizations and as she points out "[w]hen compliance failures are assessed through a process frame, greater clarity regarding the nature of the compliance program's

compliance is generally as a process.[43] Under the reactionary process view, compliance law is also contingent on the dyadic relationship between regulators and firms. Regulation arises due to the behavior undertaken by an actor or actors in industry that is deemed socially undesirable. This behavior must have serious enough consequences that it negatively impacts public welfare.[44] In some cases, the negative behavior is revealed in a way that draws public attention and scrutiny and is attributable to a regulator, investigative committee, law enforcement officer, journalist, competitor or whistleblower.[45] This reactionary approach to regulation has been identified by scholars, particularly in the field of financial regulation.[46]

In other cases, the public coalesces around a set of values that contradict the desired actions of the marketplace. For example, higher auto emissions regulations may result due to a legislative response to public concerns about global warming, not due to the bad behavior of any specific actor. Alternatively, the legislative or common law processes may yield new private rights that create duties and thus constrain commercial activities. For example, in the *Caremark* decision the Delaware Court of Chancery altered the liability for corporate boards that fail to implement an effective compliance and internal control system.[47]

The legislature creates statutory law and the courts create precedent.

---

failure may be discerned." Root, *The Compliance Process*, *supra* note 2, at 205.

43. *See generally* Root, *The Compliance Process*, *supra* note 2 (referring to compliance as a process); Griffith, *supra* note 2, at 2082 ("More concretely, compliance is the set of internal processes used by firms to adapt behavior to applicable norms."); PRINCIPLES OF THE LAW COMPLIANCE, RISK MANAGEMENT, AND ENFORCEMENT § 3.01 (AM. LAW INST., Tentative Draft No. 1, 2019) ("Depending on the kind of organization, its business or affairs, and other circumstances, compliance and risk management are organizational processes that require certain organizational actors to perform specific tasks.").

44. *See, e.g.*, Lydie Pierre Louis, *Hedge Fund Fraud and the Public Good*, 15 FORDHAM J. CORP. FIN. L. 21, 90–93 (2009) (advocating for greater hedge fund regulation in light of major hedge fund-related scandals).

45. *See, e.g.*, Bethany Mclean, *How Wells Fargo's Cutthroat Corporate Culture Allegedly Drove Bankers to Fraud*, VANITY FAIR, June 2017, https://www.vanityfair.co m/ne ws/2017/05/wells-fargo-corporate-culture-fraud [https://perma.cc/9NLV-L3GS] (describing how disgruntled former bank employees and investigative journalists exposed the rampart fraud at Wells Fargo).

46. *See* Roberta S. Karmel, *The SEC at 70: Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission Is Appropriate?*, 80 NOTRE DAME L. REV. 909, 949 (2005) (arguing that "[i]n the absence of a new crisis involving derivatives, excessive leverage in the market or manipulative activities by institutional investors, it is unlikely that Congress, the SEC or any other financial regulator will decide to study and reform institutional investor behavior"); Pierre Louis, *supra* note 44, at 41 (recognizing that "[i]n the absence of a crisis . . . it is unlikely the SEC or any other regulators will move to reform the hedge fund industry").

47. In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).

This is then followed by regulatory action, heightened enforcement and private ordering behavior that seeks to internalize the new regulations to comply with the law.[48] At this point, industry must find ways to make sense of the regulation and decide how to best accommodate it within the firm's resources and risk appetite.[49] Firms then internalize compliance through various best practices and strategic processes.[50] In some cases, resource-rich firms and trade associations may strategically employ the non-market system to weaken the heightened requirements of new compliance law.[51]

The strategic lobbying efforts by firms and trade associations may weaken several aspects of regulation at the administrative and enforcement level.[52] For example, an administration may favor lessening the impacts and requirements of regulation in response to industry demands.[53] Two recent examples of this include the curbing of environmental regulations and efforts to weaken the regulatory oversight power of the Consumer Financial Protection Bureau.[54]

48. *See* Christine Hurt, *The Undercivilization of Corporate Law*, 33 J. CORP. L. 361, 379 (2008) (discussing how the DOJ's budget for corporate fraud investigations increased by $24.5 million following the establishment of the Corporate Fraud Task Force in 2002). Sometimes regulation has sweeping consequences that are later deemed an overreaction. *See* Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39, 55 (2009) (noting that "[m]any observers cite Sarbanes-Oxley as illustrating the kind of dangerous overreaction that crisis-driven legislative and regulatory reform can pose.").

49. *See* Fleischer, *supra* note 31 (stating that "[r]egulatory arbitrage is a consequence of a legal system with generally applicable laws that purport to define, in advance, how the legal system will treat transactions that fit within defined legal forms. Because the legal definition cannot precisely track the underlying economic relationship between the parties, gaps arise, and these gaps create opportunities.").

50. *See generally* PRINCIPLES OF THE LAW COMPLIANCE, RISK MANAGEMENT, AND ENFORCEMENT (AM. LAW INST., Tentative Draft No. 1, 2019) (listing best practices for compliance and risk management).

51. Katy Milani, *Latest Assault on Dodd-Frank Has Bank Lobbyists Beaming*, THE HILL (Mar. 5, 2018), https://thehill.com/opinion/finance/376749-latest-assault-on-dodd-frank-has-bank-lobbyists-beaming [https://perma.cc/Q5CD-JC4K].

52. *See* Nicholas Confessore & Cecilia Kang, *Facebook Data Scandals Stoke Criticism that a Privacy Watchdog Too Rarely Bites*, N.Y. TIMES, Dec. 30, 2018 (discussing how the Federal Trade Commission has become subservient to corporate interests such as Big Tech).

53. Milani, *supra* note 51.

54. *See* Steve Eder, *White House Boasts of Its Savings in Regulatory Rollback*, N.Y. Times, July 19, 2017, https://www.nytimes.com/2017/07/19/business/white-house-boasts-of-its-savings-in-regulatory-rollback.html [https://perma.cc/X9BM-VGL9] (discussing criticisms of attempts to rollback government regulations due to their effect on the environment); Lalita Clozel, *CFPB Acting Chief Asks Staff to Cut Budget by 20%*, WALL ST. J., June 12, 2018, https://www.wsj.com/articles/cfpb-acting-chief-asks-staff-to-cut-budget-by-20-1528842446 (discussing cuts in the CFPB's fiscal spending for 2019). The CFPB was widely lauded as a much-needed watchdog to oversee financial institutions and created by the

Despite industry's attempts to weaken regulation, the constellation of harmful corporate behavior has resulted in a dizzying array of regulation.[55] Ironically, large incumbent firms in mature industries may benefit from regulation as a barrier to entry that prevents new entrants from entering a market. For example, pharmaceutical companies benefit from the extensive Food and Drug Administration (FDA) clinical trial regulations for new medical compounds. The result of these regulations, which cost hundreds of millions of dollars to comply with, is that new entrants to the pharmaceutical drug manufacturing industry are effectively priced out of the market.[56]

This process-based view of compliance law, however, yields unsatisfactory explanatory and predictive power nor does it present a faithful picture of what occurs in practice. The resulting portrait is a dim view of compliance law that appears to be *ad hoc*, reactionary or *ex post*, distributed across unrelated domains of business and subject to weakening by strategic actors. Absent bad behavior that incites public ire, or a change in public values, the reactionary process view fails to explain the various compliance scenarios that occur in practice. For example, the MF Global case discussed in the following section highlights scenarios that involved shared regulatory authority and overlap, regulatory arbitrage, an aggressive corporate regulatory strategy and the lack of proper corporate governance controls. All of these forces, none of which are explained by the process-dominant view of compliance, played a significant role in the MF Global case study.

Nonetheless, the seeds of a new compliance law era have been sown.[57] For example, the emergent scholarly literature increasingly points to compliance law's need to focus on extra-legal factors, variables and institutions.[58] As recognized by scholars from other fields, behavior cannot be properly understood without recognizing the economic and normative social forces that impact individuals, organizations and institutions.[59] These powerful forces and their impact on compliance law and practice will be examined next.

Dodd-Frank Wall Street Reform and Consumer Protection Act.

55. *See* Ellen S. Podgor, *Overcriminalization: New Approaches to a Growing Problem*, 102 J. CRIM. L. & CRIMINOLOGY 529, 531 n.10 (2012) (discussing how there are between 10,000–300,000 regulations that expose companies to civil and criminal liability).

56. Rebecca S. Eisenberg, *The Role of the FDA in Innovation Policy*, 13 MICH. TELECOMM. & TECH. L. REV. 345, 356 (2007) (stating that "FDA regulation does much to support the profitability of drug development even as it adds to its costs. Like other costly regulatory regimes, FDA regulation serves as a barrier to entry that protects market incumbents from competition from new firms.").

57. *See supra* note 12 and accompanying text.

58. *See, e.g.*, Haugh, *supra* note 2 (focusing on behavioral ethics); Langevoort, *supra* note 2 (emphasizing the components of a successful compliance program).

59. Christine Oliver, *Sustainable Competitive Advantage: Combining Institutional and Resource-Based Views*, 18 STRATEGIC MGMT. J. 697, 700–08 (1997).

II. A STRUCTURAL–REALIST VIEW OF COMPLIANCE LAW AND PRACTICE

The reactionary process view of compliance fails to provide an adequate theory since it fails to offer generalizable principles that explain behavior or adequately predict outcomes.[60] Yet, a robust theory of compliance must be able to do so. This section offers insights on the practice of compliance that inform the realities of this complex area of activity and describe its multidimensional aspects. This section then outlines the basis for a theory that examines the legal and extra-legal forces that impact compliance practices. A theory of compliance that draws from these insights to connect concepts, actors and relationships within the *compliance system* will then be introduced.

A. Overview

Several aspects of compliance must be acknowledged to proceed. First, practitioners, scholars and policymakers recognize that as a human endeavor, compliance is never perfectly realized within firms.[61] Instead, the practice of compliance is inherently a probabilistic activity due to administrative resource constraints, managerial error, misinterpretation and at times evasion.[62]

Second, the law and its resulting regulations will have varying degrees of uncertainty. This may arise from statutory vagueness,[63] weak regulatory

60. *See Social and Behavioral Theories: 3. Theory and Why It Is Important*, ESOURCE: BEHAV. & SOC. SCI. RES., http://www.esourceresearch.org/eSourceBook/SocialandBehavioralTheories/3TheoryandWhyItisImportant/tabid/727/Default.aspx [https://perma.cc/CA7R-EE2U] (last visited Nov. 17, 2019) (defining theory as "a set of interrelated concepts, definitions, and propositions that explains or predicts events or situations by specifying relations among variables").

61. Robert Bird & Stephen Park, *An Efficient Investment-Risk Model of Compliance*, CLS BLUE SKY BLOG (Nov. 30, 2016), http://clsbluesky.law.columbia.edu/2016/11/30/an-efficient-investment-risk-model-of-corporate-compliance/ [https://perma.cc/Q9M4-C4K5] (recognizing that "[f]rom the moment [a regulation] is enacted, it is already embedded with imperfections that make full compliance unknowable"); Root, *The Compliance Process*, *supra* note 2, at 216 (explaining that it is commonly understood that it would be inefficient for firms to attempt to achieve perfect levels of compliance).

62. *See* Baer, *supra* note 18, at 1059 (listing ways in which an employee can avoid detection).

63. Fleischer, *supra* note 31 (stating that "[t]wo groups within the administrative state, congressional staff members and agency lawyers, together provide another constraint on gamesmanship by interpreting ambiguous statutes and conveying the unwritten rules to interested parties. Because the interpretation of new deal structures is not fixed *ex ante*, staffers and agency lawyers often consult with deal lawyers, and such meetings are not immune from the usual political force of interest groups and their lobbyists.").

enforcement,[64] overlapping regulatory authority,[65] or new market activities that challenge or fall outside of existing regulations.[66] Third, compliance cannot be divorced from human behavior and this likewise renders the subject open to various possibilities. As the proponents of legal realism would claim, the law is a prediction regarding what a court (or regulator) will do.[67]

To analogize the gap between behavior and legal formalism in another area of law, formal contract doctrine often fails to explain contracting behavior in practice.[68] Instead, the relational theory of contracting provides a much more accurate account of applied contracting behavior.[69] The theoretical foundations of relational contracting and realism have impacted contract doctrine. For example, one of the crowning achievements of this modern view of contract theory was the creation and widespread adoption of the Uniform Commercial Code.[70]

As a behavioral subject, compliance falls within a spectrum of legal and strategic business behavior and these forces cannot be disregarded if compliance doctrine is to be understood and improved. As pointed out by scholars, businesses have varying in-house legal capabilities that are used to

64. *See* Baer, *supra* note 18, at 1049 (stating the reality that "[f]ederal prosecutors . . . lack both the physical and political resources to prosecute every guilty entity.").

65. Jody Freeman & Jim Rossi, *Agency Coordination in Shared Regulatory Space*, 125 HARV. L. REV. 1131, 1131–36 (2012) (recognizing that "[m]any areas of regulation and administration are characterized by fragmented and overlapping delegations of power to administrative agencies.").

66. *See* Jeff Horwitz & Parmy Olson, *Facebook Unveils Cryptocurrency Libra in Bid to Reshape Finance*, WALL ST. J. (June 18, 2019), https://www.wsj.com/articles/facebook-unveils-crypto-wallet-based-on-currency-libra-11560850141 [https://perma.cc/X8YD-579L] ("Much of Libra's future could also depend on which U.S. regulatory bodies claim authority to police it.").

67. Oliver W. Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 461 (1897) ("The prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law.").

68. Stewart Macauley, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 1, 6 (1963) (finding that instead of formal contracting "[b]usinessmen often prefer to rely on "a man's word" in a brief letter, a handshake, or "common honesty and decency"- even when the transaction involves exposure to serious risks").

69. *See* IAN R. MACNEIL, CONTRACTS: EXCHANGE TRANSACTIONS AND RELATIONS, 12–13 (2d ed. 1978) (demonstrating an example of the relational theory of contracting).

70. *See* James W. Fox Jr., *Relational Contract Theory and Democratic Citizenship*, 54 CASE W. RES. L. REV. 1, 8 (2003) (noting that "the legal principles of the realists, particularly those implemented in the U.C.C. such as good faith, open-price terms, the flexibility accorded output and requirements contracts, and the attempt to find a contract where the parties' expressions of offer and acceptance contradicted each other but their actions show an agreement to proceed, are the focus of scholarly attention and the model for further expansion of 'relational' principles to non-sales long-term contracts").

achieve strategic ends.[71] The same is true of the law-dependent field of compliance. The range of compliance capabilities will vary between complicit compliance officers who look the other way and enable illegal and unethical behavior, to those with a formalistic check-the-box mentality, and those who are forward-looking, preventive and, in some cases, strategic.[72]

Recognizing the behavioral aspects of compliance law and practice are critical to develop theory; however, an equally important task is to amplify the focus of compliance law to include broader aspects of the regulatory environment. This by necessity amplifies both the scope of analysis and the examined unit of analysis. From a strictly legal perspective, the unit of analysis is a regulation and its impact on an economic actor, namely a firm and its managers. The current state of compliance research, particularly the strain that emphasizes compliance as a subset of corporate governance, focuses on this dyadic relationship between regulator and regulated entity.[73] The practice and reality of compliance, however, requires the analysis to expand to include additional interrelated units. These include inter-organizational structures such as inter-agency coordination efforts and self-regulatory organizations.

