# COMMENTS TO THE ADVISORY GROUP ON ORGANIZATIONAL GUIDELINES TO THE UNITED STATES SENTENCING COMMISSION

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I am pleased to participate in the Advisory Group's deliberations on the effectiveness of the criteria for an effective compliance program. My comments will be indirect to many of the issues you are considering, because my research does not deal specifically with criminal corporate liability or the use of sentencing as an incentive mechanism. Rather, my work - which is primarily in corporate and securities law - touches on issues of compliance monitoring generally, with special attention to financial services firms. Its methodology borrows from a mix of conventional and behavioral economics, the latter being a blending of psychology into the usual predictors of economic activity.

The focus my work has been to determine what social and cognitive psychology research - the stuff of contemporary behavioral law and economics - has to say about the task of compliance and the contest between hard and soft monitoring strategies. The psychological work touching on this subject is tentative, often contestable, and always highly context-dependent, making it difficult to articulate strong confident predictions. My aim, however, is slightly less ambitious. Most of the legal discourse on supervision and compliance today makes behavioral predictions while ignoring this body of research entirely. I am content to think about what conclusions might follow if it turns out that these psychological predictions are robust within firms. In other words what are the risks associated with ignoring these predictions?

The potential pay-off from this effort is two-fold. There is a strong consensus that the law must do something other than simply relying on its conventional strategy of strict vicarious corporate liability in order to induce good monitoring. As the Sentencing Guidelines recognize, firms must be sanctioned for having poor systems or be given some sort of bonus for having good ones. But that necessarily means that a fact-finder has to make a reasonableness determination with respect to any given system, which in turn implies some cost-benefit analysis. My main claim is that these evaluations are prone to unexpected error in two somewhat off-setting directions. First, evaluators are likely to overestimate the extent to which a firm can rely on line supervisor monitoring to detect possible illegality. Which such supervision will catch some misconduct, a host of forces thwart its effectiveness overall. Here, the bias is toward tolerating sub-optimal monitoring. Secondly, there is also a likelihood of underestimating the costs associated with the most obvious cure for line supervisor bias: third-party compliance audits. This likely error biases the legal response towards insisting on too much auditing, forcing unnecessarily costly compliance initiatives.

I cannot quantify the net impact of these kinds of errors, which limits the precise policy lessons we can draw from the analysis. But if these unexpected or immeasurable costs of monitoring turn out to be high enough, it might mean that *any* affirmative regulatory insistence on high-powered monitoring will be inefficient. The problem is less severe if these costs turn out to be less, but it still does not go away. My point for now is simply that judges are likely to do a poor job of estimating the costs associated with specific compliance initiatives in a given firm, creating at least the risk that the legal regime will be an inefficient one.

These errors may also create disincentives for firms to experiment with so-called integrity-based systems, which have some promise even if they can be expected to fail rather dramatically on occasion. There is an inverse relationship between high-powered monitoring and trust-based systems, and any effort to encourage them must necessarily step down the intensity of command and control-style supervision.

To be sure, all I am doing is pointing out a risk of inefficiency in the process of evaluating compliance, with a bias in the direction of forcing excessive monitoring. This does not automatically translate into a reason for the law to become less aggressive. It may be that the social costs of the particular illegality in question are sufficiently large or immeasurable that this bias is a risk worth tolerating. My sense is that my analysis has the greatest normative bite in settings where (1) the harms in question are economic and (2) large externalities do not result from the conduct. In other words, we should worry most about this problem where the costs of over-precaution are most readily passed on to the class of persons who are the beneficiaries of the regulation. Here, at least, my sense is that the risk of inefficiency via insistence on too much monitoring is sufficiently strong that the law presumptively ought to take a fairly moderate position with respect to firm-level obligations. Some carrots and sticks are desirable with respect to compliance: vicarious liability is necessary, but not sufficient, for optimal organizational compliance. However, I would normally set the bar at medium height. Two steps seem wise along these lines. One is limiting our insistence on compliance to that which is already a best practice within the relevant industry (as opposed to trying to force steps to significantly on these standards, *de novo*). The other is shifting the emphasis to individual supervisory liability when supervisors actually ignore the red flags waving in their faces.

I will be happy to elaborate on these points to the extent that you would find helpful in your deliberations.