Corporate Wrongdoing: Interactions of Legal Norms and Corporate Culture

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Abstract

Reports of violations of legal standards by mainstream corporations crowd the news media. These reports document recurrent violations of legal standards and recidivist corporate behavior. In some industries, such as the banking and securities industries, legal violations occur across large segments of the industry. This is not a recent phenomenon. How has this behavioral pattern emerged, and how might it be changed? This paper explores the interaction of two institutions that influence corporate actors: government and corporate culture. The focus of the paper is on the interaction of these influences viewed through the lens of complexity theory.

Introduction

Reports of violations of legal standards by mainstream corporations crowd the news media. Reports document recurrent violations of legal standard and recidivist corporate behavior. In some industries, such as the banking and securities industries, legal violations occur across large segments of the industry. As a result, enforcement officials have imposed billions of dollars in sanctions against all the major U.S. financial institutions and many major financial institutions abroad in recent years. The large sanctions are the result of findings of recurrent violations of law as well as recidivism. Why have existing regulatory standards and enforcement policies led to repeated violations of law? Will the recent billion dollar sanctions deter future wrongdoing? This paper explores the interaction of two institutions that influence corporate actors: government and corporate culture. The focus of this paper is on the interaction of these influences viewed through the lens of complexity theory.

Part one of the paper examines the traditional viewpoint embraced by government agencies in dealing with corporate wrongdoing. It documents a regulatory viewpoint assuming

a model of corporate decisions determined by reason. In addition, it documents a regulatory viewpoint that assumes linear outcomes - a linear relationship between sanctions, such as fines, and deterrence. Part two of the paper explores evidence that corporate decisions are determined by multiple influences that interact. Government as an institution, reflected in legal standards and enforcement policy and actions, is one influence. Accepted business models, cognitive factors, and behavioral tendencies are components of corporate culture as an institution, and play an important role as well in shaping corporate decisions. Such influences interact, in a dynamic system, and outcomes are nonlinear. As a result, nongovernmental influences can and have become dominant influences, overshadowing the directives in law and the influence of higher fines and similar sanctions. Regulatory agencies in the U.S. have largely ignored these nongovernmental influences in shaping regulatory policy. By contrast, regulatory agencies in some other countries, such as the U.K., have begun to recognize them. The final portion of this paper then preliminarily explores how regulatory policy can be modified to reduce future recidivist corporate behavior.

Government regulatory philosophy in the U.S. and U.K. has long reflected an assumption of corporate commitment to law-abiding behavior. Mainstream corporations were viewed as embracing an ethical obligation to comply with legal mandates. The result was a light-touch approach to enforcement policy – a policy relying on agreements to cease violations and not emphasizing the imposition of civil penalties. When law-abiding behavior was absent and a breach of legal standards was substantial, recurrent or systemic, then financial penalties were imposed. More recently regulatory philosophy been modified to embrace the view that corporate actors are rational decision makers, choosing to comply, evade or violate legal obligations based on cost-benefit evaluations. This regulatory philosophy reflects a neoclassical economic view of cost-benefit evaluations. The current assumption is that corporate actors will comply with legal requirements if all potential costs of noncompliance exceed its benefits. In this scenario it is assumed that corporate actors assess risk based on a full appreciation of all the short-term and long-term consequences of their actions. The related assumption is that corporate decisions are linear in nature, so that increasing the size of fines, for example, will have a direct and proportional impact on future decisions concerning legal compliance. This is both a reductionist and a linear view of human decision making. The recent financial crisis has revealed the flaws in both of these viewpoints. This paper explores why increased sanctions, imposed by government institutions, alone will likely not deter future corporate misconduct. Its focus is behavioral decision theory and complexity theory. Specifically, it explores the multiple influences on corporate decision making. These include not only reason, reflected in cost-benefit evaluations, but also internal and external market conditions, including accepted business models, cognitive influences on decision making, including the role of decision making heuristics, and other influences that form a firm or industry corporate culture. This paper also explores the interaction of the various influences on corporate behavior resulting in nonlinear outcomes. It examines the likely effect of a heightened level of fines on corporate behavior as this factor interacts with other influences on future corporate decisions.

Part one of the paper examines both the assumptions of law-abiding behavior and rational decision making in past formulations of government regulatory standards, and

enforcement policy, in the U.S and U.K. The actions and policies of financial services regulators provide the case study presented. In the 1970s and 1980s the academic community began to reject a reductionist view of individual, consumer decision making, and later of corporate decision making - a reductionist view that assumed compliance decisions were determined solely by ethical commitment to law abiding behavior and later solely by reason. Market experience confirmed academic criticisms. Regulators, however, did not embrace this change in viewpoint. Instead regulatory authorities in the U.S. and U.K., for many years, continued to base regulatory standards and enforcement policy on a general assumption of commitment to law - abiding behavior by mainstream corporations, with outliers reigned in through monetary sanctions. In recent years regulatory philosophy was modified to reflect the role of reason in corporate compliance decisions. Greater reliance on financial penalties to deter future misconduct reflects this change. This regulatory philosophy assumes full recognition of all long-term and short-term risks of misconduct by corporate actors. Academic research has long criticized this neoclassical economic view of rational decision making, and market experience had confirmed that criticism. Nonetheless, regulatory authorities in the U.S. remain blind to the multiple influences on corporate decisions, including the effect of cognitive influences and heuristics on cost-benefit evaluations, and more generally on organizational behavior.

Part two of the paper examines modest, recent changes in regulatory assumptions embraced by government agencies. In the last six to eight years regulators in both nations have recognized the influence of cognitive factors on consumer decisions. However, regulators in the U.S. continue to be blind to such influences on corporate behavior. By contrast, regulators in the U.K. have begun to recognize cognitive influences on corporate behavior. Enforcement policy in the U.S. has similarly ignored the multiple influences on corporate behavior, including cognitive influences, which interact and lead to nonlinear outcomes. The change, if any, in U.S. enforcement strategy is a greater emphasis on large penalties to deter future misconduct. This continues to reflect a linear, reductionist view of corporate behavior. In contrast, regulatory authorities in the U.K. are rethinking their enforcement strategy based, in part, on recognition of multiple influences on corporate decision making including cognitive influences. In the U.S. this regulatory blindness seems likely to lead recurring issues of noncompliance.

Part One - Traditional Regulatory Philosophy

The academic literature has explored and debated the proper goal of regulatory enforcement policy – restitution, deterrence and/or retribution. [1] It has also examined individual influences on corporate commitment to legal compliance. [2] Scholarly debate has focused on the cognitive and behavioral influences on human decision making, but that debate

[1] *See* Max Minzer, *Why Agencies Punish*, 53 WM. & MARY L. REV. 853 (2012) and articles cited therein.
[2] *See* discussion *infra* notes 74-84 and accompanying text.

has focused on consumer decision making. [3] Less attention has been paid to cognitive influences on organizational behavior. [4] More importantly the academic literature has largely ignored whether regulators have recognized cognitive influences on organizational behavior. This paper explores this issue. It then examines the changes in regulatory philosophy that are necessary to induce greater corporate commitment to legal compliance.

A. The Law-Abiding Decision Maker

The traditional view of regulatory agencies in the financial services industry was that industry members were committed to legal compliance.[5] Noncompliance was viewed as limited to situations involving rogue organizations or individuals, or occasional, negligent wrongdoing. Both regulatory requirements and enforcement policy reflected this viewpoint. The American Law Institute's Principles of Corporate Governance reflect this perspective. Section 2.01 recognizes that a corporation should have as its objective the conduct of business that enhances corporate profit and shareholder gain. However, "[e]ven if corporate profit and shareholder gain are not thereby enhanced, the corporation…[i]s obliged, to the same extent as a natural person, to act within the boundaries set by law…." [6] The obligation to comply with the law did not depend on cost-benefit evaluations.[7] Section 2.01 was first tentatively approved in1984. Its aspiration was accepted as the norm by financial services regulators.

For example, in the U.S. the Comptroller of the Currency in 1983 decided to impose no explicit limitations on national banks' real estate lending activities, and to rescind current regulations that did impose precise limits.[8] This decision constrained industry lending practices solely by the general principles that "unsafe and unsound" banking practices must be avoided and that underwriting practices must be "prudent." This principles-based approach relied on bank management to determine which practices were "unsafe and unsound" and "prudent." The Comptroller justified this decision on the following grounds:

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[3] *See e.g.,* Christine Jolls et al., *A Behavioral Approach to Law and Economics,* 50 STAN. L. REV. 1471, 1476 – 1481 (1998); Russel B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited,* 79 OR. L . REV. 23, 43-56 (2000); Russel B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics,* 88 CAL. L. REV. 1051, 1075-1102 (2000). *See also* the review of the behavioral economics literature commissioned by the Financial Services Authority which was prepared by Professor de Meza, Professor Reyniers and Dr. Irlenbusch of the London School of Economics. FINANCIAL SERVICES AUTHORITY, FINANCIAL CAPABILITY: A BEHAVIORAL ECONOMICS PERSPECTIVE, CONSUMER RESEARCH 69 (2008).