The following case study illustrates the complex and multi-dimensional aspects of compliance practice and law. The following section analyzes the downfall of MF Global to illustrate the various aspects of compliance that a robust compliance theory should take into consideration.

B. Compliance Case Study – MF Global

MF Global was once a prominent commodities broker; however, the company experienced financial difficulties shortly after its initial public offering in 2007 due to its overreliance on the brokerage business' thin margins, interest rate risk and several compliance failures such as a $141.5

71. *See* Robert C. Bird, *Pathways of Legal Strategy*, 14 STAN. J.L. BUS. & FIN. 1, 7–8 (2008) (discussing how the use of legal knowledge evolved into playing an active role in the strategic management of a firm); David Orozco, *Legal Knowledge as an Intellectual Property Management Resource*, 47 AM. BUS. L.J. 687, 687–94 (2010) (discussing the importance of legal and managerial knowledge as a source of competitive advantage); Constance E. Bagley, *Winning Legally: The Value of Legal Astuteness*, 33 ACAD. MGMT. REV. 378, 378 (2008) (articulating the value of legal astuteness within firms).

72. *See* J.S. Nelson, *Disclosure-Driven Crime*, 52 U.C. DAVIS L. REV. 1487, 1544 (2019) (describing how the compliance function at Volkswagen was complicit in hiding information from regulators); Haugh, *supra* note 2, at 686 (discussing "behavioral ethics nudging," a new trend in corporate compliance strategy, which creates a structured decision-making process to encourage employees to act ethically).

73. *See, e.g.*, Root, *Coordinating Compliance Incentives*, *supra* note 2 (analyzing government regulatory mechanisms and their effect on corporate compliance).

million dollar loss caused by a rogue trader.[74] In 2010, Jon Corzine, the former New Jersey governor and senator and once head of Goldman Sachs, was hired to turn the company's fortunes around.[75]

Corzine immediately sought to transform the company into a global investment bank.[76] As a commodities dealer and a brokerage firm, MF Global was subject to regulation by the Securities and Exchange Commission (SEC), the Commodities and Futures Trading Commission (CFTC), the Securities and Investors Protection Company (SIPC) and self-regulatory organizations such as the Chicago Board of Exchange (CBOE) and the Financial Industry Regulatory Authority (FINRA).[77]

To achieve the goal of transforming the company into an investment bank, Corzine used his political influence to secure regulatory approval with the Federal Reserve Bank of New York to designate MF Global as a New York Primary Dealer, a status that would enable the company to deal directly with the U.S. government to distribute U.S. Treasury debt.[78] The Primary Dealer designation carries financial benefits and is viewed as a strong seal of approval by regulators and Wall Street. The Federal Reserve somewhat hastily approved the Primary Dealer designation despite previously denying MF Global's application and a warning from regulators at the CFTC that MF Global lacked proper internal controls as uncovered during a recent investigation.[79]

Once he was in place as Chairman and CEO, Corzine failed to

74. STAFF OF H.R. COMM. FINANCIAL SERVICES OVERSIGHT AND INVESTIGATIONS, 112TH CONG., REP. ON MF GLOBAL 1–7 (Comm. print 2012) [hereinafter *MF Global House Report*].

75. *Id.* at 20.

76. *Id.* at 27.

77. The SEC, CFTC and SIPC are governmental regulatory agencies. The last two entities are what are known as self-regulating organizations, or SROs. FINRA regulates all broker-dealers that interact with the public and derives its authority to do so under the Securities and Exchange Act of 1934. *See* Jonathan Macey & Caroline Novogrod, *Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation*, 40 HOFSTRA L. REV. 963, 964 (2012) (stating that "FINRA was created pursuant to the Securities Exchange Act of 1934 . . . which contemplated a system wherein member-owned securities exchanges and broker-dealer associations would regulate the activities of its member securities firms, subject to the oversight of the Securities and Exchange Commission. . . ."). SROs like FINRA play an important role in compliance although their role has not been fully examined. *See id.* at 963 (stating that "[f]ew issues are as poorly understood and under-theorized as the concept of 'industry self-regulation'").

78. Sarah N. Lynch, *A Persistent MF Global Won NY Fed Dealer Status*, REUTERS (Dec. 14, 2011), https://www.reuters.com/article/us-mfglobal-nyfed/a-persistent-mf-global-won-ny-fed-dealer-status-idUSTRE7BD2B920111215 [https://perma.cc/UQ7X-MXCA] (reporting that "[n]ow bankrupt MF Global lobbied the New York Federal Reserve heavily to become a primary dealer, eventually succeeding after a delay sparked by a regulator flagging internal control problems").

79. *MF Global House Report*, *supra* note 74, at 29.

implement adequate compliance controls from a risk management perspective and implemented a culture of aggressive risk-taking. Corzine's strategy focused on multi-billion dollar purchases of European sovereign debt.[80] These bonds had been trading at a steep discount and under volatility since the European debt crisis had called into question the ability of certain countries like Greece, Portugal, Ireland, Italy and Spain to repay their loans.[81] In addition, Corzine promoted a company culture that reflected a lack of accountability and transparency. For example, when the company's Chief Risk Officer began to voice concerns about the amount and volatility of foreign sovereign debt investments pursued by Corzine, Corzine removed the risk officer from reporting directly to the board and reassigned him to report into the company's Chief Operating Officer, who was one of Corzine's long-time underling.[82] The risk officer was shortly thereafter fired and replaced.[83]

The lack of accountability extended up to the board of directors since they failed to adequately place controls on Corzine's increasingly risky bets on European sovereign debt and approved MF Global's large capital allocations to fund these investments.[84] They also failed to monitor and correct inadequate risk management procedures, such as the aggressive use of a riskier method of calculating reserves to protect customers' brokerage account funds held in segregated accounts.[85] This riskier method was allowed by the CFTC, although it was not widely employed in the industry, and was later prohibited by regulators after MF Global's collapse.[86] Adequate supervision by the board would have spotted the increased risk assumed by this more aggressive reserve calculation method and, given the high risk of taking such a large position in volatile European debt, it would have been prudent to switch to the more conservative method. In July 2011, the company's CFO produced a memo that suggested the firm could provide overnight "loans" from the commodities business' segregated and secured accounts to be used as working capital for broker-dealer operations in New

80. *MF Global House Report*, *supra* note 74, at 31.

81. Jennifer Rankin, *Weakest Eurozone Economies on Long Road to Recovery*, THE GUARDIAN (Sept. 16, 2017), https://www.theguardian.com/business/2017/sep/16/weakest-eurozone-portugal-ireland-spain-italy [https://perma.cc/F8HK-AU63].

82. *MF Global House Report*, *supra* note 74, at 37.

83. *Id.* at 38.

84. *Id.* at 39–40.

85. *See* Cause of Action Institute, *The Collapse of MF Global: Summary and Analysis* 5 (June 25, 2013), https://causeofaction.org/the-collapse-of-mf-global-summary-analysis/ [https://perma.cc/GTP9-BQ7H] (noting that "[t]he SIPA Trustee noted in his report that the Alt Method results in a significantly lower regulatory capital requirement. MF Global's Secured Statements on file with their regulators show that the company indeed used the Alt Method for reporting purposes.").

86. *MF Global House Report*, *supra* note 74, at 90–92.

York.[87] This was a dramatic change from customary practice and would have raised a red flag had proper controls been implemented by the board.[88]

The board and management also failed to properly monitor the regulatory requirement to increase capital reserves and comply with liquidity rules triggered by the purchase of the volatile sovereign debt. According to a congressional investigation report, FINRA disagreed with MF Global's assessment that the European sovereign bonds were equivalent to U.S. treasury debt from a default risk perspective.[89] FINRA and the SEC required MF Global to increase its capital reserves in light of the higher risk of default related to these bonds. Also, the mandated processes and reports to comply with liquidity regulations were all performed manually, despite the fact that a number of compliance officers within the company had requested that the IT department automate the process.[90]

When the losses triggered by the high exposure to sovereign debt and the lack of adequate compliance controls were made public, this compelled several ratings agencies to downgrade MF Global.[91] Counterparties to the sovereign debt trades then demanded higher margin payments, and brokerage customers began to withdraw their funds.[92] This caused a liquidity crisis that resulted in rushed and inappropriate fund transfers that drew money from MF Global customer accounts, violating one of the most fundamental rules in the industry which is that customer property should never be co-mingled or used for company purposes.[93] When MF Global declared bankruptcy on October 31, 2011 there was a $1.6 billion dollar shortfall related to customer funds that were missing since they were improperly used to repay creditors.[94]

The MF Global case illustrates how various actors within and outside of the organization impacted the practice of compliance, ranging from the board, to its top executives in charge of designing and conceptualizing a

87. *MF Global House Report*, *supra* note 74, at 48–49.

88. *See* Jonathan Stempel, *Corzine, Others Settle MF Global Lawsuit for $64.5 Million*, REUTERS (July 7, 2015), https://www.reuters.com/article/us-mfglobal-settlement-idUSKCN0PH1RJ20150707 [https://perma.cc/GYW5-7AWL] (reporting that insurers agreed to settle claims brought by investors against MF Global executives and directors alleging improper management).

89. *MF Global House Report*, *supra* note 74, at 52 (stating that "FINRA staff members responded by noting that MF Global had indicated in its regulatory filings that the company retained the default risk on its European bonds and that this risk was non-trivial").

90. *Id.* at 47.

91. *Id.* at 56–57.

92. *Id.* at 59.

93. *Id.* at 60–61. *See* Cause of Action Institute, *supra* note 85, at 7 ("The SIPA trustee report notes that 'some personnel at MFGI interpreted the regulations as permitting customer funds to be used intraday.'").

94. *MF Global House Report*, *supra* note 74, at 73.

compliance program, to the officers in charge of executing this program, including the board, Corzine, the CFO, COO and its Chief Risk Officer. Also, parties external to the firm such as regulators played a role in the firm's collapse.

It is important to highlight that the MF Global case is not meant to represent an archetypal or representative compliance case study since such a thing does not exist given the wide diversity of compliance-related issues and contexts faced by firms. Rather, the case highlights the complexity of compliance-related issues that should be accounted for by a suitable theory of compliance law. As discussed below, a theory of compliance law should take into account the complex reality of compliance practice.[95] Before beginning that discussion, however, the next section discusses how existing compliance law theory fails to adequately account for MF Global's failure.

C. Existing Theory's Inability to Explain the MF Global Failure

On its face, the MF Global case may seem like another example of bad corporate governance. This viewpoint would support the argument that compliance law is simply a subset of corporate governance and that it lacks a rigorous theoretical basis as its own area of scholarship.[96] However, corporate governance failings do not entirely account for MF Global's failure. The causal factors behind this massive collapse suggest various additional forces were at play.

For example, regulatory behavior should be assessed to find out if regulators played a role that facilitated MF Global's failure.[97] For one, a congressional subcommittee that investigated the MF Global collapse offered the following recommendation to the Federal Reserve Bank of New York:

> The Subcommittee further recommends that the New York Fed consider re-examining its primary dealer selection process to provide for greater scrutiny of companies with questionable financial health, risk management histories, and ambitious business strategies. If a company has experienced multi-year losses, chronic regulatory failures, or is in the process of implementing a dramatic change in business strategy-red flags that

---

95. *See* discussion *infra* Part III.B.

96. Cunningham, *supra* note 2, at 14.

97. The case of federal prosecutors aggressively seeking criminal charges against Arthur Andersen due to the role it played in the Enron scandal is a classic case involving what is viewed as overly-zealous prosecutorial overreach. *See generally* James Kelly, *The Power of an Indictment and the Demise of Arthur Andersen*, 48 S. TEX. L. REV. 509 (2006) (discussing the negative consequences of indicting entire corporations at the expense of thousands of innocent employees).

> were clearly present during [MF Global's] application–the New York Fed should consider prolonging the application process to better assess how these factors will affect the company's overall suitability as a counterparty.[98]

It is believed that the Federal Reserve Bank of New York accelerated MF Global's application to become a primary dealer, which is viewed as a stamp of approval.[99] This imprimatur of legitimacy might have altered the perception among stakeholders regarding the level of risk inherent within the company.

The same congressional investigation report also had the following to say about the CFTC's allowance of a riskier method to calculate segregated customer funds:

> By permitting [futures merchants] to exclude a customer's excess margin funds from the amount that must be set aside in secured accounts, the Alternative Method is inconsistent with the Commodity Exchange Act's "bedrock" customer protection principle, which "ensure[s] that property entrusted by customers to their brokers will not be subject to the risks of the broker's business" . . . On October 23, 2012, the CFTC announced that it would be proposing new rules to enhance customer protections by, among other things, amending Part 30 of its regulations to no longer permit [futures merchants] to use the Alternative Method . . . The Subcommittee welcomes the CFTC's announcement of proposed rules and will follow their development with great interest.[100]

Needless to say, this finding and recommendation came too late for the customers who saw their funds comingled with MF Global's and then disappear in the process. The reason why the CFTC may have allowed the riskier Alternative Method may have been due to industry pressure from futures merchants who preferred to operate at a higher risk profile. As noted by one scholar who discussed proposed regulatory changes in the related area of net capital requirements in the futures industry:

> The viability of any change in the existing net capital rule will depend in large measure on its acceptance by both regulators and the industry. That acceptance will meet resistance. First, the industry will oppose any requirement that increases capital over

---

98. *MF Global House Report*, *supra* note 74, at 95.

99. *See* Lynch, *supra* note 78 (explaining that MF Global pushed the NY Fed to expedite its application for primary dealer status, but the NY Fed delayed approving the application because of concerns raised by the CFTC).

100. *MF Global House Report*, *supra* note 74, at 91–92 (quoting In re Stotler & Co., 144 B.R. 385, 387 (N.D. Ill 1992)).

> existing levels . . . Consequently, the "political" obstacles to the creation of a risk-based system are formidable.[101]

The CFTC's allowance of the riskier Alternative Method may have been the result of industry pressure to retain this method for those firms that desired to assume greater risk in this area of the business. This preference among more aggressive risk-taking firms likely impacted the CFTC's regulation as it catered to accommodate the higher risk tolerances of these firms. In the process, the CFTC made compliance with the regulation more ambiguous given that there were several methods to choose from.

There is also evidence that the multiplicity of regulators assigned to oversee MF Global failed to adequately coordinate their oversight efforts.[102] The congressional investigation report into the demise of MF Global found that there was

> no record of meaningful communication between the regulators regarding MF Global before the company's final week of business, even though [MF Global] was registered with both agencies. The SEC's and the CFTC's failure to coordinate regulatory oversight of the company meant that the agencies missed several opportunities to share critical information with one another.[103]

This points to an area of administrative law theory that is particularly relevant to compliance law. Administrative law scholars have recently conceptualized what they call shared regulatory spaces, that is, the coordination challenges presented by overlapping and fragmented delegations of power to multiple agencies and the mechanisms employed by agencies to overcome these difficulties.[104] According to these scholars,

> so many domains of social and economic regulation now seem populated by numerous agencies, which — to satisfy their missions — must work together cooperatively or live side by side compatibly. One cannot recognize this challenge using the single-agency lens that has been central to administrative law. It requires an appreciation of shared regulatory space.[105]

From a compliance law theory standpoint, this suggests that regulatory agencies face constraints related to institutional design that result in agency

101. Jerry W. Markham, *The CFTC Net Capital Rule – Should a More Risk-Based Approach Be Adopted?*, 71 CHI.-KENT L. REV. 1091, 1108–09 (1996).

102. *MF Global House Report*, *supra* note 74, at 80.

103. *Id.* at 79–80.

104. Freeman & Rossi, *supra* note 65, at 1133–36 ("Many areas of regulation and administration are characterized by fragmented and overlapping delegations of power to administrative agencies.").

105. *Id.* at 1138.

costs such as monitoring and coordination costs.[106] This is particularly true when agencies such as the SEC and the CFTC possess overlapping authority. These challenges also extend to self-regulatory organizations (SROs), which are private quasi-governmental self-regulating entities.[107] In the MF Global case, FINRA and the CBOE were the two SROs that shared regulatory oversight of that firm's activities, and they also failed to effectively communicate with one another.[108]

Interestingly, the MF Global case reinforces one of the perceived benefits of agency overlap in a shared regulatory space. That is, spreading oversight among various regulators acts as a form of insurance since one regulator may detect a compliance failure that was ignored by other regulators.[109] This occurred when FINRA took note of MF Global's large sovereign debt position and required the company to increase its capital reserves.[110] Other regulators such as the SEC, CFTC and CBOE had failed to identify this mandated risk-based capital adjustment.[111]

Corporate governance law alone, therefore, fails to adequately account for the various factors behind the compliance failure at MF Global. As the systems theory of compliance will demonstrate, corporate governance is an important piece of a much larger compliance law theory puzzle.

III. A SYSTEMS THEORY OF COMPLIANCE

This section introduces the first holistic portrait of compliance as a dynamic, multi-party and interrelated system. The theory integrates insights

---

106. Root, *Coordinating Compliance Incentives*, *supra* note 2, at 1029–32 ("Governmental enforcement agencies and actors are also subject to the information and coordination complexities that confront many regulatory agencies within the current administrative state.").

107. *See* Benjamin P. Edwards, *The Dark Side of Self-Regulation*, 85 U. CIN. L. REV. 573, 583 (2017) ("FINRA straddles the line between a public and private entity. Although FINRA officially remains a private, not-for-profit corporation, it plays such an integral-and increasingly governmental-role in securities regulation that debates have emerged over whether it should be classified as a state actor. The literature and case law frequently describe it as a quasi-governmental organization.").

108. *MF Global House Report*, *supra* note 74, at 23.

109. Freeman & Rossi, *supra* note 65, at 1138 ("Yet from another perspective, redundancy has certain benefits, like providing a form of insurance against a single agency's failure.").

110. *MF Global House Report*, *supra* note 74, at 54–56.

111. *Id.* at 50–52, 80.

from behavioral ethics,[112] administrative law,[113] corporate governance,[114] transaction cost economics[115] and regulatory arbitrage[116] from the perspective of systems theory.[117] After an overview of systems theory, each section below discusses various conceptualized system units and their principal compliance-related activities. These system units include regulators, firms, executives and inter-organizational structures.

As prior scholarly research demonstrates, economic and normative social forces exert pressure on individuals and organizational processes.[118] The systems theory proffered here is the first to integrate the various units operating within a *compliance system* and discusses their activities in relation to one another. The systems theory of compliance is largely descriptive, yet, as pointed out by scholars descriptive theory can go a long way to help clarify and illuminate salient issues and provide the foundation for normative analysis.[119] As will be demonstrated, the systems theory of compliance provides an integrated, generalizable and accurate portrayal of compliance as it exists in practice.

Each actor within the system plays a critical role in the development of compliance practice, law and theory. The three main variables that will be assessed for each unit are: a) the practices that each unit undertakes to promote or hinder compliance; b) the economic determinants of this behavior; and c) the institutional determinants of this behavior that include non-economic normative social forces.[120]

---

112. *See, e.g.*, Haugh, *supra* note 2 (discussing how corporations can make small adjustments to the conditions under which individuals make decisions in order to increase ethical decision making by employees).

113. *See, e.g.*, Freeman & Rossi, *supra* note 65 (discussing the fragmented and overlapping authority of administrative agencies and the challenges of interagency coordination).

114. *See, e.g.*, Cunningham, *supra* note 2 (discussing the importance of prosecutors considering corporate governance structures when investigating corporations and imposing reforms).

115. *See, e.g.*, Oliver E. Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979) (discussing "[t]he importance of transaction costs to the organization of economic activity").

116. *See* Fleischer, *supra* note 31 (discussing preconditions and implications of regulatory arbitrage, a technique that involves legally exploiting gaps in the law to reduce regulatory costs).

117. Lynn M. LoPucki, *Systems Approach to Law*, 82 CORNELL L. REV. 479 (1997).

118. *See* Oliver, *supra* note 59, at 697–713 (theorizing that both the economic foundations of the resource-based view of the firm and the normative social pressures of institutional theory impact managerial behavior).

119. *See* Freeman & Rossi, *supra* note 65, at 1137–38 ("Though much of the Article is descriptive and analytic, its larger goal is conceptual. More than ever, it seems, a proper understanding of the administrative state requires a fuller grasp of interagency dynamics.").

120. *See* RICHARD W. SCOTT, INSTITUTIONS AND ORGANIZATIONS 33 (4th ed. 1995) (discussing how institutions are resilient social structures comprised of cultural-cognitive,

A. Systems Theory

As the MF Global case illustrates, the practice of compliance is impacted by various actors internal and external to the firm. This introduces dynamism and complexity that requires a deep analysis of the various interacting parts that constitute the compliance system. To analyze a system, one must break down its various constituent parts.[121] Understanding how various constituent parts function and impact each other is a primary concern of systems theory and analysis.[122] As stated by Professors Belinfanti and Stout:

> [S]ystems theory is a design and assessment methodology routinely employed in a wide variety of fields, including computer science, engineering, biology, and environmental science. It can be applied to any process (system) in which multiple elements interact with each other, over time, to achieve particular purposes or functions.[123]

Systems are complex interwoven tapestries that often elude definition and conceptual separation from the broader environment.[124] Scholars recognize, however, that there are three techniques available to help an analyst disentangle a system from the broader environment as separate phenomena worthy of study. Those techniques are the human participant test, the interaction principle and the purpose principle.[125] The human participant test simply asks who is grappling with the issue under examination.[126] With regard to the last two, Professor LoPucki states:

> [T]he "interaction principle" holds that the persons and things that form a system interact more closely and more frequently among themselves than they do with persons and things in their environment. Systems can be defined more or less expansively by varying the degree of closeness or frequency of interaction required to define a person or thing as included in the system. The only limitation that must be observed is that persons and things

---

normative, and regulative elements that provide stability and meaning to social life.)

121. LoPucki, *supra* note 117, at 482.

122. *Id.* at 487.

123. *See* Tamara Belinfanti & Lynn Stout, *Contested Visions: The Value of Systems Theory for Corporate Law*, 166 U. PENN. L. REV. 579, 583 (2018) (applying systems theory to the theory of the corporation).

124. LoPucki, *supra* note 117, at 498 (stating that "[d]istinguishing social systems, including law-related systems, from their environments is often difficult. Social systems are often interwoven in a rich, complex tapestry that can at first appear seamless. A single actor, element, or subsystem may contribute simultaneously to the functioning of several systems.").

125. *Id.*

126. *Id.*

> with less interaction cannot be included if persons and things with more interaction are excluded. The "purpose principle" holds that persons and things that are necessary to the functioning of the system-that is, to the accomplishment of system goals-are included. Those that are unnecessary are excluded.[127]

Following the definition of these three delimiting attributes of a system, this article posits that the compliance system is comprised of the dynamic and complex relationships that interlock regulators, firms, executives, and inter-organizational structures. Each of these conceptually distinct, yet, interrelated units comprise a subsystem within the larger compliance system.[128]

B. Regulators

A natural starting point to begin to analyze compliance as a separate field of inquiry naturally begins with a theory of regulation and regulatory agencies. Under administrative law theory, agencies derive their legitimacy and regulatory authority from the legislative process.[129] The consensus among scholars is that regulations should strive to uphold the normative goals of efficacy, legitimacy and accountability.[130] Yet, the scope of agency authority may expand or "drift" over time since under traditional principal-agent theory, whenever Congress delegates authority to an agency, the delegation will grant the agency some level of discretion that may change over time.[131]

As the reactionary process view of compliance suggests, regulation results from a political process and reflects the public's desire to constrain market activities.[132] From an economics standpoint this may be done to

---

127. LoPucki, *supra* note 117, at 499.

128. *Id.* at 498 ("The structure of relatively distinct systems, each composed of subsystems which are themselves composed of subsystems, is the natural structure of our universe.").

129. *See* McCubbins et al., *Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies*, 75 VA. L. REV. 431, 433–34 (1989) (discussing how legislatures, in terms of policy from a positive political theory perspective, are principals and agencies are their agents. This relationship thus triggers classic agency problems involving monitoring costs).

130. *See* Jody Freeman, *Collaborative Governance in the Administrative State*, 45 UCLA L. REV. 1, 4–5 (1997) (explaining that "[n]ormative claims about the goals of regulation are either explicit or implicit in scholarly critiques of what ails the administrative state. Most scholars profess commitments to both efficacy and legitimacy and therefore seek reform that will produce high-quality solutions for which decisionmakers are accountable.").

131. Freeman & Rossi, *supra* note 65, at 1187 (discussing that policy drift may result in shirking of responsibilities or the pursuit of expanded policymaking objectives not originally contemplated by legislation).

132. *See* discussion *supra* Part I.

lessen the negative social externalities created by a market failure.[133] How and whether those goals are implemented at the regulatory level requires an analysis of regulatory behavior within agencies. The rich body of administrative law theory provides a strong foundation to examine regulatory behavior in practice.[134]

A key regulatory practice is to define the scope of regulation, taking into account legislative goals and the legislative delegation of authority.[135] The scope of delegated authority may depend on several factors, such as the legislative intent to distribute authority among several agencies, judicial decision making that contracts or expands administrative authority, and bureaucratic policy drift that occurs over time.[136] Additionally, agencies can expand their authority through a collaborative rulemaking process such as negotiated rulemaking. In the process, they may implement regulatory innovations that result from the active participation and information-sharing among impacted stakeholders.[137] Professor David Zaring also highlights how agencies may informally expand their authority and freedom from judicial review through the adoption of best practices.[138]

A comprehensive analysis of administrative law is beyond the scope of this article, however, the courts have generally applied the *Chevron* doctrine to support the finding that an agency has discretion to interpret a statute due to a statute's ambiguity, known as step one of the analysis.[139] Under step two of the analysis, the judiciary will uphold the agency's interpretation of

---

133. *See* Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1–44 (1960) (discussing the role of transaction costs as the primary source of analysis for the justification of regulation).

134. McCubbins et al., *supra* note 129, at 435–38.

135. This may trigger constitutional questions related to the proper role of congressional delegation of authority to administrative agencies and the potential problems this creates due to the constitutional principle of separation of powers. Related concerns involve agencies that overstep their authority or interpret statutes in an overly-broad manner that, for example, create rights and obligations that are not grounded in any intelligible principle and thus extend beyond what a statute contemplated or authorized. *See* Whitman v. Am. Trucking Ass'ns, Inc., 531 U.S. 457, 472 (2001); J. W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 409 (1928) ("If Congress shall lay down by legislative act an intelligible principle to which the person or body authorized to fix such rates is directed to conform, such legislative action is not a forbidden delegation of legislative power."). *See generally* Gary Lawson, *The Rise and Rise of the Administrative State*, 107 HARV. L. REV. 1231 (1994) (discussing the design of the modern administrative state and the gap between constitutional meaning and constitutional practice).

136. Freeman & Rossi, *supra* note 65, at 1139–43.

137. *See generally* Freeman, *supra* note 130 (proposing a model of collaborative governance as an alternative to the model of interest representation in regulatory reform).

138. *See* David Zaring, *Best Practices*, 81 N.Y.U. L. REV. 294, 324 (2006) ("Confronted with a wide range of remedial options in a complex issue-area, regulators can rationally save costs through the adoption of 'off the shelf' rules, such as best practices.").

139. Chevron U.S.A. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 842–43 (1984).

statutory ambiguity or silence as long as the agency's interpretation is based on a permissible construction of the statute.[140] A recent empirical study affirms that fairly deferential results occur when the courts apply the *Chevron* doctrine to administrative behavior.[141]

Regulators are authorized to enforce the law; otherwise they will refer cases to the appropriate enforcement authority. Enforcement authorities have sole discretionary authority to decide whether to charge a company and can recommend the penalties and remedial actions that should be imposed and have the power to craft settlements.[142] Enforcement authorities also have the ability to design incentives as part of their discretion to cease investigations and settle disputes. This can greatly alter the cost-benefit calculation of compliance performed within companies. For example, the Department of Justice (DOJ) Federal Sentencing Guidelines are an important aspect of compliance law.[143] The guidelines technically apply only to criminal enforcement actions, however, they have been vigorously used by prosecutors to craft civil settlements.[144] In the guidelines, the DOJ provides reduced fines and penalties and the ability to enter a deferred prosecution arrangement if the company under investigation has a well-defined compliance program and follows what are deemed to be good corporate governance practices.[145] Regulators and the enforcement authorities do not operate in a vacuum, however, as recognized by administrative law scholarship. Several economic and social institutional forces influence their behavior.[146]

1. Economic Forces

An economic force that impacts regulators is the mandate to structure or define regulation in a way that achieves economic efficiency. In the case of federal regulations, it has been the case since 1993 through Executive Order 12,866 that certain regulations should have financial efficiency as a

140. *Id.* at 843.