[4] *Cf.* discussion *infra* note 84 and accompanying text (citing studies of cognitive influences).

[5] *See* IAN AYRES and JOHN BRAITHWAITE, RESPONSIVE REGULATION 19-20 (1992) (describing most regulators as being in the compliance camp – namely, that most corporate actors will comply with the law most of the time because it is the law- and embracing that viewpoint).

[6] AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE, section 2.01(1994).

[7] "Cost-benefit analysis may have a place in the state's determination whether a given type of conduct should be deemed legally wrongful. Once that determination has been made, however, the resulting legal rule normally represents a community decision that the conduct is wrongful as such, so that cost-benefit analysis whether to obey the rule is out of place." *Id.,* section 2.01, comment g.

[8] Real Estate Lending by National Banks, 48 Fed. Reg. 40698, 40699 (Sept. 9, 1983).

> ..the Office believes that, in the interest of facilitating national banks' ability to respond to market conditions, removal of the restrictions is warranted.
>
> Decisions concerning the forms and terms of national bank lending are properly the responsibility of each bank's directorate and management.[9]

Implicit in this approach was a view that mainstream financial institutions were law-abiding actors and therefore would be committed to legislative and regulatory mandates that imposed constraints in the form of general principles. A similar principles-based approach to regulation, and similar view of banking corporations as law-abiding citizens, was embraced by the Financial Services Authority (FSA) in the U.K. [10]

Based on the viewpoint of a law- abiding corporate actor, enforcement policy responded to most violations through what has been termed a light-touch approach. Under this approach when a violation was uncovered the offender was required to agree to refrain from further violations of law. Substantial fines or other sanctions were not thought necessary to ensure future compliance on the part of most industry members, including most violators, precisely because of an assumption that a law-abiding culture characterized most organizations.

For example, the enforcement policy of the U.S. federal bank regulators has relied on informal agreements, formal agreements and cease and desist orders when regulators encountered examples of noncompliance with legal mandates. Under this policy, when firms failed to comply with legal mandates they faced an agreement or order to cease the activities in question. Firms did not face fines for past violations and, in fact, typically retained all the benefits (profits) of past practices conducted in violation of legal mandates.

The actions of the U.S. federal banking regulators prior to the 2008 mortgage crisis in response to examinations revealing unsafe or unfair mortgage lending activities provide a revealing case study. Federal banking regulators rarely brought supervisory actions to address unfair or unsafe mortgage lending practices.[11] When enforcement actions of any kind were brought, they typically involved a written agreement to correct past violations and, occasionally, a cease and desist order.[12] More generally, when agencies encountered any violation of law, typically the only enforcement measure would be an agreement or order

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[9] *Id*. at 40699-40700.

[10] "We want to give firms responsibility to decide how to best align their business objectives and processes with the regulatory outcomes we have specified…Principles-based regulation is not new, however we see real benefits for firms, markets and consumers in tipping the balance of our approach toward greater reliance on principles…." FIN. SERVS. AUTH., PRINCIPLES-BASED REGULATION 4 (2007).

[11] *See* Vincent Di Lorenzo, *Principles-Based Regulation and Legislative Congruence*, 15 N. Y.U. J. LEGIS. & PUB. POL'Y 45, 95-98 (2012) [hereinafter DiLorenzo, *Principles-Based* Regulation].

[12] *See id.* at 97.

against an individual bank to stop unsafe or unsound practices.[13] Both written agreements and cease and desist orders typically merely outline corrective actions a financial institution's management and directors must take to address deficiencies in the institution's operations.[14]

This light–touch approach to enforcement by U.S. banking agencies is also reflected in a policy of the U.S. Justice Department, as well as the SEC. This is the policy of using "deferred prosecution agreements" or "non-prosecution agreements." In such agreements, no actions are commenced if firms investigate their own past wrongdoing and promise to change their behavior.[15] In fact, this policy became the official policy of the Justice Department in 2008, just as the financial crisis unfolded.

In the U.K. the Financial Services Authority (FSA) had, earlier, embraced a similar, light-touch enforcement policy. The FSA noted that when noncompliance with legal requirements was uncovered it may be appropriate to deal with this without formal disciplinary or enforcement action. Namely, FSA's policy was that if the firm acts promptly in taking remedial action agreed to with its supervisors, the FSA may decide against taking formal disciplinary action. If the firm does not do this, then FSA may take disciplinary or other enforcement action.[16]

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[13] *See* Testimony of John C. Dugan, Comptroller of the Currency, before the House Financial Services Committee at 4-7, http://www.occ.gov/ftp/release/2009-26a.pdf (most bank problems are resolved through the supervisory process, without resort to an enforcement action, and enforcement actions whether informal or formal typically involve an agreement or order to cease the unsafe or unsound practice with relatively few civil money penalties being imposed against the banks). The types of enforcement actions utilized by the federal banking agencies is described in Types of Enforcement Actions, http://www.kansascityfed.org/banking/references/RegulatoryUpdateSeminar/2009/0-ISActions.pdf. Regulatory actions related to the mortgage crisis exemplify this light-touch approach. *See* Todd Davenport, *OCC's New Predator Rule; Are Violations a Safety-and-Soundness Issue?,* WALL ST. J, February 3, 2005, at 1 (OCC defines anti-predatory lending standards as a safety and soundness issue, and enforces violations through a deficiency letter or in an examination report first, followed by a safety-and-soundness order, the equivalent of a cease and desist order, and lastly, for failure to comply, possible civil money penalties). *See also* Greg Ip and Damien Paletta, *Lending Oversight: Regulators Scrutinized in Mortgage Meltdown; States, Federal Agencies Clashed on Subprimes As Market Ballooned,* WALL ST. J., Mar. 22, 2007 at A1 (actions taken by the federal banking agencies in the last two years have been in the form of cease and desist orders). Civil money penalties are available in addition to formal and informal supervisory actions and cease and desist orders, but are rarely imposed for consumer violations generally, let alone for unfair mortgage practices specifically. Neil Willardson and Jackie Brunmeier, *Supervisory Enforcement Actions Since FIRREA and FDICIA*, THE REGION, September, 2006, http://www.minneapolisfed.org publications papers/pub display.cfm? id=3222 (a single action related to violation of consumer protection statutes accounts for the entire number of assessments in the form of civil money penalties attributed to consumer protection weaknesses in the period 1999-2005).

[14] JACKIE BRUNMEIER AND NEIL WILLADSON, THE REGIONAL FEDERAL RESERVE BANK OF MINNEAPOLIS, SUPERVISORY ENFORCEMENT ACTIONS SINCE FIRREA AND FDICIA (2006), www.minneapolisfed.org/publications-papers/pub-display.cfm?id=3222. The paper also discusses trends in civil money penalties in the 1989-2005 period and finds that 1 percent of all civil money penalties imposed in the 1999-2005 period were based on consumer protection violations.

[15] Gretchen Morgenson and Louise Story, *As Wall St. Policies Itself, Prosecutors Use Softer Approach*, N.Y. TIMES, July 7, 2011.

[16] FIN. SERVS. AUTH. THE ENFORCEMENT GUIDE at 5 (November 1, 2009).

This light-touch approach in enforcement policy seemed reasonable in an era in which regulatory policy assumed a law- abiding corporate culture. The regulators' role was primarily to (a) spot violations of law, which were presumed to occur inadvertently or, perhaps, through uncertainty arising from legal mandates that were in the form of general principles, (b) bring the violations to the corporation's attention, and (c) secure a promise of future compliance.

B. The Rational Decision Maker

To some degree the assumption of the law-abiding corporate actor was being reconsidered as early as 1989 in response to the savings and loan crisis in the United States. For example, the U.S. Congress decided to significantly increase the level of permissible civil penalties that banking regulators could impose.[17]

However, regulators continued to primarily rely on a light-touch approach to enforcement until the outbreak of the 2008 mortgage crisis. When faced with repeated violations of law, or significant and systemic violations, regulators did impose large monetary sanctions, including civil penalties. When they did so, regulatory policy assumed that substantial penalties would help to deter further misconduct. However, deterrence was not the primary aim of the sanctions imposed. Rather, monetary sanctions were sought primarily to provide restitution, and, at times, to fund structural changes in the industry.

It is useful to compare the regulatory philosophy reflected in regulators' statements accompanying the 2002 industry wide settlements regarding the improper activities of research analysts in investment banking firms, and the more recent statements accompanying settlements in the period 2012-2015. In the 2002 settlements, structural changes in the industry were highlighted as the means to ensure future legal compliance. Monetary sanctions of $1.4 billion were imposed, but the primary purpose of the sanctions was to provide restitution to investors and to fund some of the structural changes that would help ensure future compliance with legal mandates. Contrary to what might be assumed, deterrence of future wrongdoing was not emphasized as the purpose of the monetary sanctions.[18] This

[17] Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. 101-73, section 907(a) (1989) (codified at 12 U.S.C. 1818(i)(2)),modified civil penalties that may be imposed by federal banking regulators. The former fine of $1000 per day was modified to provide for first tier penalties of up to $5000 per day, second tier penalties of up to $25,000 per day, and third tier penalties of up to $1 million per day.