141. *See generally* Kent Barnett & Christopher J. Walker, *Chevron in the Circuit Courts*, 116 MICH. L. REV. 1 (2017) (discussing the *Chevron* doctrine's application in circuit courts and its impact on case outcomes).

142. *See* U.S. Dept. of Justice, PRINCIPLES OF FEDERAL PROSECUTION OF BUSINESS ORGANIZATIONS (2018) (proposing a set of recommended penalties for business organizations). *See generally* Cunningham, *supra* note 2 (arguing for the integration of the role of corporate governance into prosecutions).

143. U.S. SENTENCING GUIDELINES MANUAL (U.S. SENTENCING COMM'N 2016).

144. Root, *The Compliance Process*, *supra* note 2, at 215.

145. Cunningham, *supra* note 2, at 18.

146. *See generally* Freeman & Rossi, *supra* note 65 (discussing the challenges and benefits of interagency coordination in modern governance).

primary criteria and policy objective.[147] For example, under Executive Order 12,866, the Office of Information and Regulatory Affairs (OIRA) is responsible for determining which agency's regulatory actions are "significant" and, in turn, subject to interagency review.[148] Among other things, significant regulatory actions are defined by that executive order as those that "have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities . . . "[149] This executive order also requires agencies to provide an explanation of the need for the regulatory action and an assessment of its potential costs and benefits.[150]

As economic actors, regulators are also subject to resource constraints and limited budgets.[151] This places stress on the ability of the regulator to prosecute offenses. As resource-constrained actors, regulators must focus on punishing those violations that will maximize social welfare and to do so

147. Exec. Order No. 12,866, 3 C.F.R. 638 (1994), reprinted as amended in 5 U.S.C. § 601 app. at 83–87 (2006) [hereinafter *Exec. Order No. 12,866*].

148. *See* Stuart Shapiro, *Unequal Partners: Cost Benefit Analysis and Executive Review of Regulation*, 35 ENVTL. L. REP. 10433 (2005) (describing the antecedents to the executive order and stating that "President Jimmy Carter established the Regulatory Analysis Review Group and issued Executive Order No. 12044, which, for the first time, required economic impact statements on all rules with an impact of more than $100 million").

149. Agencies must produce detailed cost-benefit analyses justifying major economically significant rules as defined by section 3(f)(1). *Exec. Order No. 12,866*, *supra* note 147 § 6(a)(3)(C). The White House Office of Management and Budget (OMB) has elaborated on the requirements for regulatory review in detail in OMB Circular A-4. *See* OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, CIRCULAR A-4, REGULATORY ANALYSIS (2003), https://obamawhitehouse.archives.gov/omb/circulars_a004_a-4/ [https://perma.cc/6S2Q-UPGP] (providing the Office of Management and Budget's (OMB's) guidance to Federal agencies on the development of regulatory analysis as required under Section 6(a)(3)(c) of Executive Order 12866, "Regulatory Planning and Review," the Regulatory Right-to-Know Act, and a variety of related authorities). Executive Order No. 12,866 and OMB Circular A-4 explain that the monetized benefits of a rule are not required to exceed its monetized costs; the costs of the rule must only be "justified" by the benefits, including quantitative and qualitative benefits. *Exec. Order No. 12,866*, *supra* note 147 § 1(b)(6), 3 C.F.R. at 639.

150. *But see* Shapiro, *supra* note 148 (discussing how presidential administrations may oppose regulations that meet efficiency criteria and support rules that do not); THOMAS MCGARITY, REINVENTING RATIONALITY 61 (1993) (describing how the EPA chose a "realist" approach over the more stringent standards that would have produced the most net benefits).

151. *See* Edwards, *supra* note 107, at 607 (stating that "[e]ven with independent, effective, and competent frontline personnel, financial regulators may perform poorly if the 'message from the top skews their effectiveness.' For example, an organization's board may reduce enforcement budgets or issue directives to expedite oversight examinations.") (quoting Steven Davidoff Solomon, *The Government's Elite and Regulatory Capture*, N.Y. TIMES (June 11, 2010), http://dealbook.nytimes.com/2010/06/11/the-governments-elite-and-regulatory-capture [https://perma.cc/5DVT-RYKD]).

they focus on activities that generate the greatest harm to society.[152] From a public choice theory perspective, regulators are rational, even strategic actors.[153] From this perspective, regulators may rationally decide to focus their limited resources on easier-to-win cases that may be resolved quickly and that provide high-profile victories that maximize political gains.[154]

Lastly, an economic force recognized by scholars in the area of regulatory law and public choice theory is regulatory capture.[155] Regulatory capture is defined as "the misalignment of incentives of government actors who pursue narrow private interests that may conflict with the public interest they purport to serve."[156] In these instances, the regulator is coopted through various formal and informal mechanisms such as hiring industry officials as regulators, the use of revolving doors to reward regulators with lucrative industry jobs, lobbying and social interactions that yield an unconscious bias that favors industry.[157]

2. Institutional Forces

Institutional forces also moderate regulatory behavior. One non-economic force includes the mandate of public officials to promote the public interest ahead of industry profits.[158] This interest acts as a foil against regulatory capture, since promoting the public interest is a norm held by regulators who seek to ensure that the public aims of regulation take priority over any particularized goals of industry.[159] According to one theoretical

152. Baer, *supra* note 18, at 1049.

153. GORDON TULLOCK, ARTHUR SELDON & GORDON L. BRADY, GOVERNMENT FAILURE: A PRIMER IN PUBLIC CHOICE 87 (2002).

154. *See* Cunningham, *supra* note 2, at 56 (discussing the motivations prosecutors may have to settle a case using a DPA); Richard T. Boylan, *What Do Prosecutors Maximize? Evidence from Careers of U.S. Attorneys*, 7 AM. L. & ECON. REV. 379 (2005) (providing evidence on the subsequent career paths of former U.S. Attorneys).

155. *See* Nathaniel O. Keohane et al., *The Choice of Regulatory Instruments in Environmental Policy*, 22 HARV. ENVTL. L. REV. 313, 319–21 (1998) (discussing regulatory capture of environmental agencies).

156. Saule T. Omarova, *Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation*, 37 J. CORP. L. 621, 630 (2012).

157. *See,* e.g., Solomon, *supra* note 151 (discussing the social and ideological capture of financial regulators and the difficulty of finding an adequate solution).

158. *See* Pierre Louis, *supra* note 44, at 40 (stating that "[t]he main purpose of federal regulation is protection of the general public even to the extent of foregoing the extraordinary profits").

159. *See* Edwards, *supra* note 107, at 586 ("Ideally, public representatives zealously guard the public's interest and counterbalance industry influence within self-regulatory organizations. To achieve this ideal, a public representative must have actual independence and a true public-interest orientation. If, however, public representatives share the same perspectives, beliefs, and biases as industry members, they may represent the public's interest

perspective, regulators are entitled to broad delegations of authority since they are more insulated from the pressure of factions and can engage in enlightened deliberations that further the public good.[160]

Another institutional determinant is the regulator's scope of discretionary authority. Broad delegations of authority buttressed by vague or sweeping legislation provide regulators with greater authority to craft regulations that have a greater impact on industry. For example, financial industry regulators were able to resort to the anti-fraud provisions of the Securities and Exchange Acts and state anti-fraud securities laws, such as the Martin Act, to broadly regulate entities that had exploited the regulatory loopholes created by more narrowly defined statutes.[161]

The exercise of regulatory expansion may be an inherent aspect of the system. Under the traditional principal-agent theory of administrative law, whenever Congress delegates authority to an agency, that delegation inevitably provides the agency with varying degrees of discretion.[162] This, in turn, creates the risk of bureaucratic drift away from the lawmakers' preferences.[163] The scope of agency discretion may be difficult to change since agencies are granted high levels of deference by the judiciary with respect to agency determinations and interpretations of law.[164]

Lastly, the political climate is an institutional force that impacts regulators.[165] Since the heads of regulatory agencies are for the most part appointed by the president and serve at the president's discretion, the broader political climate will impact the culture and regulatory processes within an agency.[166] For example, the current anti-regulatory environment has filtered

with less vigor. At worst, industry-aligned public representatives provide only a veneer of publicness, cloaking industry domination over a purportedly independent board.").

160. *See* Mark Seidenfeld, *A Civic Republican Justification for the Bureaucratic State*, 105 HARV. L. REV. 1511 (1992) (arguing that agencies are better situated than courts and legislatures to engage in deliberation over the public good).

161. *See* Pierre Louis, *supra* note 44, at 51 (discussing how these laws allowed regulators to extend their regulatory oversight to previously exempt hedge funds).

162. *See,* e.g., Freeman & Rossi, *supra* note 65, at 1187 (considering the varying degrees of discretion afforded to federal agencies in the context of principal-agent theory).

163. *See* Pablo T. Spiller & John Ferejohn, *The Economics and Politics of Administrative Law and Procedures: An Introduction*, 8 J.L. ECON. & ORG. 1, 6–7 (1992) (discussing the risk that an agency may deviate from the interests of the political coalition that created the agency).

164. *See generally* Barnett & Walker, *supra* note 141 (assessing the findings of an empirical study on how the federal courts of appeals have applied Chevron deference).

165. *See* Shapiro, *supra* note 148, at 10437–38 (discussing the role of the OIRA to further presidential agendas and commenting "[n]ow that the role of OIRA has been affirmed both by Republican and Democratic administrations, its place seems secure: future presidents are likely to continue to use OIRA to impose their agendas on regulatory agencies").

166. *See* David B. Spence, *Administrative Law and Agency Policy-Making: Rethinking the Positive Theory of Political Control*, 14 YALE J. ON REG. 407, 419 (1997) (stating "presidents exert more ex ante control over agency policy-making than does Congress, noting that

to the level of regulatory enforcement through the appointment of regulators who have a *laissez faire* attitude toward regulation and market behavior.[167]

On the other hand, political pressure may also induce the regulator to pursue an aggressive plan of enforcement.[168] This occurred shortly after the mortgage crisis in 2008 and the enactment of Dodd-Frank legislation during a pro-regulatory environment.[169] Financial institutions were faced with the issue of heightened compliance and spent considerable sums to comply with regulations designed to monitor and ensure transparency and fair dealing.[170] In these cases, firms must make investments in compliance or face the higher probability of liability. As suggested by the reactionary process view of compliance, however, industry efforts to challenge regulations through lobbying may weaken these enforcement efforts over time.[171]

C. Firms

Under a theory of agency and vicarious liability due to employee behavior, firms must comply with regulations or pay criminal and civil penalties.[172] As a result, firms are responsible for establishing firm-wide compliance programs that are meant to prevent, detect, investigate and remediate compliance failures.[173] As the architects of internal policies that digest regulations and internalize them to achieve the appropriate levels of risk management, firms are also the decision makers with respect to the broad compliance strategy that is to be pursued.[174]

---

presidents are endowed with Constitutional and statutory powers which enable them to control agency structure. The power of appointment is the most important power, because presidents can use this power to place political appointees in key agency positions . . . .").

167. *See* Jeremy C. Kress, *The Last SIFI: The Unwise and Illegal Deregulation of Prudential Financial*, STAN. L. REV. ONLINE (Dec. 2018) (discussing how the current administration appointed federal regulators who eliminated oversight of all non-bank systemically important financial institutions in contravention of statutory goals).

168. *See* Cunningham, *supra* note 2, at 18 (discussing the aggressive enforcement and prosecution of Arthur Andersen LLP).

169. *See generally* Cunningham & Zaring, *supra* note 48 (analyzing the regulatory response to the 2008 financial collapse and the hurdles posed by the regulatory response).

170. *See id.*

171. *See* Solomon, *supra* note 151 (discussing the social and ideological capture of financial regulators and its pro-industry effect).

172. *See* Arlen, *supra* note 2, at 1–2 (discussing potential criminal and civil liability of a corporation and its directors for employee misconduct).

173. *See generally* Root, *The Compliance Process*, *supra* note 2 (proposing a new method for compliance within firms that focuses on the compliance process itself to fix various compliance failures).

174. For example, some firms are experimenting with nudges as a behavioral compliance strategy. *See* Haugh, *supra* note 2, at 686 (stating that "behavioral ethics nudging finds itself on the cutting edge of corporate compliance strategy. Some of America's largest and most

Yet, what is meant by the firm and how does compliance impact the theory of the firm? As discussed by Professor Sean Griffith, "[c]ompliance thus presents a profound challenge to theories of corporate law and corporate governance."[175] Is a definition of the firm in compliance law theory to include large shareholders who have voting power, individual board members who have the power to direct firm policies and activities, board sub-committees entrusted with overseeing particularized compliance-related issues such as auditing, the board as a whole, or top-level executives who can impact corporate policy and strategy? A coherent systems theory of compliance law should address all these stakeholders since they have the power to impact firm-wide levels of behavior. Yet, from an analytical perspective, a line must be drawn to theoretically define the firm as the separate legal entity (principal) and those who have the highest level of decision-making authority to direct the affairs of this principal entity, that is, the board of directors.[176]

One of the chief compliance-related activities of the firm is to establish a compliance culture and infrastructure that will ensure adequate levels of controls and risk-taking.[177] These responsibilities filter throughout the organization and impact its agents and top fiduciaries in different ways. For example, the top decision makers such as the board and its top executives have the fiduciary responsibility to create and implement a sound and reliable compliance program within the organization.[178] As the Delaware Chancery Court said *In Re Caremark*, "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable

respected companies see nudging as the future of their compliance initiatives.").

175. Griffith, *supra* note 1, at 2079 (discussing how compliance subverts traditional notions of corporate governance and theories of the firm since regulators and compliance officers have supplanted the traditional role of shareholders, boards and executives in the execution of corporate governance within firms).

176. *See* Griffith, *supra* note 1, at 2079 ("Seen through the prism of compliance, the corporation no longer resembles a nexus of contracts but rather a real entity, subject to punishment and rehabilitation at the pleasure of a sovereign.").

177. *See* Root, *The Compliance Process*, *supra* note 2, at 218 (recognizing that firms are not expected to achieve perfect levels of compliance).