[18] Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission, Statement at the Announcement of Agreement in Principle on Research Analyst Issue (December 20, 2002); U.S. Securities and Exchange Commission, SEC, N.Y. Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices; $1.4 Billion Global Settlement Includes Penalties and Funds for Investors, Release 2002-179 (December 20, 2002), www.sec.gov/news/press/2002-179.htm. *See also* Speech by SEC Chairman William H. Donaldson for Delivery at SEC Press Conference Regarding Global Settlement, April 28, 2003, www.sec.gov/news/speech/spch042803whd.htm (although the monetary relief secured in the settlement is substantial, the losses investors suffered far exceeds the ability to compensate them fully, and the structural reforms required are, in my view, more significant).

reflects a regulatory philosophy that continued to be shaped by the assumption of a law-abiding corporate culture in the industry generally.

Curiously, the regulatory assumption of corporate ethical commitment to law-abiding behavior was brought into question by market experience in the 1980s and 1990s. For example, government estimates of the number of savings and loan failures in the savings and loan crisis of the 1980s that were caused by insider fraud ranged from twenty-five to forty percent.[19] Indeed, some wrongdoing was criminal, with 1100 criminal prosecutions brought that resulted in 839 convictions. [20] Yet, financial regulators have also exhibited sustained path dependence. The regulatory assumption of corporate ethical commitment to law-abiding behavior was brought into question, if not disproven by market experience in the 1980s and 1990s. [21] Apart from actions related to the savings and loan crisis, a light-touch approach to regulation continued to be the norm, including the norm for subsequent wrongdoing that led to the mortgage crisis of 2008. [22]

By contrast, in recent settlements U.S. regulators have emphasized the expectation of a deterrent effect produced by significant monetary sanctions.[23] The deterrent effect is sought not only for the violator but for other members of the industry. It is true that deterrence is not the only regulatory purpose. Restitution is also a stated regulatory goal. However, deterrence has now become an equally important goal. This change in significance reflects two underlying changes in regulatory philosophy. One change is a rejection of the assumption of a law-abiding corporate culture. Instead, regulators recognized that corporations comply, evade or, at times, decide to violate legal mandates based on cost-benefit evaluations. Commitment to legal compliance will not be robust if the benefits of noncompliance exceed its costs. This reflects a view that the decisions of corporate actors are entirely, or at least primarily, determined by reason. The type of rational decision making assumed to exist is cost –benefit evaluations in neoclassical economic terms.[24] Regulators have embraced the view that the corporate actor will appreciate and weigh all the long-term and short-term risks and benefits of a proposed course of action. Such a viewpoint ignores, among other influences, cognitive influences on evaluation of risks and benefits. It also ignores the concept of complexity, the multiple influences on human behavior that interact to shape decisions. [25] Instead, U.S. regulatory philosophy continues to reflect a reductionist and linear view of human decision making.

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[19] *See* Bruce A. Green, *After the Fall: The Criminal Law Enforcement Response to the S & L Crisis*, 59 FORD. L. REV. S155, S162-S163 (1991)

[20] *Two Financial Crises Compared: The Savings and Loan Debacle and the Mortgage Mess*, N.Y. TIMES, April 13, 2011

[21] *See* Bruce A. Green, *After the Fall: The Criminal Law Enforcement Response to the S & L Crisis*, 59 FORD. L. REV. S155, S162-S163 (1991) (twenty five to forty percent of savings and loan failures were caused by insider fraud).

[22] *Two Financial Crises Compared: The Savings and Loan Debacle and the Mortgage Mess*, N.Y. TIMES, April 13, 2011 (as a result of the savings and loan crisis 110 criminal prosecutions were brought resulting in 839 convictions).

[23] *See* discussion *infra* notes 112 to 115 and accompanying text.

[24] *See* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECO. 169 (1968).

[25] Complexity theory recognizes that an effect is often not the product of one, constant cause. Rather, it results from the interaction of many forces that are constantly changing – i.e. the existence and influence of each force is not constant. GREGOIRE NICOLIS & ILYA PRIGOGINE, EXPLORING COMPLEXITY 6 (1989). *See also* Donald T. Hornstein, *Complexity Theory, Adaptation, and Administrative Law*, 54 DUKE L.J. 913, 917-918 (2005) (complexity theory as the

Curiously, when U.S. financial regulators embraced the view that corporate compliance decisions are influenced by cost-benefit evaluations, they ignored the academic studies and market evidence that called into question the neoclassical economic view of cost-benefit evaluations. They ignored the evidence that had led to the rise of behavioral decision theory.

C. The Outcome: Recurrent and Recidivist Corporate Behavior

Corporate actions in the financial services industry have exhibited recurrent violations of law and recidivist behavior. First, individual financial institutions have repeatedly violated particular laws over extended periods of time. Some financial institutions have violated numerous legal standards. Second, simultaneous violations of particular legal requirements have occurred by numerous members of the financial services industry. In some cases, the wrongdoing appears to have become systemic. Third, recidivist behavior has also been experienced, with industry members repeating violations after being subject to significant sanctions, or failing to comply with the terms of earlier settlements.

There are many recent examples of recurrent violations of law. In 2015 Credit Agricole agreed to sanctions totaling more than $1.1 billion to settle charges brought by the Justice Department, Federal Reserve, Treasury Department and New York Department of Financial Services for violations of the International Emergency Economic Powers Act and the Trading With the Enemy Act.[26] The violations occurred between august 2003 and September 2008. Similarly, in 2015 Commerzbank agreed to pay $1.5 billion to settle charges that it had violated the Bank Secrecy Act, which targets money laundering, and the International Emergency Economic Powers Act, which targets transfer of funds for countries subject to economic sanctions. These violations occurred from 2002 to 2008.[27] In 2015 Deutsche Bank also settled charges that it had violated the economic sanctions laws, and agreed to pay $258 million to the Federal Reserve and the New York Department of Financial Services.[28] The violations occurred from 199 to 2006. BNP Paribas settled with the Justice Department in 2014 for violating U.S. laws prohibiting transfer of funds for countries subject to U.S. economic sanctions. The violations occurred from at least 2004 through 2012, and BNP Paribas went to elaborate lengths to conceal prohibited transactions and deceive U.S. authorities.[29] In 2013 Royal Bank of Scotland settled with U.S. regulators for violating U.S. laws imposing economic sanctions and agreed to pay $100 million. The bank concealed the identities of clients in at least 3500

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study of many actors and their interactions); Glenn Harlan Reynolds, *Chaos and the Court*, 91 COLUM. L. REV. 110,113-114 (1991) (applying the concept of complexity to the interaction of the multiple judges on the U.S. Supreme Court); J.B Ruhl and Harold J. Ruhl, Jr. , *The Arrow of the Law In Modern Administrative States*, 30 U.C. DAVIS L. REV. 405, 417- 418 (1997) (behavior of a system described according to the community of its components, mechanics of evolution of the system, and the overall direction of change).

[26] Department of Justice, Press Release, Credit Agricole Corporate and Investment Bank Admits to Sanctions Violations (October 20, 2015).

[27] Ben Protess, *Commerzbank of Germany to pay $1.5 Billion in U.S. Case*, N.Y. TIMES, March 13, 2015 at B1.

[28] Liz Moyer, *Deutsche Bank to Pay $258 Million and Fire 6 in Settlement*, N.Y. TIMES, November 4, 2015.

[29] Department of Justice, Press Release, Treasury Reaches Largest Ever Sanctions-Related Settlement with BNP Paribas SA for $963 million (June 30, 2014).

transactions with the knowledge of senior employees, including the group head of money laundering and the head of global banking services for Europe, the Middle East and Africa.[30]

Similarly, in 2012 HSBC admitted to violations of both money laundering laws and laws prohibiting transfer of funds for countries subject to U.S. economic sanctions. These violations occurred from 2006 to 2010. HSBC agreed to forfeit $1.256 billion and also agreed to pay $665 million in civil penalties. Assistant Attorney General Brewer noted that "[t]he record of dysfunction that prevailed at HSBC for many years was astonishing." [31]

In 2012, British bank Standard Chartered settled with the Justice Department and other regulators for violations of U.S. laws prohibiting transfer of funds for countries subject to U.S. economic sanctions. The violations occurred over a period of years. They were characterized by the Justice Department as deliberate and flagrant, and the bank later made misleading statements to regulators to conceal its misconduct. It agreed to pay $227 million, and the settlement required it to remediate anti-money-laundering compliance problems.[32] At the same time, the Federal Reserve Board assessed a civil penalty of $100 million against Standard Chartered, and the Treasury Department's Office of Foreign Assets Control announced a $132 million settlement with Standard Chartered based on the same violations.[33] In August, 2014 Standard Chartered agreed to pay an additional $300 million fine to the New York State Department of Financial Services for continuing deficiencies in its computer systems that failed to flag wire transfers from parts of the world considered vulnerable to money laundering.[34]

Charges for violations of money laundering and/or economic sanctions laws brought by U.S. authorities are still pending against Societe Generale and Unicredit.[35] All of these actions evidence not only recurrent violations, but also violations by numerous members of the financial services industry.

Citigroup provides another example of recurrent violations of law as well as recidivist conduct. Citigroup has been charged with repeated violations of federal securities laws limiting research analysts' conduct. Citigroup was fined by the Financial Industry Regulatory Authority (FINRA) for violating laws concerning research analysts' communications in 2014 with respect to the planned Toys R Us initial public offering. In 2013, Citigroup was charged with violations with respect to its analyst sharing unpublished research about Apple with hedge funds and a fund manager. It was similarly charged in 2012 for a research analyst sharing nonpublic information concerning Facebook, and in 2011 for violating FINRA rules concerning research

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[30] Sarah Todd, *RBS to Settle Foreign Sanctions Probe for $100 Million*, AMER. BANKER, December 12, 2013.
[31] Department of Justice, Press Release, HSBC Holdings PLC and HSBC Bank N.A. Admit to Anti-Money Laundering and Sanctions Violations, Forfeit $1.256 Billion in Deferred Prosecution Agreement (December 11, 2012).
[32] Department of Justice, Press Release, Standard Chartered Bank Agrees to Forfeit $227 million for Illegal Transactions with Iran, Sudan, Libya and Burma (December 10, 2012).
[33] Board of Governors of the Federal Reserve System, Press Release (December 10, 2012).
[34] Chad Bray, *Standard Chartered Agrees to 3-year Extension of Nonprosecution Agreements*, N.Y. TIMES, December 10, 2014.
[35] Liz Moyer, *Deutsche Bank To Pay $258 Million and Fire 6 in Settlement*, N. Y. TIMES, November 4, 2015.

analysts' assisting issuers in preparation of road show presentations.[36] Citigroup has also settled with regulators for violating U.S. laws in actions involving misrepresentations in the sale of residential mortgage-backed securities (RMBS), mortgage servicing violations, manipulation of foreign currency markets, and manipulation of LIBOR and other benchmarks.

Recidivist conduct is also evidenced by recent violations of law by other banks also involving research analyst activities. In 2003 the Securities and Exchange Commission, state prosecutors and market regulators settled with 10 firms, including Citigroup, Merrill Lynch, Credit Suisse First Boston, and UBS Warburg for actions alleging conflicts of interest on the part of stock research analysts, as well as fraud and misrepresentations, in violation of federal law. The settlement was for $1.4 billion.[37] Ten years later, 10 firms, including many of the same banks charged in 2003, were charged by FINRA with the same violations regarding conflicts of interest and research analysts' communications with potential investment banking clients. FINRA concluded that flouting these securities regulations was the norm for every one of the firms.[38]

Recurrent violations have also occurred across large segments of the industry with respect to particular legal standards. Investigators in the RMBS Working Group probed misrepresentations in mortgage bond sales leading to the 2008 mortgage crisis. They found improper actions occurred "not only occasionally, but in the end, with almost every deal examined."[39]

For example, Citigroup's $7 billion settlement was based on misrepresentations that violated federal laws in various RMBS offerings in 2006 and in 2007.[40] Settlements were also reached in November 2013 for similar violations by J.P. Morgan Chase and two institutions it had acquired, Bear Sterns and Washington Mutual.[41] Settlements were again reached in August 2014 for similar violations by Bank of America and two institutions it had acquired, Merrill Lynch and Countrywide Financial.[42] J.P. Morgan Chase and Credit Suisse also settled with the SEC and agreed to pay more than $400 million combined for misleading investors in offerings of residential mortgage-backed securities. J.P. Morgan Chase was charged with misconduct in its 2006 RMBS offering, while Bear Stearns, the company it later acquired, was charged with violations in 156 different RMBS transactions issued from 2005 to 2007. Credit Suisse was charged with violations in 75 different RMBS transactions issued from 2005 to

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[36] Michael Corkery, *Finra Fines Citigroup Over Acts by Analysts*, N.Y. TIMES, November 24, 2014.
[37] Stephen Labaton, *Wall Street Settlement: The Overview; 10 Wall Street Firms Reach Settlement in Analyst Inquiry*, N.Y. TIMES, April 29, 2003.
[38] Gretchen Morgenson, *At Big Banks, A Lesson Not Learned*, N.Y. TIMES, December 12, 2014.
[39] Jody Shenn, *Flaws Found in 'Almost Every' Mortgage-Bond Deal as Crash Began*, 102 BANKING REP. (BNA) 967 (May 21, 2014).
[40] Department of Justice, Press Release, Statement of Facts and Settlement Agreement (July 14, 2014), Fed. Banking L. Reporter (CCH) ¶3152.
[41] *See* discussion *infra* note 111.
[42] *See* discussion *infra* note 114.

2010.[43] Following a trial, Nomura Securities and Royal Bank of Scotland were found liable in May 2015 of misleading Fannie Mae and Freddie Mac in their sales of mortgage-backed securities. Judge Cote wrote in a May 11, 2015 ruling in the case that "[t]he magnitude of the falsity, conservatively measured, is enormous." [44]

A distinct industry wide example of improper conduct involves mortgage servicers' activities. In 2012 the Justice Department, U.S. Department of Housing and Urban Development, 49 attorneys general and other federal agencies reached a $25 billion settlement with the nation's five largest mortgage servicers: Bank of America, J.P. Morgan Chase, Wells Fargo, Citibank, and Ally Financial (formally GMAC).[45] This was to resolve violations of state and federal law with respect to loan servicing and foreclosure practices. A year later recidivist conduct was uncovered. Three of the five institutions subject to the settlement had failed to fully comply with its requirements, based on investigation by a court appointed monitor.[46] In 2015 the Comptroller of the Currency again found noncompliance with earlier foreclosure practices settlements on the part of JPMorgan Chase, Wells Fargo and other banks, and therefore restricted their purchases of mortgage servicing rights.[47] In a separate settlement involving Ocwen Financial Corp. and the New York State Department of Financial Services, a 2012 examination revealed "widespread noncompliance with the 2011 [Settlement] Agreement" aimed at remediating mortgage servicing deficiencies. Due to these violations, Ocwen agreed to pay $150 million in restitution and host an independent monitor for up to three years.[48]

A final example of both recurrent violation of law and violations by numerous industry members is provided by industry manipulation of both foreign exchange rates and the LIBOR rates. Five banks – Citigroup, JP Morgan Chase, Barclays, Royal Bank of Scotland and UBS agreed with the Justice Department to plead guilty to felony charges for manipulating the foreign currency exchange market and to pay $2.5 billion in criminal fines. The wrongdoing occurred from 2007 to 2013. The Federal Reserve imposed a separate fine on the five banks of $1.6 billon. And Barclays settled related claims with U.S. and U.K. authorities and agreed to pay a combined penalty of approximately $1.3 billion. Adding earlier settlements with U.S. and European regulators, the five banks have been subjected to fines and penalties of nearly $9 billion. [49]

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[43] Securities and Exchange Commission, Press Release, SEC Charges J.P. Morgan and Credit Suisse with Misleading Investors in RMBS offerings (November 16, 2012).

[44] *Nomura, RBS Slammed by Judge for "Enormous" Mortgage Deception*, 104 Bloomberg BNA Banking Report 975 (May 19, 2015).

[45] Department of Justice, Press Release, $25 Billion Mortgage Servicing Agreement Filed in Federal Court (March 12, 2012).

[46] Andrew M. Ballard, *Compliance Deficiencies Remain After $25 billion Mortgage Settlement, Monitor Says*, BANKING REP. (BNA), December 10, 2013.

[47] Jesse Hamilton, *OCC Limits Servicing Rights Purchases: JPMorgan, Wells Fargo Among Targets*, 104 Bloomberg BNA Banking Report 1170 (June 23, 2015).

[48] Stephen Joyce, *Ocwen Agrees to Pay $150 million, Finance On-Site Independent Monitor in Lawsky Order*, BANKING REP. (BNA), January 6, 2015.

[49] Department of Justice, Press Release, Five Major Banks Agree to Parent-Level Guilty Pleas, (May 20, 2015).