178. *See In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) (establishing that directors have a duty to implement information and reporting systems, in good faith, such that appropriate, compliance-related information would be brought to their attention); Linda Klebe Trevino et al., *Legitimizing the Legitimate, A Grounded Theory of Legitimacy Work Among Ethics and Compliance Officers*, 123 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 186, 195 (2014) (discussing the importance of support for compliance within the organization's board and senior executives).

for losses."[179] The highest company fiduciaries are also tasked with setting the "tone at the top" to instill a sense of values within the organization. Those below will often look to these leaders for guidance and will emulate the values promulgated at that highest level.[180]

These top fiduciaries also have the power to decide agency structures that directly impact the compliance function within the organization. For example, the board and chief executive officer (CEO) have the authority to alter reporting lines among compliance officers. This can have dramatic consequences, as seen in the MF Global case.[181] As described in cases of compliance failures centralizing the compliance function and burying its reporting authority to another C-level officer other than the CEO can prevent critical information from reaching the highest levels of the organization, perhaps intentionally by willfully turning a blind eye.[182]

Company fiduciaries have the authority to impact organizational compliance structures. For example, they may create a hybrid decentralized compliance function that spreads across the organization and reports to a CCO.[183] In some cases, a regulatory agency may mandate the appointment of a CCO. For example, the SEC requires this for investment companies such as mutual funds and investment company advisors.[184] Increasingly, the consensus within the compliance industry is that large enough companies across industries should create a separate compliance unit with oversight

---

179. *Supra* note 178, at 970. States other than Delaware likewise impose broad oversight duties on top fiduciaries. *See* Francis v. United Jersey Bank, 432 A.2d 814, 822 (N.J. 1981) (holding that "[d]irectors are under a continuing obligation to keep informed about the activities of the corporation. Otherwise, they may not be able to participate in the overall management of corporate affairs.") (citing Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924)); *id.* at 822 ("Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect.") (citing Wilkinson v. Dodd, 42 N.J. Eq. 234, 245 (N.J. Ch. 1886)).

180. *See* Lynn Sharp Paine, *Managing for Organizational Integrity*, 72 HARV. BUS. REV. 106–17 (1994) (describing a values-and-integrity approach which rests on employees governing their own behavior by voluntarily choosing compliance behavior because they believe it is the best way to act).

181. *See* discussion *supra* Part II.

182. *See generally* Nelson, *supra* note 72 (discussing the problem of willful blindness among corporations' upper management and the resulting potential for coordinated wrongdoing). This occurred in the MF Global case discussed earlier. *Supra* notes 82–83 and accompanying text.

183. *See* Lee Usnick et al., *Managing Compliance Functions: Decentralize, Decentralize, or Hybridize?*, 28 S. L.J. 201, 212 (2018) (assessing the potential for hybrid approaches to compliance management and providing examples of this approach).

184. Compliance Programs of Investment Companies and Investment Advisers; Final Rule, 68 Fed. Reg. 74,714, 74,720–22 (Dec. 24, 2003) (to be codified at 17 C.F.R. pt. 270, 275, 279).

over general compliance matters.[185] This decision will trigger additional important considerations related to organizational design that impact the effectiveness of compliance practice.

The creation of a separate compliance department will likely be headed by a CCO.[186] The question then is whom will this individual report to? In an increasing number of cases, the answer is the CEO, yet competing arguments can be made that the CCO should also have a reporting line to the board of directors.[187] In some cases, which are criticized, the CCO reports to the Chief Financial Officer (CFO), Chief Operating Officer (COO) or Chief Legal Officer (CLO).[188] A current debate in the compliance world is whether the CCO should report to the CLO or demonstrate independence from in-house legal counsel.[189] A strong argument can be made that relegating compliance issues to a strictly legal perspective narrows that function and weakens it.[190] Creating various levels of reporting is also likely to increase agency costs and weakens the power and efficacy of the CCO.[191]

Savings can be encouraged through centralized compliance, yet, oversight may be hampered if that unit is not given adequate resources to monitor a sprawling organization with various moving parts.[192] De-centralized structures may fail to achieve an effective compliance mission if the head of that compliance unit reports to the business unit head or another individual within that de-centralized unit.[193] Also, decentralized corporate

---

185. *See* Usnick et al., *supra* note 183, at 205, 214 (discussing various approaches to compliance management).

186. Usnick et al., *supra* note 183, at 205–07.

187. *See* Griffith, *supra note* 1, at 2101–02 (contemplating the CCO as a standalone position versus a position reporting to a legal department or CEO).

188. *See* SOCIETY OF CORPORATE COMPLIANCE AND ETHICS AND THE HEALTH CARE COMPLIANCE ASSOCIATION, SHOULD COMPLIANCE REPORT TO THE GENERAL COUNSEL? 3–5 (2013), https://assets.corporatecompliance.org/portals/1/PDF/resources/surveys/908_0_908_0_2013-compliance-gen-counsel-survey-report.pdf [https://perma.cc/E2YK-WFKC] (reporting on a survey showing that the majority of respondents opposed a system in which the compliance officer reports to corporate counsel).

189. *See* Vikramaditya Khanna, *An Analysis of Internal Governance and the Role of the General Counsel in Reducing Corporate Crime*, *in* RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING 1, 294–300 (Jennifer H. Arlen ed., 2018) (arguing that separating compliance from legal creates inefficiencies.)

190. Michele DeStefano, *Creating a Culture of Compliance: Why Departmentalization May Not Be the Answer*, 10 HASTINGS BUS. L.J. 71, 78–79 (2014) (expounding the arguments for and against the departmentalization of the compliance function).

191. The previous MF Global case study is a prime example. *Supra* notes 82–83 and accompanying text.

192. See PRINCIPLES OF THE LAW COMPLIANCE, RISK MANAGEMENT, AND ENFORCEMENT § 3.08, cmt. f (AM. LAW INST., Tentative Draft No. 1, 2019) (discussing the provision of adequate resources for the internal-control and compliance departments).

193. *See* WELLS FARGO & CO., INDEPENDENT DIRECTORS OF THE BOARD OF WELLS FARGO & COMPANY SALES PRACTICES INVESTIGATION REPORT 10 (2017) (discussing how a

structures may create unintended consequences that impact compliance, for example, an aggressive sales culture.[194]

At the firm level, top decisionmakers must not only conceptualize and then oversee the execution of an effective compliance program and infrastructure, they must staff this function appropriately and allocate resources so it can achieve the intended goals of risk management and in some cases value creation.[195] As discussed by legal management scholars, the quality of personnel can vastly impact the range of legal decision-making options, and this also extends to the area of compliance.[196]

As an internal policy matter, strategic behavior can impact compliance. For example, a firm may develop a compliance strategy that exploits the agency overlap created by shared regulatory spaces. Part of the strategy in these scenarios may be to pit regulators against one another or exploit loopholes.[197] This was manifested in the MF Global case when that company's executives tried to persuade the SEC to veto FINRA's net liquidity capital requirements.[198] As scholars have pointed out, this amounts to a regulatory arbitrage strategy.[199]

1. Economic Forces

Various economic forces impact compliance-related activities undertaken by a firm. One economic variable is the level of competitive pressure facing the firm.[200] It is often the case that compliance failures occur

---

decentralized corporate structure at Wells Fargo prevented senior leadership from properly monitoring and implementing controls that would have flagged the pervasive account fraud practices practiced at that bank), https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf [https://perma.cc/9D4H-9B9D].

194. *Id.* at 7–8.

195. PRINCIPLES OF THE LAW COMPLIANCE, RISK MANAGEMENT, AND ENFORCEMENT § 3.08 (AM. LAW INST., Tentative Draft No. 1, 2019).

196. *Bird, supra* note 71 and accompanying text.

197. *See* Freeman & Rossi, *supra* note 65, at 1183 (noting that, "[c]onceivably, however, regulated entities might sometimes prefer fragmentation to coordination, to the extent that it allows firms to play one agency against another in an effort to weaken regulation overall, or to forum shop among regulators").

198. *MF Global House Report*, *supra* note 74, at 52 ("When FINRA refused to change its position, Corzine and other MF Global representatives took their case to the SEC, arguing that FINRA was re-interpreting the rule and that a capital charge was not required.").

199. *See generally* Fleischer, *supra* note 31, at 230 (defining regulatory arbitrage as, "the manipulation of the structure of a deal to take advantage of a gap between the economic substance of a transaction and its regulatory treatment."); Freeman & Rossi, *supra* note 65, at 1185 ("Arbitrage refers to the possibility that regulated entities will seek to take advantage of situations of shared or overlapping authority to get the best deal possible, or play agencies against one another in an effort to drive regulatory standards downward.").

200. *See* Langevoort, *supra* note 40, at 8 (noting that, "intense competition produces

when an organization faces high levels of stress due to competitive threats.[201] For example, the Ford Pinto design failure that foreseeably caused vehicles to explode during rear impact collisions can be attributed in part to the competitive threat of Japanese and German compact auto imports.[202] If a firm is facing a disruptive technology and sustains losses or diminished market share this can trigger an internal sense of crisis that propels the firm into reaction or survival mode.[203] These environmental pressures can motivate a firm to cut corners to survive. This, in turn, can lead to compliance disasters.[204]

As with many other business activities, firms position compliance within a cost-benefit framework.[205] On the cost side, the potential of liability from civil or criminal prosecution will impact the cost-benefit calculus of implementing a compliance program.[206] For some offenses, the fines can be fairly significant, which will incentivize the firm to launch a more robust compliance program.[207]

---

unethical behavior is another non-surprising finding. Competition produces both the excitement of potential gain as well as the fear of loss, and so cheating goes up as the goal gets closer but you are a step behind.").

201. Langevoort, *supra* note 40, at 8.

202. Dennis A. Gioia, *Pinto Fires and Personal Ethics: A Script Analysis of Missed Opportunities*, *in* THE FORD PINTO CASE – A STUDY IN APPLIED ETHICS, BUSINESS AND TECHNOLOGY 99–100 (Douglas Birsch & John H. Fielder eds., 1994).

203. *See id.* at 99 (recounting the culture within Ford at the time as, "[m]arket forces (international competition) and government regulation (vehicle safety and emissions) were affecting the auto industry in disruptive ways that only later would be common to the wider business and social arena. They also produced an industry and a company that felt buffeted, beleaguered, and threatened by the changes. The threats were mostly external . . . and led to a strong feeling of we-vs-them, where we (Ford members) needed to defend ourselves against them (all the outside parties and voices demanding that we change our ways.)").

204. The MF Global case is illustrative of this. *See supra* notes 74–92 and accompanying text.

205. *See* W. Kip Viscusi & Ted Gayer, *Behavioral Public Choice: The Behavioral Paradox of Government Policy*, 38 HARV. J.L. PUB. POL'Y 973, 1000 (2015) (discussing how adopting a cost-benefit framework, businesses largely failed to comply with the burdensome and expensive Occupational Safety and Health Administration (OSHA) regulations since the penalties for non-compliance were low and enforcement was weak); MICHEL CROUHY, DAN GALAI & ROBERT MARK, RISK MANAGEMENT 480–504 (2001) (providing the example of compliance with the law as a form of operational risk within firms and explaining how firms may address operational risk in one of several ways and that the chosen method should be based on a cost-benefit analysis.)

206. Very few firms are ever indicted for criminal offenses since this drastic penalty often fails to achieve deterrence objectives. *See* Arlen & Kahan, *supra* note 18, at 6 (arguing that U.S. prosecutors no longer target corporations because the approach, "was not effective at inducing firms to take the most basic actions needed to deter corporate crime").

207. *See* Robert C. Bird & Stephen Kim Park, *Turning Corporate Compliance into Competitive Advantage*, 19 U. PA. J. BUS. L. 286–87 (2017) (arguing that corporate compliance with regulatory mandates is a core concern of corporate governance).

The firm's risk appetite is another economic factor that can influence firm-wide levels of compliance. Some firms exhibit a greater tolerance for risk than other similarly situated firms.[208] In these cases, risk-taking firms will exhibit a more lenient attitude toward compliance than similarly situated risk-avoiding firms. Firms that are risk-takers may discount the costs associated with establishing a compliance program and opt to not make compliance-related investments, sometimes mispricing the risk.

2. Institutional Forces

Several institutional forces impact the firm's compliance practices. For example, the firm's culture toward regulatory, legal, and ethical issues will have a significant impact. Often, corporate culture is linked to either an effective or ineffective compliance program.[209] Corporate culture includes "the set of shared beliefs and norms [within the corporation] that tells people how to act when there are no formal rules."[210] The various cultures of compliance range from disdain and avoidance, skepticism, grudging acceptance, proactive behavior, regulatory strategy and ethical decision-making.[211]

Since it is related to ethics and public policy, compliance can also impact what is known as a firm's social license to operate. As stated by scholars: "[a] company can only gain a [s]ocial [l]icense to [o]perate through the broad acceptance of its activities by society or the local community. Without this approval, a business may not be able to carry on its activities without incurring serious delays and costs."[212] As an element of non-market strategy, firms must pay careful attention to retain the public's trust, since failing to do so can lead to devastating non-market actions against the company, including boycotts, calls for regulatory action, public shaming and

---

208. *Id.* at 331 (discussing risk-averse vs. risk aggressive firms in the area of compliance).

209. Paine, *supra* note 180 (discussing organizational integrity as the best approach to achieve compliance with the law); Robert C. Bird & Stephen Kim Park, *The Domains of Corporate Counsel in an Era of Compliance*, 53 AM. BUS. L.J. 203, 234–38 (2016) (describing how a culture of integrity promotes compliance); *see generally* David Hess, *Ethical Infrastructures and Evidence-Based Corporate Compliance and Ethics Programs: Policy Implications from the Empirical Evidence*, 12 N.Y.U. J.L. & BUS. 317 (2016) (arguing that a compliance program must be aligned with the organization's culture to have legitimacy in the eyes of the organization's employees).

210. René M. Stulz, *Risk-Taking and Risk Management by Banks*, 27 J. APPLIED CORP. FIN. 8, 16 (2015).

211. *See* Robert C. Bird & David Orozco, *Finding the Right Corporate Legal Strategy*, 56 MIT SLOAN MGMT. REV. 81 (2014) (discussing these varying approaches within the context of legal decision-making).

212. Kathleen M. Wilburn & Ralph Wilburn, *Achieving Social License to Operate Using Stakeholder Theory*, J. INT'L BUS. ETHICS 1, 4 (2011).

loss of customer loyalty.[213] In the worst case, a firm can lose its social license to operate and cease to operate if trust is completely lost.[214]

Lastly, corporate governance practices and laws will impact compliance practices.[215] Corporate governance includes a wide variety of internal practices that are a product of norms, history, culture, contract, bylaw, charter, regulation, or statute.[216] According to scholars, good corporate governance practices include reducing agency costs between owners of the firm and its leaders to avoid self-dealing or lack of oversight.[217] Some of the mechanisms of good corporate governance include the presence of activist institutional investors,[218] the use of independent directors,[219] separating the role of Chairperson and CEO, sub-dividing tasks within the board and maintaining policies that protect whistleblowers.[220]

Corporate governance has a direct link to compliance. Recently, for

213. *See generally* David Orozco, *Strategic Legally Bullying*, 13 N.Y.U. J.L. & BUS. 137–91 (2016) (describing potential adverse consequences of firms losing the public trust, which often can occur to a weaker company when a more powerful company brings meritless litigation against that weaker company).

214. *See* Tony Carter, *Crisis Management for Sales Force Managers*, 15 J. PROF. SERV. MKT. 87, 90 (1997) (discussing the case of Sears Automotive Centers operating under an aggressive commission system that resulted in customers being charged for unnecessary auto repairs, resulting in comprehensive and severe regulatory action and the loss of consumer trust that nearly caused the automotive centers to halt conducting business in several states).

215. *See* In re Caremark Int'l Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996) (involving the approval of a settlement agreement between Caremark and Caremark's board of director's relating to a breach of duty in connection with alleged violations by Caremark employees of federal and state laws and regulations); *but see* Griffith, *supra* note 1, at 2113–14 (arguing that compliance law and corporate governance do not share common antecedents: "[a]s a result, state corporate law has not meaningfully contributed to the development of compliance. Whatever compliance may be, it is not a product of corporate law. Indeed, it is more correct to say that compliance does what corporate law's duty of care might have done, had the business judgment rule not eviscerated duty of care jurisprudence. Compliance now occupies the space left in the wake of corporate law's retreat").

216. Cunningham, *supra* note 2, at 7.

217. *Id.* at 8.

218. Cunningham, *supra* note 2, at 8–9.

219. *See* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 873 (1991) (arguing that corporate boards need directors who are both independent and accountable); *see also* Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 78, 84–90 (2007) (attempting to unpack and conceptualize the use of independent directors). Outside directors provide the ability to render independent judgments and promote shareholder value. *See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1526 (2007) (chronicling the use of outside, independent directors from the mid-twentieth century through the early-twenty-first century).

220. *See* Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1022–23 (2010) (arguing that, "chief executive officers (CEOs) of publicly held corporations in the United States are losing power to their boards of directors and shareholders").

example, a class action derivative shareholder lawsuit was brought against Yahoo! directors due to their alleged mishandling of customer data.[221] The company settled the derivative litigation for $29 million to avoid potential fiduciary duty liability.[222] This settlement, the first of its magnitude, suggests the company acknowledged there may have been serious compliance oversight failures. Also, as mentioned earlier, the DOJ's sentencing guidelines link compliance-related liability to the adequacy of cooperation and corporate governance practices.[223] Scholars have also identified attributes of board governance that can impact compliance. For example, one study concluded that directors burdened by too many professional commitments are detrimental for large, public companies since these overly-committed directors lack the time and attention to provide the monitoring and oversight that larger, more complex companies require.[224]

D. Executives

Scholars such as Professor Daniel Sokol have emphasized that compliance means different things to different people at various levels within the firm, such as board members, top executives and mid-level executives.[225] What all these individuals share in common, however, is the need to operationalize compliance at some level. The highest fiduciaries such as board members under Delaware's *Caremark* corporate governance standard must ensure that there is an effective compliance system and have a duty to monitor its performance.[226] Top officers are tasked with ensuring that the organizational design works, which often includes creating the role of a CCO, ensuring adequate reporting lines to top decision-makers, and ensuring that the system provides adequate information flows.[227] Mid-level managers are tasked with executing the program to ensure the law is followed within the parameters established by the program and to report information to the relevant officers who have authority to take action in the event of a

221. In re Yahoo! Inc. Customer Data Sec. Breach Litig., No. 16-md-02752 (N.D. Cal. Jan. 30, 2019).

222. *See* Kevin LaCroix, *Yahoo Data Breach-Related Derivative Suit Settled for $29 Million*, D&O DIARY (Jan. 21, 2019), https://www.dandodiary.com/2019/01/articles/cyber-liability/yahoo-data-breach-related-derivative-suit-settled-29-million/ [https://perma.cc/4VFG-FAP2] (claiming that, "[t]he Yahoo data breach derivative lawsuit is noteworthy in that it represents the first significant recovery in a data breach-related derivative lawsuit").

223. *See supra* notes 142–144 and accompanying text.

224. Jeremy C. Kress, *Board to Death: How Busy Directors Could Cause the Next Financial Crisis*, 59 B.C. L. REV. 877, 899 (2018).

225. Sokol, *supra* note 12, at 401–02.

226. In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996).

227. *See* Griffith, *supra* note 1, at 2101–02 (describing the role, responsibility and importance of the CCO).

compliance-related issue.

Non-executive employees who work on the front lines play an important role in the execution of compliance at an operational level. They are important sources of risk, information and feedback within the firm subsystem since they can report violations internally up the chain of command.[228] Frontline employees are also an important source of information feedback within the entire compliance system, and the law recognizes and protects this useful role. For example, employment law doctrines such as the public policy exception protect whistleblowers who report a violation to a public authority.[229] Specific statutes also protect this source of feedback through mandated anti-retaliation protections that are designed to encourage whistleblowing.[230]

1. Economic Forces

As the literature points out, economic forces impact executives in a way that in turn impacts their compliance-related behavior.[231] For example, the economic pressure faced at the firm level will seep down to the executive level since executives may be pressured by higher-ranked officers to deliver results under difficult circumstances.[232] These high-pressure environments, where economic incentives can override ethics, often yield compliance failures.[233]

228. *See* Belinfanti & Stout, *supra* note 123, at 603–04 (discussing the role of information feedback loops as important sustainability mechanisms within their conceptualized systems theory of corporate law).

229. *See, e.g.*, Keveney v. Mo. Military Acad., 304 S.W.3d 98, 101 (Mo. 2010) (holding, in part on grounds of public policy, that an employee's termination is wrongful if it results from his refusal to perform an illegal act); Skillsky v. Lucky Stores, Inc., 893 F.2d 1088 (9th Cir. 1990) (holding that terminating an employee for his having a poor reputation can be an actionable claim); Dicomes v. Washington, 782 P.2d 1002, 1006–07 (Wash. 1989) (holding that the firing of an employee for her disclosure of potentially damaging information to an overseeing agency was in contravention of public policy and constituted a wrongful termination).

230. *See, e.g.*, 15 U.S.C. § 78u-6 (2010) *and* 17 C.F.R. § 240.21F-1 (2014) (providing for heightened anti-retaliatory provisions for whistleblowers and bounties offered under Dodd-Frank).

231. For example, the burgeoning behavioral economics literature on compliance recognizes how psychology interacts with economic factors to impact compliance-related behavior. *See generally* Haugh, *supra* note 2 (analyzing behavioral phenomena such as "nudging" that can corporate compliance decision-making).

232. *See* Carter, *supra* note 214 (discussing how a difficult circumstance in which automotive centers had to halt conducting business in several states resulted in comprehensive regulatory action within the industry).

233. *See* Michael Corkery & Stacy Cowley, *Wells Fargo Warned Workers Against Sham Accounts but 'They Needed a Paycheck'*, N.Y. TIMES (Sept. 16, 2016), https://www.nytimes.com/2016/09/17/business/dealbook/wells-fargo-warned-workers-again st-fake-accounts-but-

Executives with bounded rationality face cognitive costs conceptualizing and executing compliance.[234] For one, executives must familiarize themselves with the language and culture of compliance, which is largely based on law and may be difficult to comprehend by non-lawyers.[235] Managers and attorneys, as scholars have pointed out, have different mental models for processing information.[236] This may become a serious issue if the action undertaken by a manager falls within a grey area of legal compliance and these scenarios may exacerbate cognitive biases and rationalizations.[237]

Other economic costs may include the fines imposed on executives for acting in a way that causes harm to the principal and is unauthorized.[238] In these cases, individuals may face personal liability for behavior that generates a compliance failure. For example, twenty-two directors of Enron and WorldCom paid $39.25 million out of their own pockets, unreimbursed by insurance or the corporation, to settle suits against them.[239] These deterrent aspects of personal liability will factor into the individual's behavior and compliance efforts. On the other hand, incentives may also play an economic role. For example, some firms reward managers for meeting compliance-related objectives.[240]

---

they-needed-a-paycheck.html [https://perma.cc/LHK9-EDP8] (discussing the aggressive sales culture at Wells Fargo that contributed to a massive compliance failure at that bank).

234. *See generally* Langevoort, *supra* note 40 (analyzing behavioral economics and the effects of compliance on behavior).

235. *See* Freeman, *supra* note 130, at 16 (stating that " . . . as drafted by the EPA, permits are primarily legal documents-they can dictate extremely technical and detailed effluent and emission limits, as well as design and technology standards. These permits are often incomprehensible to workers who must comply with them.").

236. Bird, *supra* note 71, at 13 (discussing how lawyers are perceived as being overly conservative, quick to throw up barriers, and more interested in legal technicalities than furthering the goals of their client.)

237. *Id.*

238. *See* Associated Press, *Enron Sentences Will Be Tied to Investor Losses*, NBC NEWS (May 26, 2006), http://www.nbcnews.com/id/12993408/ns/business-corporate_scand als/t/enron-sentences-will-be-tied-investor-losses/#.XeQzdehKjD4 [https://perma.cc/R393-TPLA] (discussing the fines imposed on executives convicted in the Enron scandal for crimes such as money laundering and wire fraud).

239. Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1069–70 (2006).

240. Usnick et al., *supra* note 183 (describing how Walmart has implemented a compensation system directly related to compliance objectives).

2. Institutional Forces

Scholars have identified various cognitive biases or rationalizations that impact individual-level decision-making within organizations.[241] These rationalizations impact an executive's compliance with the law.[242] Biases of all kinds enable bad behavior such as unconscious biases that promote unethical or illegal choices based on economic incentives or groupthink.[243] Emotional numbing due to routines in a high-pressure environment can lead to ethical lapses and compliance failures.[244] Other biases include underestimating the injury caused by illegal behavior, and discounting the chances of causing harm or being caught by a regulator.[245]

Ethics plays an important role in business decision making, and this includes compliance.[246] Whistleblowers, for example, are lauded as ethical champions who risk retribution and being shunned for speaking out and doing what is right.[247] Prominent scholars identify ethics as the main driver for compliance with the law.[248]

E. Inter-Organizational Structures

Compliance is also impacted by structures and relationships that extend beyond the firm's boundaries or the regulator-regulated entity dyad. For example, agencies with regulatory overlap must forge relationships within a

241. *See* Haugh, *supra* note 7, at 1255–58 (listing eight of the most prominent rationalizations used by corporate offenders).

242. *Id.*

243. *See generally* Langevoort, *supra* note 40 (analyzing behavioral economics and the effects of compliance on behavior).

244. *See id.* (noting that "[s]uch forces as stress and tiredness (so common in the business setting) weaken the ability to resist, as can repetitive acts of goodness. The assumption here is that being selfish is the more automatic process, which deliberation has to override, and that takes a cognitive toll.").

245. *See* Viscusi & Gayer, *supra* note 205, at 989–90 (discussing how systematic biases lead to small risks being overestimated and large risks being underestimated.)

246. The field of behavioral ethics analyzes the choices individuals make to either promote or hinder ethical decision making. *See* Haugh, *supra* note 2 (discussing behavioral phenomena that can affect corporate compliance).

247. *See* Jennifer M. Pacella, *Inside or Out? The Dodd-Frank Whistleblower Program's Anti-Retaliation Protections for Internal Reporting*, 86 TEMPLE L. REV. 721, 755 (2014) (stating whistleblowers speak out about issues their superiors would rather avoid, creating resistance towards the whistleblower); Orly Lobel, *Linking Prevention, Detection, and Whistleblowing: Principles for Designing Effective Reporting Systems*, 54 S. TEX. L. REV. 37, 51 (2012) (noting studies indicate that the attitude of managers plays a pivotal role in shaping the ethical conduct of employees, such as reporting misconduct).

248. Paine, *supra* note 180.

shared regulatory space.[249] These regulators face monitoring and coordination costs that impact the regulated entities' cost of compliance due to greater regulatory demands.[250] Regulators in a shared regulatory space thus may increase the potential for evasion, or regulatory arbitrage.[251] As noted by scholars, "regulated entities might sometimes prefer fragmentation to coordination, to the extent that it allows firms to play one agency against another in an effort to weaken regulation overall, or to forum shop among regulators."[252]

Another type of inter-organizational structure involves contracting. For example, indemnification and insurance contracts play a role in compliance since they effectively price the risk of non-compliance and transfer this risk to a third party. If transaction costs are low, under transaction cost economics theory parties will outsource this risk to a third party in the most efficient way possible.[253]

Third party organizational structures play an important although under-appreciated role in compliance law theory. For example, firms may join an umbrella organization that self-regulates the industry through a self-regulating organization (SRO).[254] Some quasi-governmental SROs such as FINRA may even have the stamp of public legitimacy and authority due to their authority derived from public agencies, in this case the SEC.[255] Inter-firm committees such as the Committee of Sponsoring Organizations of the Treadway Commission (COSO) can create private industry-wide regulations that normatively induce firms to follow compliance best practices.[256] Trade associations of various types are designed to overcome collective action problems and coordination costs to effectively lobby regulators or file

---

249. *See generally* Freeman & Rossi, *supra* note 65 (analyzing the persistence and impact of shared regulatory spaces).

250. Multiple regulators within a shared regulatory space, however, increase the costs of compliance. *See generally* Elizabeth F. Brown, *The New Laws and Regulations for Financial Conglomerates: Will They Better Manage the Risks than the Previous Ones?*, 60 AM. U. L. REV. 1339 (2011) (discussing the overwhelming complexity of financial regulation).

251. *See* Freeman & Rossi, *supra* note 65, at 1183 ("Coordination also has the potential to reduce the costs of participation in the regulatory process for interest groups and regulated firms. Private transaction costs can be reduced by harmonizing inconsistent regulatory approaches where agencies have overlapping jurisdiction, or by simplifying and integrating related jurisdictional assignments.").

252. Freeman & Rossi, *supra* note 65, at 1183.

253. *See* Williamson, *supra* note 115 (describing transaction cost economics and efficient contracting).

254. *See* William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1, 5 (2013) (describing SROs as "private police officers").

255. *See* Macey & Novogrod, *supra* note 77, at 971 (discussing FINRA principles that give it the appearance of authority to compel rule following and sanctioning).