U.S. and European regulators have imposed $6 billion in fines on 10 banks and brokerage firms for manipulating the London interbank offered rate (LIBOR) and the European interbank offered rate (EURIBOR). Three additional banks, HSBC, JPMorgan and Credit Agricole, have refused to settle but have been similarly charged.[50] Barclays Bank, for example, admitted manipulating the LIBOR and another benchmark in order to increase its trading profits, and agreed to a $160 million penalty in its agreement with the Justice Department, and an additional $200 million penalty in its agreement with the CFTC.[51] One scheme flourished from 2005 to 2007 and continued sporadically through 2009. A second scheme took place from August 2007 to January 2009.[52] United Bank of Switzerland, and its various subsidiaries, agreed to a total of more than $1.5 billion in penalties and disgorgement with U.S., U.K. and Swiss authorities for LIBOR manipulation from 2006 through 2009. UBS Securities Japan also agreed to plead guilty to felony wire fraud.[53] Deutsche Bank has been ordered to pay a $2.5 billion fine to settle investigations by U.S. and U. K. regulators for rigging LIBOR benchmark rates from 2003 to 2011. [54] In the LIBOR manipulation investigations the Justice Department concluded that "certain institutions condoned a culture of illegal behavior".[55]

Part Two – A Modest Evolution in Regulatory Philosophy

A. Recognition of Complexity and Behavioral Influences in Consumer Decision Making

There is an interesting contrast between the evolving view of financial industry regulators with respect to consumer decision making and the static view of these regulators with respect to corporate decision making. In the realm of consumer decision making, U.S. regulators in recent years went to great lengthens to document the multiple influences on consumer decisions, including cognitive limitations and decision making heuristics. As a result, regulatory policy was modified in recognition of these influences and the resultant limits to self-protection by consumers. However, in the realm of corporate decision making, multiple influences including cognitive influences and heuristics have been ignored. The same cannot be said of financial industry regulators in the U.K. Cognitive influences on both consumer decisions and corporate decisions have been acknowledged, and regulatory policy, including enforcement policy, is evolving in response.

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[50] Foo Yun Chee, *EU Commission Charges HSBC, JPMorgan, Credit Agricole with Rigging*, REUTERS, May 20, 2014.
[51] Department of Justice, Press Release, Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Offered Rate and Agrees to pay $160 million Penalty (June 2, 2012).
[52] James B. Stewart, *Barclays: Too Big to Indict?* N.Y. TIMES, July 14, 2012 at B1.
[53] Department of Justice, Press Release, UBS Securities Japan Co. Ltd. to Plead Guilty to Felony Wire Fraud for Long-running Manipulation of LIBOR Benchmark Interest Rates (December 19, 2012).
[54] *Deutsche Bank to Pay Record $2.5 Billion, Fire Employees to End U.S.- U.K Libor Probes*, 104 Bloomberg BNA Banking Report 813 (April 28, 2015).
[55] Jeff Bater, *Top Justice Department Official Urges Banks To Create 'A Culture of Compliance'*, Bloomberg BNA Banking Report (November 26, 2013) (statements by Deputy Attorney General James Cole).

Before 2008 the regulatory approach to consumer protection relied on a rational decision maker model. Namely, consumers could protect themselves against unfair or unsafe financial products by weighing all the risks and the benefits of the product in question. Cost-benefit evaluation was considered the basis of consumer decisions, with the law intervening merely to provide full and early disclosure in order to allow proper cost-benefit evaluations.

Studies, however, confirmed that many consumers are unable to protect themselves in the mortgage market that emerged in the last decade. The Federal Reserve Board recognized this state of affairs when it modified real estate lending regulations in July 2008.[56] Similarly, the Financial Services Authority recognized that behavioral biases on the part of consumers have a significant impact on what can be achieved through disclosure, education and counseling.[57] Both regulators, therefore, considered greater product intervention.[58]

The Federal Reserve Board and the Financial Services Authority recognized that the inability of consumers to protect themselves results from a combination of market characteristics and behavioral barriers as they interact in the decision making process of individual consumers. The factors identified by one or both agencies include:

(a) the market characteristic of limited transparency, particularly in the market for subprime loans, which prevents comparison shopping, [59]

(b) the market and cognitive characteristic that innovative mortgage products are too complex to be understood and properly evaluated by consumers, a barrier exacerbated by inexperience,[60]

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[56] *See* Truth in Lending: Final Rule, 73 Fed. Reg. 44522, 44524-44526 (July 30, 2008).

[57] *See* FIN. SERV. AUTH., DP 09/3 MORTGAGE MARKET REVIEW. at 72–75 (2009). *See also* FIN. SERVS. AUTH., DP08/5: CONSUMER RESPONSIBILITY 16 [hereinafter *Consumer Responsibility*] (2008) (recognizing cognitive biases on the part of consumers).

[58] FIN. SERV. AUTH., DP 11/1 PRODUCT INTERVENTION at 23–28 (2011); HM TREASURY, A NEW APPROACH TO FINANCIAL REGULATION: BUILDING A STRONGER SYSTEM at 70-71 (2011) (discussing an early intervention policy and an array of powers to impose product requirements and standards and even to ban products or product features).

[59] *See* Truth in Lending, *supra* note 56 at 44524 (rates can vary significantly based on the individual's risk profile and are usually obtainable only after application and payment of application fees); FINANCIAL SERVICES AUTHORITY, PRODUCT INTERVENTION, *supra* note 58, at 24 (it can be difficult for consumers to compare products, in part due to opaque charging structures).

[60] *See* Truth in Lending, *supra* note 56 at 44524-44525 (most consumers either do not understand or cannot properly evaluate the terms and risks of nontraditional loan products, such as adjustable rate mortgages or payment option loans). FIN. SERVS. AUTH., CP 12/35, THE FCA'S USE OF TEMPORARY PRODUCT INTERVENTION RULES at 10 (December 2012) (some financial products or features may be so complex that most consumers would be unable to understand or would have difficulty understanding the risks or features of the product they are purchasing). See also FIN.. SERVS. AUTH., PRODUCT INTERVENTION, *supra* note 58 at 26 (complexity of financial products plus behavioral biases of consumers can result in misleading views about a product).

(c) the behavioral characteristic of limited shopping caused by the combined effect of limited transparency, complexity and the cost of comparison shopping, [61]

(d) persistent negative beliefs concerning credit availability and ability to qualify for loans (pessimism bias) that prevent some consumers from shopping for more favorable terms, and

(e) the inability of consumers to properly evaluate additional information that might be disclosed, in part due to complexity but also due to decision-making heuristics, including limited focus.

Focusing on behavioral and cognitive barriers to consumer self-protection, regulators recognized that market barriers to consumer self-protection combine with additional psychological barriers that surface from invalid borrower beliefs. One belief is that lenders are required by law to provide the best possible rate on loans.[62] Another belief is that lenders or brokers will offer suitable products. The Financial Services Authority found that consumers assume that no firm will identify options that are not broadly appropriate for them.[63] This leads to limited comparison shopping or no comparison shopping.

A third belief is pessimism of borrowers concerning their credit quality. A Freddie Mac Consumer Credit Survey found that thirty percent of white borrowers, approximately one-third of Latino borrowers, and approximately fifty percent of African-American borrowers who had good credit believed they had poor credit.[64] As a result consumers will accept a subprime mortgage, at a higher interest rate, carrying higher fees and a prepayment penalty, because they believe they would not qualify for a prime mortgage or would not qualify for a non-prime mortgage with a lower interest rate and fee structure.

A fourth belief preventing consumer self-protection, by further undermining comparison shopping, is the belief among low-income borrowers and subprime borrowers that there are few alternatives available to them either due to fewer lenders willing to make loans in their

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[61] Truth in Lending, *supra* note 56 at 44525 (footnotes omitted). *See also* Patricia McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. LEGIS. 123, 140–141 (fees and interest rates are disclosed after the consumer pays a nonrefundable application fee).

[62]The Fannie Mae National Housing Survey found that more than forty percent of borrowers generally, almost two-thirds of African-American borrowers and seventy-five percent of Spanish speaking Hispanic borrowers did not know that this statement was false. FANNIE MAE, UNDERSTANDING AMERICA'S HOMEOWNERSHIP GAPS: 2003 FANNIE MAE NATIONAL HOUSING SURVEY 7 (2003), http://www.fanniemae.com/global/pdf/media/survey/survey2003.pdf.

[63] FIN. SERVS. AUTH., CP 10/28 MORTGAGE MARKET REVIEW: DISTRIBUTION AND DISCLOSURE 12 (2010), http://www.fsa.gov.uk/pubs/cp/cp10_28.pdf.

[64] *See* Sheila D. Ards and Samuel L. Myers, Jr., *The Color of Money: Bad Credit, Wealth and Race*, 45:2 AM. BEHAV. SCIENTIST 223, 229 (Oct. 2001) (citing FREDDIE MAC, 1999 CONSUMER CREDIT SURVEY (1999)). *See also* FIN. SERVS. AUTH., THE FINANCIAL CONDUCT AUTHORITY: APPROACH TO REGULATION 24 [hereinafter *Approach to Regulation*] (2011) (stating there can be opportunities for firms to exploit consumer behavior such as lack of confidence or knowledge in retail markets).

communities or due to the lower, actual quality of their credit history.[65] This was a belief uncovered by both U.S. and U.K. regulatory authorities.[66]

Pessimism concerning credit quality and/or availability of credit may be characterized as pessimism bias, the opposite of optimism bias that is displayed in most situations by most individuals. It is most prevalent among low-income and minority borrowers. Regulators recognized that all of these beliefs undermine self-protection by serving as barriers to comparison shopping.Consumer pessimism leads to an emotional response to a favorable credit decision that undermines rational decision making. Relief is triggered when a loan application is approved, and fear is triggered that if the particular loan offered is not accepted, regardless of its terms, no other lender or loan will be available.