256. COSO develops frameworks and guidance on enterprise risk management, internal control, and fraud deterrence. COSOS, www.coso.org (last visited Nov. 25, 2019).

amicus briefs during litigation. Lastly, firms may join professional compliance societies such as the Society for Corporate Compliance and Ethics (SCCE) to share best practices and information that reify industry-wide compliance norms.[257]

1. Economic Forces

The main economic forces acting on these inter-organizational structures include coordination and transaction costs.[258] Among regulatory agencies, these costs arise due to regulatory authority overlap within shared regulatory spaces.[259] Coordination costs in shared regulatory spaces can be lessened through interagency consultations, joint policymaking exercises and presidential mandates.[260] These coordination efforts will likely decrease compliance costs for firms. As professors Freeman and Rossi state: "[p]rivate transaction costs can be reduced by harmonizing inconsistent regulatory approaches where agencies have overlapping jurisdiction, or by simplifying and integrating related jurisdictional assignments."[261] If regulatory coordination costs are lower than the benefits offered by private self-regulation than efforts will be expended by firms to implement an SRO that will oversee significant aspects of regulation within the industry.

Transaction cost economics theory applies to inter-firm relationships. Under that theory, firms are expected to contract with third parties when transaction costs are low and the gains of exchange exceed the costs of internally-sourced production.[262] In certain fields of activity risk can be efficiently priced and contracts can be executed that effectively mitigate compliance risks. The three contractual mechanisms that achieve this include compliance outsourcing, indemnification and insurance contracting.

Compliance outsourcing is preferred to an in-house compliance strategy when transaction costs exceed the benefits of in-house compliance due to the knowledge specialization of third-party compliance specialists.[263]

257. SOC'Y CORP. COMPLIANCE & ETHICS, https://www.corporatecompliance.org/ [https://perma.cc/43W7-MKAN] (last visited Nov. 25, 2019).

258. *See generally* Freeman & Rossi, *supra* note 65 (discussing the fragmented and overlapping authority of administrative agencies and the challenges of interagency coordination).

259. *Id.*

260. *Id.* at 1155–69 (describing various instruments that can be implemented to increase inter-agency coordination).

261. *Id.* at 1183 (providing examples of FTC and DOJ merger guidelines and the EPA-NHTSA joint rulemaking process as methods for reducing costs among regulated communities).

262. *See* Williamson, *supra* note 115, at 250 (describing when it would be efficient to make certain types of transactions).

263. *See Meeting Compliance Challenges - Leveraging the Value of Outsourcing*,

Indemnification contracts impact compliance since they transfer the risk of loss due to compliance failures to another party. Indemnification may be negotiated between firms, as in the case when a subcontractor agrees to indemnify a contractor for losses due to negligence. It may also arise from a firm's agency duty to indemnify fiduciaries and corporate officers from liability undertaken due to business decisions. Insurance contracts may impact compliance practices since insurers may limit or deny liability coverage if weak or insufficient compliance protocols are in place.

Inter-organizational structures need to overcome coordination costs to overcome collective action problems and the free rider problem. One technique designed to overcome this problem is privatizing membership benefits. For example, a compliance association may designate knowledge or certifications that are exclusively available to its members. In the case of lobbying, membership in a trade association, for example, may offer members the benefit of providing input toward model legislation or preferred access to policymakers.

2. Institutional Forces

A social institutional pressure that impacts inter-agency coordination includes regulatory turf battles. Regulatory turf battles can emerge due to ideological differences among regulators, distrust, personality clashes or competition for resources.[264] This was manifested in the MF Global case when the SEC and CFTC failed to coordinate their oversight activities and left each other in the dark with respect to important matters that demanded interagency collaboration.[265]

Social institutional forces that impact private inter-organizational structures include business norms and isomorphism. Business norms can, in turn, impact law and regulation. For example, trade usage within the context

---

DELOITTE CENTER FOR REG. STRATEGIES 1, 8, https://www2.deloitte.com/us/en/pag es/regulatory/articles/managed-regulatory-compliance-services.html [https://perma.cc/2B5Z-F5KC] (stating that "[e]ven with proper funding, an organization's ability to scale up compliance operations may be limited by the availability of adequately qualified people to an in-house compliance function. In contrast, external providers focus on developing and maintaining the required knowledge as a core competency, often by hiring former regulators and compliance officers and developing industry-aligned talent pools.").

264. Freeman & Rossi, *supra* note 65, at 1186.

265. *See MF Global House Report*, *supra* note 74, at 80–81 ("The SEC did not include the CFTC or the commodities SROs in the meeting it held with MF Global in June 2011 to examine the company's global operations and subsidiaries. That meeting, prompted by MFGI's continued losses and change in business strategy, would have been relevant to the CFTC's oversight of the company's FCM business . . . . The CFTC, for its part, did not inform the SEC that MFGI was using the Alternative Method to calculate its obligations to its commodities customers trading on foreign exchanges . . . .").

of the sale of goods is defined by the Uniform Commercial Code as "any practice or method of dealing having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to the transaction in question."[266] Compliance-related norms akin to trade usage have emerged at the industry level. For example, in the information technology (IT) industry encrypting sensitive customer data to prevent hackers from accessing the data has become a compliance best practice, or norm in that industry.[267]

Institutional isomorphism compels firms to behave similarly and is driven by professional societies promulgating best practices, standardized codes of ethics and conduct, model laws, regulations and risk management strategies.[268] The ALI's efforts to promulgate standards in the field of compliance, for example, is likely to generate isomorphism.[269] Best practices can also be found in regulatory agencies and are used as an informal policy-setting tool.[270]

The systems theory of compliance is visually summarized below in Figure 1.

266. U.C.C. § 1-303 (AM. LAW INST. & UNIF. LAW COMM'N 1977), https://www.law.cornell.edu/ucc/1/1-303 [https://perma.cc/YEZ9-43WY].

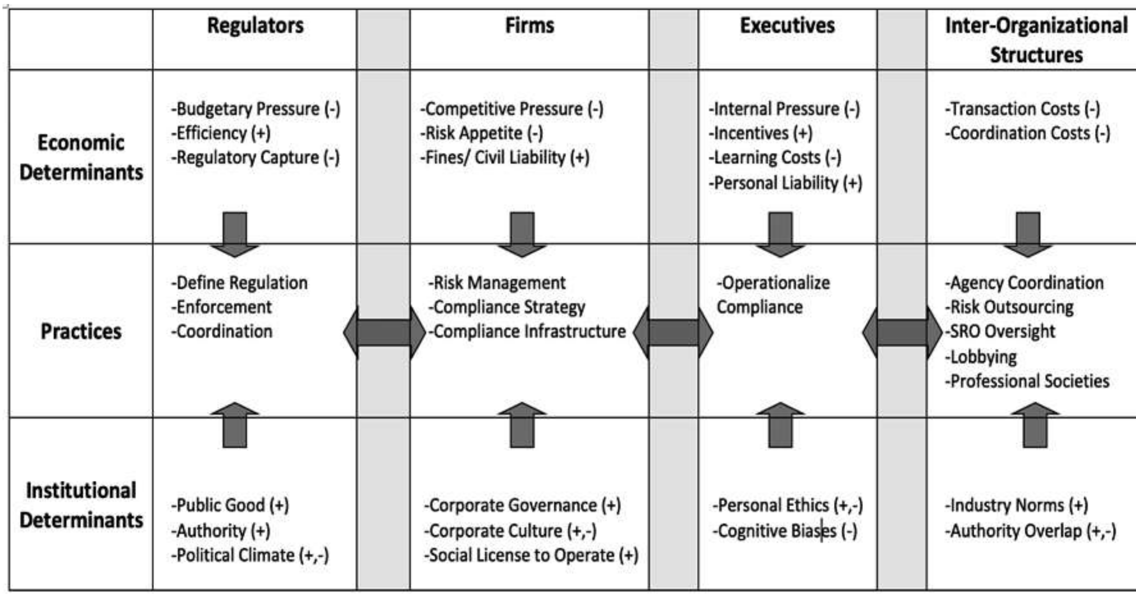
267. *See* Drjim, *Do We Really Need to Encrypt Our Customer Data?*, ACCIDENTAL SUCCESSFUL CIO (2015), http://theaccidentalsuccessfulcio.com/security-2/do-we-really-need-to-encrypt-our-customer-data [https://perma.cc/2CPR-PJRL] (discussing the importance of encrypting data in order to protect customers in the case of hacker break ins).

268. *See generally* P.J. DiMaggio & W.W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, 48 AM. SOC. REV. 147, 147–160 (1983) (analyzing how competitive marketplaces counterintuitively drive firms to behave similarly and hypothesizing on the effects of these behaviors).

269. *Supra* note 24 and accompanying text.

270. *See generally* Zaring, *supra* note 138, at 300 (noting best practices help regulators make sense of regulation areas by being a more straightforward method of policy dissemination).

Figure 1. The Systems Theory of Compliance



F. Explanatory and Predictive Aspects of the Theory

This section summarizes the explanatory and predictive aspects of the systems theory of compliance law. This section will also summarize the interrelationships between the economic and institutional factors discussed thus far and their impact on compliance practices. Additional cross-sectional relationships that span the various units will also be assessed. These propositions explain and predict a wide range of compliance-related practices and provide a systematic, generalizable, and rigorous basis for verification through empirical analysis.

1. Regulators

Budgetary pressure is expected to have a negative impact on the regulatory practices of enforcement and coordination. With less resources, agencies have less ability to enforce the law and coordinate with other agencies. Less resources will also likely trigger inter-agency competition that may deter cooperation. Efficiency will be positively associated with all regulatory practices since efficiency is a precondition of federal regulatory implementation under Executive Order 12,866. If the regulation's economic impact falls outside of the ambit of Executive Order 12,866, then efficiency is simply a normative aspiration that is not required. Regulatory capture is expected to negatively impact all regulation practices since industry demands will seek to limit these regulatory practices in ways that weaken regulatory compliance requirements. For example, capture may lead a regulator to define ambiguous or watered-down regulations that are easily circumvented.

Regulators who are motivated to promote the public good are expected to positively impact all regulatory practices, since they all help achieve social welfare. The level of authority delegated to an agency is also expected to be positively associated with the regulator's ability to define the scope of regulations and enforcement. The political climate may positively or negatively impact any of the regulation practices. Political climates change over time and may veer toward heightened levels of regulation or to more hands-off *laissez faire* attitudes.

2. Firms

Competitive pressures will have a negative impact on risk management, compliance strategy, and the firm's compliance infrastructure. The Ford Pinto example discussed earlier illustrates this point. Under pressure to produce a subcompact car to compete with foreign imports, the Pinto's production schedule was shortened by half and safety concerns were minimized. Lee Iacocca, the executive at Ford responsible for the Pinto, imposed a rigid command that the Ford Pinto was not to weigh an ounce over 2,000 pounds and not cost a cent over $2,000.[271] According to several individuals at Ford "Iacocca enforced these limits with an iron hand" and whenever a problem was raised that meant a delay on the Pinto, such as a safety issue, Mr. Iacocca would "chomp on his cigar, look out the window and say 'read the product objectives and get back to work.'"[272] This directive placed meeting these strict operational goals ahead of safety and regulatory concerns.

Under these conditions, a company's compliance strategy and infrastructure are expected to suffer since economic goals are prioritized by organization leaders. For example, a compliance strategy of lobbying against regulations, exploiting regulatory loopholes or pitting regulators against one another may emerge in these situations. Also, the compliance function may be weakened and starved of necessary resources.

The firm's risk appetite will also have a negative impact on compliance practices since higher risk tolerances will likely yield scenarios where regulations are viewed as probabilistic events and hindrances to overcoming

271. Mark Dowie, *Pinto Madness*, MOTHER JONES (Sept./Oct. 1977), https://www.motherjones.com/politics/1977/09/pinto-madness/ [https://perma.cc/Z692-7UVS].

272. *Id.* at 4.

business objectives. Firms with higher risk tolerances are also more likely to misprice the risk of non-compliance or discount the liability in these scenarios. The prospect of fines or civil liability are expected to have a positive impact on compliance functions since they alter the cost-benefit calculus of maintaining a compliance program.

Sound corporate governance practices are expected to positively impact compliance practices within firms. The compliance-related norms of accountability and transparency are reinforced by sound corporate governance. Conversely, weak corporate governance policies will likely yield ineffective compliance-related activities within firms. Corporate culture may yield a positive or negative impact on compliance. A corporate culture that prioritizes honesty, respect, fairness, and transparency will likely yield strong compliance-related practices. A corporate culture that values profits and efficiency above anything else, even in the absence of competitive pressure, will likely have the opposite effect. The presence of a social license to operate on the other hand will have a positive impact on compliance since this normative pressure will demand investments in compliance-related activities to retain the public's trust and consumer loyalty.

3. Executives

Internal pressure to prioritize profitability and cut corners will have a negative impact on efforts to operationalize compliance. Incentives that promote and reward compliance, on the other hand, will have the opposite effect. For example, the DOJ's Sentencing Guidelines and the whistleblower provisions in Dodd Frank, the False Claims Act, and the Taxpayer First Act codify this practice.[273] As a result, some firms craft incentives and tie executive compensation to positive compliance results.[274] Another technique is to tie executive promotions to compliance results and allow the CCO to

273. The DOJ Sentencing Guidelines state: "(6) The organization's compliance and ethics program shall be promoted and enforced consistently throughout the organization through (A) appropriate incentives to perform in accordance with the compliance and ethics program . . . ." U.S. SENTENCING GUIDELINES MANUAL § 8B2.1(b)(6) (U.S. SENTENCING COMM'N 2018).

274. *See* Joseph E. Murphy, *Using Incentives in Your Compliance and Ethics Program*, SOC. CORP. COMPLIANCE ETHICS 1, 21 (2011), https://assets.hcca-info.org/Portals/0/P DFs/Resources/library/814_0_IncentivesCEProgram-Murphy.pdf [https://perma.cc/YT8U-HSUC] (discussing how at one organization "business unit leaders are rated on 25–30 elements tied to the Sentencing Guidelines standards for effective compliance and ethics programs. Their rating in these categories acts as a threshold for determining eligibility to participate in the incentive program each year.").

provide input on this important process.[275] Learning costs are expected to be negatively associated with compliance. The threat of personal liability for compliance failures will, on the other hand, have a positive effect.

Personal ethics is expected to have either a positive or negative effect on the execution of compliance. Ethical values can vary significantly from one individual to another. Whistleblowers, for example, illustrate the values that would be positively associated with a heightened level of operationalized compliance. Rogue actors who subvert compliance efforts, on the other hand, exemplify the ethics that negatively impact a compliance program. As pointed out by compliance law scholars, cognitive biases almost always negatively impact compliance.

4. Inter-Organizational Structures

All of the inter-organizational compliance structures depend on low transaction and coordination costs, therefore, these costs are negatively associated with those structures. Industry norms are expected to have a positive impact on the practices regulated by SROs and reified by professional societies.[276] Regulatory authority overlap may have a positive or negative impact on inter-agency coordination efforts. Turf battles, mistrust, and competition will stifle inter-agency collaboration and hinder compliance. On the other hand, effective oversight, trust, and cooperation may yield an opposite and positive impact on shared regulatory oversight and agency coordination.