A final barrier to consumer self-protection recognized by regulators concerns the manner in which consumers make decisions in the mortgage market. There has been a great deal of research concerning decision making heuristics, including decision making in the mortgage loan process.[67] For example, regulators have recognized limited focus as a decision-making heuristics among consumers. The Federal Reserve Board noted:

> Consumers considering obtaining a typically complex subprime mortgage loan may simplify their decision by focusing on a few attributes of the product or service that seem most important. A consumer may focus on loan attributes that have the most obvious and immediate consequence such as loan amount, down payment, initial monthly payment, initial interest rate, and up-front fees…. These consumers, therefore, may not focus on terms that may seem less immediately important to them such as future increases in payment amounts or interest rates, prepayment penalties, and negative amortization. They are also not likely to focus on underwriting practices such as income verification, and on features such as escrows for future tax and insurance obligations. Thus, consumers may unwittingly accept loans that they will have difficulty repaying.[68]

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[65] *See* COMMENTS OF THE STAFF OF THE BUREAU OF ECONOMICS, THE BUREAU OF CONSUMER PROTECTION, AND THE OFFICE OF POLICY PLANNING OF THE FEDERAL TRADE COMMISSION, OCT. 28, 2002, DISCUSSED IN DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT<OFFICE OF POLICY DEVELOPMENT AND RESEARCH, RESPA: REGULATORY IMPACT ANALYSIS AND INITIAL REGULATORY FLEXIBILITY ANALYSIS, FR-5180-F-02 2-105 (2008), http://www.hud.gov/offices/hsg/ramh/res/impactanalysis.pdf (summary of the evidence).

[66] FIN. SERVS. AUTH., MORTGAGE EFFECTIVENESS REVIEW: STAGE 2 REPORT 9-10 (2008), http://www.fsa.gov.uk/pubs/other/MER2_report.pdf (subprime consumers did not see traditional lenders as a realistic option).

[67] *See* Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending,* 65 MD. L. REV. 707,766–806 (2006).

[68] Truth in Lending, *supra* note 56 at 44525-44526 (footnotes omitted). Research on the part of the Federal Reserve staff has found, for example, that 40 percent of borrowers with income less than $50,000-corresponding

Similarly, the Financial Services Authority concluded that many consumers focus only on short-term costs, and are therefore seduced by an attractive initial interest rate. This is true even among relatively sophisticated borrowers, who focused on the initial monthly payment.[69]

As a result of all of these consumer barriers to self-protection, regulatory authorities in the U.S. and U.K. have recognized that modifications in the timing or manner of disclosures will not lead to effective self-protection. The U.S. General Accountability Office came to this conclusion in as early as 2004, after discussions with federal officials and consumer advocates. It found that due to complexity in the terms of non-prime mortgages and borrowers' lack of financial education and sophistication, greater consumer education and even clear and transparent disclosures would be of limited effectiveness in decreasing the incidence of predatory lending practices.[70] The Financial Services Authority expressed similar doubt that increased disclosure will change consumer behavior.[71]

Indeed, additional disclosures may be counterproductive due to information overload, and, in any event are likely to be ineffective due to limited focus. As the Federal Reserve concluded:

> Disclosures describing the multiplicity of features of a complex loan could help some consumers in the subprime market, but may not be sufficient to protect them against unfair loan terms or lending practices. Obtaining widespread consumer understanding of the many potentially significant features of a typical subprime product is a major challenge. If consumers do not have a certain minimum level understanding of the market and products, disclosures for complex and infrequent transactions may not effectively provide that minimum understanding. Moreover, even if all of a loan's features are disclosed clearly to consumers, they may continue to focus on a few features that appear most significant. Alternatively,

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to the bottom half of the income distribution of ARM borrowers – are unaware of their per-period caps on their ARM mortgages, 53 percent are unaware of their lifetime cap, and 40 percent are unaware of the index of their ARM. By contrast, 13 percent of borrowers with income exceeding $150,000 – the top income decile of ARM borrowers – are unaware of their per period caps, while 21 percent are unaware of their lifetime cap, and 8 percent are unaware of the index. BRIAN BUCKS AND KAREN PENCE, FEDERAL RESERVE BOARD, DO HOMEOWNERS KNOW THEIR HOUSE VALUES AND MORTGAGE TERMS 20, Table 5 (2006), http://www.federalreserve.gov/pubs/feds/2006/200603/200603abs.html.

[69] *See* FIN. SERVS. AUTH., CP10/16 MORTGAGE MARKET REVIEW: RESPONSIBLE LENDING 57–58 [hereinafter *Responsible Lending*] (2010). *See also* FINANCIAL SERVICES AUTHORITY, *Product Intervention*, *supra* note 58 at 26 (consumers do not focus on costs that will arise later such as mortgage exit fees or mortgage arrears charges).

[70] U. S. GEN. ACCOUNTABILITY OFFICE, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 94-98, GAO 04-280, http://www.gao.gov/new.items/d04280.pdf (2004). The evidence of lack of understanding of mortgage loan terms and products on the part of consumers is reviewed in Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer,* 157 U. PA. L. REV. 101, 127–130 (2008).

[71] *See* FIN. SERVS. AUTH., MORTGAGE MARKET REVIEW, *supra* note 57 at 73–74.

> disclosing all features may "overload" consumers and make it more difficult for them to discern which features are most important.[72]

An interesting note is that regulators in the U.K. have also explicitly recognized not only the multiple influences on consumer decisions but also that these influences interact. The Financial Conduct Authority explained that it:

> will base its regulatory interventions on a deeper understanding of underlying commercial and behavioral drivers and the often multiple causes of poor outcomes for consumers. This will involve analysis of often complex chains of interaction. [73]

All of these statements and actions regarding regulatory policy reflects recognition of the multiple influences on consumer decisions, including but not limited to cognitive barriers and decision making heuristics. The focus of this paper is not on regulators' recognition of multiple influences on consumer decision making. Regulatory viewpoint toward consumer decision making is presented in some detail as a contrast. The question explored in this paper is whether a similar recognition has occurred with respect to corporate decision making.

B. Regulatory Blindness toward Corporate Decision Making

Regulators have recognized both the market realities and behavioral barriers that often prevent effective decision making on the part of consumers. Regulators in the U.S. have not, however, explicitly recognized behavioral barriers to proper risk assessment on the part of corporate actors. Nor have they recognized the interaction of multiple influences on corporate behavior. As a result, U.S. regulators continue to emphasize larger and larger fines as the key to deterrence. This is based on a continuing assumption that corporate decisions reflect a complete evaluation of all short-term and long-term risks and are determined directly and primarily based on such cost-benefit evaluations.

1. Influences on Industry Compliance Decisions

Some studies of organizational behavior have embraced complexity theory as descriptive of decision making in business organizations.[74] Kagan, Cunningham and Thornton, in fact, concluded "[b]oth our quantitative and qualitative analysis leave us convinced that theories of

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[72] *Id*. at 44526 (citation omitted). *See also* Willis, *supra* note 67 at 767 (discussing cognitive responses to information overload).

[73] FIN. CONDUCT AUTH., APPROACH TO REGULATION at 24 (June 2011).

[74] *See e.g.* Robert Kagan, Neil Cunningham & Dorothy Thornton, Explaining Corporate Environmental Performance: How Does Regulation Matter? 37 LAW & SOC'Y REV. 51, 76-78 (2003). *See generally* Vincent Di Lorenzo, *Does the Law Encourage Unethical Conduct in the Securities Industry*? 11 FORDHAM J. CORP. FIN. L. 765, 770-771 [hereinafter Di Lorenzo, *Does the Law Encourage Unethical Conduct*] (summarizing studies and perceived influences on corporate behavior).

corporate environmental behavior that focus on a single variable – whether legal, economic or attitudinal – are almost always doomed to be incomplete and inadequate."[75] Government imposed legal standards, as well as related regulatory policies and enforcement actions are one set of influences on corporate behavior. One factor influencing corporate behavior is the precision of the governing legal standards.[76] Another factor is the frequency of inspections and sanctions.[77] Studies and commentators have offered a difference of opinion on the significance of the size of legal sanctions on corporate decisions.[78] However, many studies have provided support for the influence of the frequency of inspections, and the frequency and severity of sanctions.[79] This debate is part of a broader debate on whether enforcement policy should assume rational decision making by corporate actors – rational decision making viewed through the lens of neoclassical economic analysis.[80]

However, factors influencing legal compliance are not limited to the nature of the legal mandate and the severity and frequency of sanctions. Legal compliance is also influenced by market realities, including prevailing business models that shape corporate decisions. One business model bases corporate decisions on cost-benefit evaluations.[81] Legal mandates are strictly followed or creatively ignored as a result of an evaluation of the benefits and risks of noncompliance.[82] In other words, resolute legal compliance is not a given but rather a

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[75] Kagan, Cunningham and Thornton, *Id.*

[76] Mark W. Nelson, *Behavioral Evidence on the Effects of Principles-and Rules-Based Standards*, 17 ACCOUNT. HORIZONS 91, 99 (March 2003) (aggressiveness of accounting reporting decisions increases with the imprecision of the relevant reporting standards); Vincent Di Lorenzo, *Business Ethics: Law As A Determinant of Business Conduct*, 71 J. BUS ETHICS 275, 288 (2007) (in a regime with a vague legal standard the influence of law on corporate conduct is weakest).