5. Cross-sectional Analysis

Thus far, the analysis has treated each conceptualized unit as a silo. However, the units are interlinked across all four levels and impact one another in various ways. For example, a regulator's definition of a regulation will impact the learning costs of individual executives. As the MF Global case demonstrates, the CFTC's allowance of the Alternative Method supported MF Global's aggressive compliance strategy and may have

---

275. *Id.* at 23–24 (discussing how the Sentencing Guidelines also speak to this issue). In this respect, the Sentencing Guidelines state: "(3) The organization shall use reasonable efforts not to include within the substantial authority personnel of the organization any individual whom the organization knew, or should have known through the exercise of due diligence, has engaged in illegal activities or other conduct inconsistent with an effective compliance and ethics program." U.S. SENTENCING GUIDELINES MANUAL § 8B2.1(b)(3) (U.S. SENTENCING COMM'N 2018).

276. This is referred to as institutional isomorphism. *See generally* DiMaggio & Powell, *supra* note 268 (discussing the various complexities associated with institutional isomorphism as well as the mechanisms by which institutional isomorphic change occurs).

enabled their faulty risk management practices. The CFTC's behavior also increased coordination costs among other regulators. Regulators who pursue weak regulatory enforcement will also impact the risk management and compliance strategy of a firm.[277]

A firm's compliance strategy of regulatory arbitrage will impact the regulator's enforcement or coordination efforts if the strategy pits regulators against one another. Likewise, a compliance strategy that weakens regulation will impact the inter-organizational lobbying structure or SRO behavior. As recognized by administrative law scholars, shared regulatory spaces bring to light the importance of lowering agency coordination costs and the effectiveness of this activity will impact regulators' levels of enforcement.

Corporate governance will also impact the firm's compliance infrastructure and executive behavior. For example, if the firm's top fiduciaries craft incentives that link compliance to executive compensation or promotion, these incentives are likely to impact behavior and may counter the negative effects of cognitive biases. These examples are not meant to be exhaustive. Instead, they are meant to illustrate the richness and complexity of interactions among the various conceptualized units that comprise the compliance law system and explain various potential outcomes and causal effects.

6. Law and Policy Implications

The systems theory of compliance and its analysis provide several insights and prescriptive recommendations for the improvement of compliance law, theory, and practice. An apparent finding is that compliance law and practice involve complex activities among various actors that are closely interconnected. Policymakers should therefore appreciate the various interacting parts and the impact they have on one another. This will guide better policymaking and avoid well-intentioned policies that achieve negative unintended results.

For example, policymakers should avoid the temptation to oversimplify issues and attribute a compliance failure to a single issue such as bad corporate governance or a corrupt organizational culture. Enforcement authorities should do the same, and this would cast serious doubt on prosecutors who at times have demanded that individual executives be terminated by the firm. As the systems theory demonstrates, removing an individual is not likely to address the root cause of a compliance failure and

277. *See* Viscusi & Gayer, *supra* note 205 (discussing how adopting weak enforcement regulations will disincentive firm compliance due to minimal noncompliance costs).

may incorrectly place remedial emphasis on a single factor.

The systems theory supports the view of scholars such as Professors Jennifer Arlen and Lawrence Cunningham, who argue that regulators, particularly prosecutors, too often rely on off-the-shelf corporate governance recommendations when they craft settlements with organizations.[278] The systems theory of compliance reinforces these scholars' arguments that regulators need to carefully consider the particularized and complex realities within each organization to craft the correct penalties and incentives, especially when crafting settlements that intrude on internal corporate governance matters. As the systems theory of compliance demonstrates, there simply is no one-size-fits-all approach to compliance issues. Carefully crafted policy and enforcement actions should consider each element within the system to narrowly and appropriately tailor a response in the event of non-compliance.

Instead, crafting regulatory responses from a systems theory perspective will likely yield pause and allow policymakers to more carefully target the root causes of specific compliance failures. Otherwise, resulting regulation that fails to recognize the interacting effects of the entire system will impact an industry in a wholesale manner, generate unintended negative consequences, and increase costs that may not be warranted, particularly among firms who maintain an effective compliance system.

The systems theory of compliance is largely descriptive in nature and does not, by itself, prescribe whether regulators should use controversial enforcement mechanisms such as DPAs or monitors as a governance mechanism. There is a vigorous scholarly debate about the appropriate levels of intrusion into internal corporate governance matters though the aggressive use of these prosecutorial and regulatory instruments. The reality, however, is that regulators have increasingly used DPAs to settle compliance-related cases, and this practice is not likely to abate. The systems theory does recognize however, through its description of the various interacting variables, that if these agreements are not carefully tailored, they may do more harm than good.[279] As the systems theory of compliance demonstrates, there can be multiple causal attributes of a compliance failure. All else being equal, if the cause of a compliance failure is due mainly to the ethical lapses of a few individuals, this should be taken into consideration when defining the penalties and remedial steps in a DPA. Likewise, if the firm, for example, grossly miscalculated the risk and harm caused by non-compliance due to an aggressive risk-taking compliance strategy such as

278. *See generally* Cunningham, *supra* note 1; Arlen, *supra* note 2 (discussing the various incentives and considerations that prosecutors incorporate into settlements).

279. *See* Cunningham, *supra* note 1, at 54–57 (noting the potential harms associated with crafting one-size-fits-all compliance mechanisms).

regulatory arbitrage, this can be taken into consideration by prosecutors when they craft penalties.

Alternatively, if there are various factors at the organizational and individual levels that point to a broader disregard for compliance practices, then a DPA should require harsher penalties and significantly more exacting remedial measures that address agency costs and failed oversight among various actors. The systems theory also supports the view held by scholars that overly aggressive criminal enforcement against companies is usually unjustified since this is likely going to overly punish the firm and will not achieve optimal levels of deterrence.[280]

The analysis also suggests that regulatory behavior should be assessed to determine if it is promoting or hindering compliance practices. Prosecutors should, for example, examine if regulatory ambiguity or the lack of inter-agency coordination played a role. For example, if the regulated subject area involves multiple agencies operating within a shared regulatory space, it may be that coordination efforts are insufficient or rationally encourage a regulatory arbitrage strategy that frustrates the aims of regulation. Prosecutors may also take this into account when crafting a DPA. Also, in these cases, additional oversight from Congress, the President, or SROs may be necessary to promote the broader goals of regulation.[281]

The systems theory can also inform improved policymaking. Policymakers have various tools at their disposal to improve compliance practices. Legislatures, for example, can craft legislation that broadly delegates authority and allows regulators to craft rules that close gaps or loopholes. The courts can likewise offer broad deference to agencies in this regard. Administrative law rulings like the one in *Goldstein v. SEC*[282] should

280. *See* Arlen, *supra* note 2 (noting the ways in which corporate malfeasance may be heavily regulated by criminal law); Haugh *supra* note 2 (discussing the pitfalls of over-enforcement of corporate noncompliance).

281. Freeman & Rossi, *supra* note 65, at 1173–78.

282. Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873, 876 (D.C. Cir. 2006). The appellate court struck down a rule implemented by the SEC that would remove many hedge funds from the safe harbor provisions of the Investment Advisors Act, which exempted from SEC regulation "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients. . . ." *Id.* The SEC had interpreted "clients" to refer to the funds themselves, but the SEC's new Hedge Fund Rule stated that "clients" includes "the shareholders, limited partners, members, or beneficiaries . . . of [the] fund" thus bringing many hedge funds within the regulatory oversight of the SEC. *Id.* at 877. This rule and new definition of client was implemented under SEC's rule to increase oversight over hedge funds due to large losses triggered by the speculative and opaque activities of hedge funds such as Long-Term Capital Management. Commentators have noted that the appellate court's decision in *Goldstein* is at odds with administrative law and wrong on policy grounds. *See* Recent Cases, *Administrative Law – Judicial Review of Agency Rulemaking – District of Columbia Circuit Vacates Securities and Exchange Commission's "Hedge Fund Rule"*, 120 HARV. L. REV. 1394 (2007) (noting that the *Goldstein* court "not only departed from its

be avoided, since they hamper flexible administrative rulemaking that promote statutory policy aims and that should be granted deference under *Chevron*. The legislature and executive branch also have the power to reduce regulatory capture within agencies, for example, by limiting the use of revolving doors.[283] All too often agencies are led by former industry insiders who, in turn, promote the negative impacts of regulatory capture as explained by the systems theory. Statutory reform and executive actions can help improve compliance practices and prevent this negative attribute of the current administrative state.

The judiciary may also play a significant role in compliance law. As mentioned by scholars, the courts can create duties that impact the compliance cost-benefit calculus within firms. Delaware's *Caremark* decision was an important first step. As pointed out by many, however, *Caremark* failed to live up to its expected effect of imposing personal liability on fiduciaries for failing to implement and monitor an effective compliance function. The subsequent case of *Stone v. Ritter*[284] largely inoculated the effects of *Caremark*. Only recently have directors faced the specter of personal liability for failing to maintain adequate compliance programs. State appellate courts, therefore, have the power to craft heightened duties that impose greater personal liability on fiduciaries.

As the systems theory suggests, heightened personal liability standards directly impact the firm's compliance infrastructure, resulting in heightened levels of compliance. The theory suggests heightened liability would impact private ordering behavior. As long as transaction costs are low, insurance companies are expected to price the greater liability risk and premiums in relation to the firm's investments in compliance infrastructure and strategy.[285]

Lastly, regulators should perhaps focus their attention and resources on the behavioral components of compliance practice as a regulatory strategy that may yield the greatest benefits to society at the lowest possible cost. Regulations, for example, can be narrowly tailored to impact incentives that reward compliance behavior. For instance, several agencies have proposed

---

tradition of deferring to agency expertise, but also failed to advance the purposes underlying the IAA. Further, the court missed an opportunity to allow agencies greater substantive rulemaking flexibility in areas in which parties have the ability and incentive to escape regulation.").

283. Dodd Frank proposes majority of Municipal Securities Rulemaking Board to be public representatives. Sen. John Kennedy R. La introduces proposed legislation to increase director independence.

284. Stone v. Ritter, 911 A.2d 362 (Del. 2006) (recasting board oversight duties related to compliance as a duty of loyalty issue).

285. Tom Baker & Sean Griffith, *Predicting Governance Risk: Evidence from the Directors' and Officers' Liability Insurance Market*, 74 CHI. L. REV. 487, 489 (2007).

rules under Dodd-Frank that "require that incentive-based compensation arrangements for certain covered persons include deferral of payments, risk of downward adjustment and forfeiture, and clawback to appropriately balance risk and reward."[286] This proposed rule seeks to prevent perverse incentives that generate excessive short-term risk taking that can, in turn, generate systemic financial risk.[287]

On the enforcement side, DPAs may be most effective if they reward companies that tie executive compensation and promotion to clearly-defined compliance objectives. Scholarly research suggests that "there is some experimental evidence that, at least for some kinds of decisions, people with incentives can partially reduce cognitive biases through learning."[288] Some companies have begun to engage in this positive compliance practice.[289] Alternatively, a well-designed DPA may structure incentives as a remedial action, particularly when other incentives such as aggressive sales commissions or inflexible quotas lead to aggressive risk taking and compliance failures. As the systems theory suggests, incentives impact compliance-related behavior and can counter the negative effects of cognitive biases. Along these lines, SROs and professional associations may likewise mandate or recommend this as a best practice.

Adopting a systems perspective will impose discipline on regulators and result in more efficient, effective, and legitimized regulation. The systems theory of compliance allows policymakers to zero in on structural weaknesses versus a strategy of wholesale reform characterized by the current reactionary process view of compliance. For example, the investigation of the MF Global collapse correctly identified particularized weaknesses in the regulatory environment that justified incremental reforms such as doing away with the Alternative Method. A wholesale regulation that would, for example, increase capital requirements across the board for all futures merchants would have been over-inclusive and had a punitive effect among firms that were adequately complying with regulations and monitoring risk.

It is important to recognize that the systems theory of compliance law challenges traditional notions of the theory of the firm, including the view of the firm as a nexus of contracts and as a conduit for stockholder wealth

---

286. Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37680 (proposed June 10, 2016), https://www.govinfo.gov/content/pkg/FR-2016-06-10/pdf/2016-11788.pdf [https://perma.cc/BP84-QG2K].

287. *Id.* at 37682.

288. Viscusi & Gayer, *supra* note 205, at 979 (citing Colin F. Camerer & Robin M. Hogarth, *The Effects of Financial Incentives in Experiments: A Review and Capital-Labor-Production Framework*, 19 J. RISK & UNCERTAINTY 7, 34–35 (1999)).

289. Usnick et al., *supra* note 183 (describing how Walmart has implemented a compensation system directly related to compliance objectives).

maximization. Instead, the systems theory of compliance supports the entity theory of the firm and justifies various stakeholder considerations in corporate governance. From a normative perspective, this theoretical vantage point may yield positive social outcomes due to greater efforts to achieve compliance for the benefit of a multitude of stakeholders, including employees, customers, regulators, communities, and stockholders.

An aspect of the systems theory that is critical to achieve these normative goals is a general feature of systems overall, that is, the presence of feedback mechanisms that promote system-wide goals and stability.[290] These feedback mechanisms are primarily comprised of information conduits within and among the various units in the system. For example, if the firm's board create incentives that reward compliance, corporate executives will want clearly defined metrics to achieve those rewards. Executives will adjust their behavior to meet those objectives and will communicate their performance to multiple stakeholders including the board, stockholders, and regulators. SROs, in turn, may mandate certain compliance practices that will require disclosures related to effective compliance practices. Whistleblower protections and hotlines are designed to incentivize and protect information feedback related to potential violations. Regulators may also encourage feedback by inviting industry and external watchdog input through collaborative governance processes such as negotiated rulemaking. Professional compliance associations may solicit and contribute feedback through their promulgation of best practices. All of these information feedback systems are features of the compliance system and can help achieve the aims of regulation.

CONCLUSION

Compliance law theory is incomplete and in a conceptually disconnected state. This article seeks to offer clarification to this seemingly disparate yet growing and vitally important area of legal practice and scholarship. A robust theory of compliance that seeks to better explain and predict compliance-related outcomes is introduced through a compliance systems theory. The systems theory of compliance conceptualizes the various actors, institutions, and relations that impact compliance practices. Currently, compliance is viewed as a process and this yields inadequate explanatory and predictive power. The behavior and practices of each conceptualized systems unit, comprising regulators, firms, executives, and inter-organizational structures are analyzed in reference to two major forces acting at each level: economic and non-economic institutional forces. These

290. Belinfanti & Stout, *supra* note 123.

forces impact each unit and help explain compliance-related behavior across all levels. This descriptive analysis in turn, yields insights and prescriptive recommendations that will help improve compliance law, theory, and practice.