[77] *See* Peter J. May, *Compliance Motivations: Affirmative and Negative Bases*, 38 LAW & SOC'Y REV. 41 (2004) (summarizing prior studies regarding the influence of various factors, such as inspection frequency and consistency, perceived legitimacy of regulations, reputation, and ability to comply including costs and competitive effects); Wayne B. Gray & John T. Scholz, *Does Regulatory Enforcement Work? A Panel Analysis of OSHA Enforcement,* 27 LAW & SOC'Y REV. 177, 199 (1993); Steven Klepper & Daniel Nagin, *Tax Compliance and Perceptions of the Risks of Detection and Criminal Prosecution,* 23 LAW. & SOC'Y REV. 209, 237 (1989).

[78] *E.g*. Braitewaite and Makkai found little support for the additive or multiplicative effects of the certainty of detection, certainty of punishment, and severity of punishment. John Braitwaite and Toni Makkai, *Testing an Expected Utility Model of Corporate Deterrence,* 25 LAW & SOC'Y REV. 7, 35 (1991) (study of Australian nursing homes).

[79] *See* Di Lorenzo, *Principles Based Regulation, supra* note 11, at 91 – 102 (study of the mortgage market in the period 2002 – 2008 in which benefits of noncompliance or evasion outweighed costs of noncompliance when sanctions were infrequent); Di Lorenzo, *Does the Law Encourage Unethical Conduct*, *supra* note 73, at 782–803 (discussing cost – benefit evaluations of legal sanctions in the securities industry, and comparing it to cost – benefit evaluations in the banking industry and the industry's compliance record under the Community Reinvestment Act); Wayne B. Gray & John T. Scholz, *Does Regulatory Enforcement Work? A Panel Analysis of OSHA Enforcement,* 27 L. & SOC'Y REV. 177, 199 (1993); Steven Klepper & Daniel Nagin, *Tax Compliance and Perceptions of the Risks of Detection and Criminal Prosecution,* 23 LAW & SOC'Y REV. 209, 237 (1989).

[80] *See* Gary S. Becker, *supra* note 24.

[81] DiLorenzo *Principles-Based Regulation, supra* note 11 at 91-100 (study of corporate decisions based on cost-benefit evaluations in the 2008 mortgage crisis and the period preceding it).

[82] *See* Di Lorenzo, *Does the Law Encourage Unethical Conduct*, *supra* note 74 at 784; *see also* Di Lorenzo, *Principles Based Regulation, supra* note 11 at 103.

determination made by industry actors in a particular context. Frequency and level of legal sanctions are one set of contributors to the costs of non-compliance but are not the only cost that industry actors encounter. Other costs include adverse impact on the reputation of the corporation.[83] Cost-benefit evaluation is not the only business model influencing corporate decisions. A related business model that has been embraced bases decisions on the goal of generating substantial and rising short-term profits - to meet the demands of investors and to sustain and increase the corporation's stock price.

In addition to the nature of the legal mandate, the nature of enforcement policy and actions, and relevant market realities, corporate decisions are also influenced by cognitive limitations and decision making heuristics. These limit a complete recognition of long-term risks. Finally, personality traits of corporate actors have an influence on corporate behavior. Personality traits trigger particular emotional responses to market conditions, and influence the overall corporate culture. Market realities, including accepted business models, cognitive limitations and heuristics, as well as personality traits of corporate actors, combine to create a corporate culture. This corporate culture is an important, institutional influence on corporate behavior distinct from the influences of government standards, policies and actions.

Behavioral barriers to effective risk assessment among industry actors have been the subject of study far less frequently than behavioral barriers among consumers. However, the studies conducted have found no difference in use of decision-making heuristics in group decision making and organizational behavior in corporations.[84]

Regulators must recognize that cognitive limitations and decision making heuristics affect industry actors as much as they affect the general public. Regulators must also recognize complexity in corporate decisions, namely the interaction of multiple influences on corporate decisions. These multiple influences on corporate behavior can skew cost-benefit evaluations in favor of "creative compliance," "creative non-compliance," or, at times, in favor of violation of clear legal mandates.[85]

Three decision-making heuristics that can play a significant role in corporate decisions on compliance with regulatory mandates are: skewed risk perception, simplified decision making and the representativeness heuristic.

Skewed risk perception is the inverse relationship between perceptions of risks versus benefits. When a significant benefit (e.g. substantial profits) is perceived to result from evasion

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[83] Reputational concerns enhance the sense of obligation to comply. May, *supra* note 77 at 48.

[84] Robert A. Prentice, *Chicago Man, K-T Man, and the Future of Behavioral Law and* Economics, 56 VAND. L. REV. 1663, 1714 (2003). *E.g.* James Montier, Behaving Badly at 3-9 (February 2, 2006), http://ssrn.com/abstract=890 563 (a study of professional fund managers revealing over-optimism, confirmatory bias, representativeness, framing and loss aversion).

[85] For a discussion of violations of state law by U.S. banking institutions in mortgage foreclosure proceedings, and violations of federal law in consumer bankruptcy proceedings, *see* Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. 121,146 (2008).

or noncompliance with legal mandates, then any risk (e.g. a legal sanction) posed by the activity is viewed as a low probability risk. This holds true regardless of the actual objective level of risk that a disinterested third-party would perceive.[86]

Simplified decision making is a response to complexity arising from many interacting variables and uncertainty regarding expected future outcomes,[87] such as the future likelihood of initiation of lawsuits and the possible actual exposure to liability as a result of potential legal actions. When faced with such complexity individuals resort to a simplified decision making strategy. The highest value is given to the choice that is the most important to the decision maker,[88] such as preserving high profits. In addition, risks that are viewed as low probability risks are ignored,[89] e.g. substantial civil penalties imposed by regulators if this has been an infrequent occurrence based on industry experience.

The representativeness heuristic is a tendency to judge the probability of an event based on the extent to which the event "is similar in essential properties to its parent population" or "reflects the salient features of the process by which it is generated."[90] Similarity in salient features leads to a conclusion of similar probability. In turn, when two events are judged or thought to be dissimilar in salient features, then the probability of the same outcome is deemed either unlikely or unable to be determined by the experience in the earlier event.

2. Countrywide As a Test Case

The experience of Countrywide Financial illustrates the multiple influences on corporate behavior that can lead to excessive risk taking and willingness to ignore legal mandates.[91]

Countrywide operated in a business environment that emphasized short-term profits and increasing market share. Prior to 2003 Countrywide's loan offerings reflected a commitment to the legal mandate of originating "safe" and "prudent" loans. After 2003, Countrywide changed its former policy of offering plain-vanilla, fixed rate loans, and increasingly offered "innovative," riskier products.[92] Origination of riskier loan products

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[86] *See* CASS R. SUNSTEIN, RISK AND REASON 40-41 (2002).
[87] *See* Russel B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1077 (2000).
[88] *Id.* at 1077–1078.
[89] Di Lorenzo, *Does the Law Encourage Unethical Conduct*, *supra* note 74 at n. 84.
[90] Daniel Kahneman and Amos Tversky, *Subjective Probability: A Judgment of Representativeness*, 3 Cognitive Psychology 430, 431 (1972). *See also* Amos Tversky and Daniel Kahneman , *Judgments of and by Representativeness*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 84, 97 (Daniel Kahneman, Paul Slovic and Amos Tversky ed., 1982)(results reported in preceding studies provide direct support for the hypothesis that people evaluate the probably of events by the degree to which these events are representative of a relevant model or process).
[91] An earlier version of the Countrywide case study was presented in *Barriers to Market Discipline: A Comparative Study of Regulatory Reforms*, 29 ARIZ. J. INT'L & COMP. L 517, 541-5 (2012).
[92] *See* Gretchen Morgenson, *How Countrywide Covered the Cracks*, N.Y. TIMES, Oct. 17, 2010 at A1.

increased profits, stock price and executive compensation. In addition to the effect of higher profits on stock price, the industry view was that increases in market share would also lead to increases in Countrywide's stock price. Due to offering of "innovative" mortgage products, Countrywide's market share in the U.S. mortgage market increased from 11.4 percent in December, 2003 to 15.7 percent in September 2006.[93] By 2005 Countrywide had become the largest mortgage lender in the U.S. It recognized earnings of $2.1 billion, $2.4 billion and $2 billion in its loan production divisions in 2004, 2005 and 2006 respectively. The $2.4 billion in earnings in 2005 represented an increase of 182 percent over earnings in 2002.[94] Countrywide's stock price increased 561 percent in the ten years ending December 2006.[95] Based on increased profit, market share and stock price, Mr. Mozilo received total compensation of $391.9 million in the five years ending in 2008.[96]

Short-term profits and increased market share were realized via lending products and practices that posed long-term risks, at times substantial risks. These long-term risks were minimized or ignored due to the interplay of cognitive influences, decision making heuristics, and ego. One loan product that posed substantial long-term risks was payment option adjustable rate mortgages (option ARMs). By 2005, option ARMs accounted for 19 percent of Countrywide's loan volume, making it the largest option ARM lender that year.[97] A super-majority of Countrywide's option ARMs were "low documentation" loans in which the borrower did not fully document income or assets.[98]

In the spring of 2006, e-mail messages from Mr. Mozilo revealed he was very concerned about the delinquency risks posed by such loans as borrowers faced payment shocks from resets. Nonetheless he actively promoted the company's option ARM loans to investors at a Wall Street conference.[99] This was understandable in a corporate environment emphasizing short-term profits since Countrywide's gross profit margin was more than 4 percent on option ARMs, double the 2 percent profit margin generated by standard loans backed by the FHA.[100] Payment option ARM loans that were securitized were sold by Countrywide and other originators to investors at higher prices, due to the higher interest rates they carried at reset as well as prepayment penalties. In addition, payment option ARMs that were kept in portfolio generated immediate phantom profits because banks were able to report as current income

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[93] Complaint for Violations of the Federal Securities Laws at 10, Securities and Exchange Commission v. Angelo Mozilo, David Sambol and Eric Sieracki, No. 09-03994 (C.D. Cal., June 4, 2009, www.sec.gov/litigation/complaints/2009/comp21068.pdf [hereinafter SEC Complaint].
[94] *Id.* At 7-8.
[95] Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N. Y. TIMES, August 26, 2007.
[96] Agustino Fontevecchia, *Mozilo Pays Record Penalty to Settle Securities Fraud Cases*, FORBES, October 15, 2010, www.forbes.com/2010/10/15/mozilo-sec-fraud-equities-markets-securities.html.
[97] Ruth Simon & James Hagerty, *Countrywide's New Scare – 'Option ARM' Delinquencies Bleed into Profitable Prime Mortgages*, WALL ST. J., Oct. 24, 2007, at C1.
[98] *Id.* (91% option ARMs in 2006 were low-documentation loans, 78% were low-documentation loans in 2004).
[99] *See* Morgenson, *supra* note 95.
[100] *Id.*

the fully amortizing repayment amount even when borrowers made minimum payments.[101] At Countrywide such phantom income equaled $654 million in 2006 and $1.2 billion in 2007.[102] Future risks were minimized or ignored. The hope was that risks would be shifted to purchasers of its mortgage backed securities.

Another risky underwriting practice was underwriting an ARM based on payments due at the initial, low interest rate. Countrywide later admitted that almost 60 percent of borrowers for whom it originated subprime hybrid ARMs would not have qualified at the fully indexed rate even if interest rates did not increase.[103] In other words, these borrowers would be unable to afford the loans except in the short-term. Countrywide ignored this risk. These underwriting practices, as well as the practice of underwriting no documentation loans, increased short-term fee income from origination fees, and therefore profits, and increased market share since more borrowers "qualified" for such loan products.

Countrywide's increased underwriting of risky loan products was also influenced by the personality and ego of its chief-executive officer, Anthony Mozilo. Mozilo had been treated as an outsider by Wall Street's investment bankers, who looked down on the flashy mortgage banker from Los Angeles. By 2003, Countrywide had become the third-largest residential loan originator in the U.S. Mozilo, however, wanted it to be Number 1, and wanted to dazzle Wall Street investment bankers by capturing a market share of at least thirty percent. This was a larger share than any company had ever achieved. In 2003, Countrywide had a market share of 10 percent, and no originator had a market share greater than 13 percent. Mozilo announced the goal of thirty percent market share at a Lehman Brothers Financial Services Conference in 2003. Once he publicly stated that goal, there was enormous pressure inside Countrywide. The culture became: "[w]e got to do this."[104] To gain market share, Countrywide expanded its offerings of loan products for which more borrowers could "qualify", such as no documentation loans. By the end of 2004, Countrywide had surpassed Wells Fargo as the largest residential loan originator in the U.S.

These risky but profitable underwriting practices were made in a legal environment characterized by an imprecise legal mandate. During the period in question, Countrywide's legal mandate was to adopt and adhere to real estate lending policies that were "consistent with safe and sound banking practices" and reflected "prudent underwriting standards."[105] In addition, risk assessment occurred in an environment in which legal compliance was not aggressively enforced.[106] The multiple influences on Countrywide's behavior, including its

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[101] Mara Der Hovanesian, *Nightmare Mortgages*, BUS. WK., Sept. 11, 2006, *available at* http://www.businessweek.com/magazine/content/06_37/b4000001.htm.
[102] Illinois, v. Countrywide Fin. Corp., 08CH22994, at 44 (praying for injunctive and other relief).
[103] *See* S. REP. NO. 111-176, at 13 (2010).
[104] The information contained in this paragraph is derived from Connie Bruck, *Angelo's Ashes: The Man Who Became the Face of the Financial Crisis*, NEW YORKER, June 29, 2009 (statement of Eric Flamholtz, UCLA business professor and consultant to Countrywide since the late nineties).
[105] 12 C.F.R. 365.2 (b)(1) and (2).
[106] *See generally* DiLorenzo, *Principles-Based Regulation, supra* note 11 at 95-98.

skewed assessment of long-term risk, led it to ignore the legal mandate of "prudent" lending operations and "safe and sound" products and practices.

The actions of Countrywide in the period 2004 through 2007 reflect skewed risk perception. Long-term risks to Countrywide were downplayed in part based on a rationalization that the risky loans were being sold to investors. In fact, this was not always or completely the case. Countrywide kept the riskiest portion of securitizations, the residuals, on its own balance sheet. By the end of 2006, it had $2.8 billion of residuals on its balance sheet. This was 15 percent of its equity.[107] In addition, starting in 2005 it began to keep some of its risky loans on its balance sheet. In 2005 and 2006 Countrywide maintained a majority of the option ARMs it originated in the investment portfolio of Countrywide Bank.[108] In addition, Countrywide would be forced to repurchase some of the loans sold in the secondary market because of their risky characteristics that did not meet the underwriting requirements of some secondary market purchasers. As Countrywide originated riskier loan products, a smaller percentage of loans that it did sell were eligible for sale on a nonrecourse basis.[109] That would allow the purchaser of loans that were sold in the secondary market to seek recourse against Countrywide when the borrowers defaulted. However, the large short-term profits produced by such loans caused Countrywide to ignore their long-term risks.

The actions of Countrywide also evidence simplified decision making. The mortgage crisis caused a significant number of lawsuits to later be filed against Countrywide, or Bank of America, its acquirer. These lawsuits imposed substantial costs.[110] However, when Countrywide's loan practices were in place, the possibility of substantial liability in future litigation would depend on a complex mix of factors. Substantial liability would require a substantial number of defaults. In addition, the possible total cost of future lawsuits, both private actions and government actions, would be uncertain and subject to a complex set of possibilities. The likelihood that an action would be initiated, the ability of a plaintiff to avoid dismissal of the action, the size of a negotiated settlement, and the ability to receive partial reimbursement of the settlement, through insurance and tax deductions, are some of the many considerations that contribute to uncertainty regarding the size and likelihood of litigation risks. Simplified decision making would cause the corporate actor to conclude the potential risk created through such a complex interaction of variables is a low probability risk. This

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[107] Scott Olster, *How the Roof Fell in on Countrywide*, FORTUNE, December 23, 2010 (excerpt from All The Devils Are Here, book by Bethany McLean and Joe Nocera), http://fortune.com/2010/10/23/how-the-roof-fell-in-on-countrywide/.

[108] SEC Complaint, *supra* note 93 at 10.

[109] *Id. a*t 14-15.

[110] Settlements involve actions by both Countrywide and Merrill Lynch, two institutions acquired by Bank of America. They include a $9.5 billion settlement involving claims by Fannie Mae and Freddie Mac for securities sold to them, James Sterngold, *B of A, Ex-CEO Lewis Settle Crisis-Era Suits*, WALL ST. J., March 26, 2014, a $16.65 billion settlement with the Justice Department to settle claims brought by federal and state authorities, note 104, *infra*, and accompanying text, and various suits brought by mortgage securities investors, including an $8.5 billion settlement approved by the New York courts. Michael Corkery, *Bank Pact on Bonds That Soured Is Approved*, N.Y. TIMES, February 1, 2014 at B1.

conclusion is one more likely to be drawn in light of the significant profits generated by the activity in question.

3. Continued Regulatory Blindness in the U.S.

The recent response of U.S. financial regulators to evidence of significant and continuing violations of law has been to impose larger and larger monetary sanctions. For example, in November, 2013 the Justice Department announced a $13 billion settlement with JPMorgan Chase, which included a $2 billion civil penalty. At the time this was the largest settlement with a single entity in U.S. history. It resolved federal and state civil claims arising out of packaging, marketing, sale and issuance of residential mortgage backed securities (RMBS) prior to January 1, 2009.[111] This is one of the suits brought by U.S. federal and state agencies that form the RMBS Working Group. The Justice Department has outlined its approach in its enforcement policy in the RMBS cases. It seeks accountability, transparency and redress. It noted that accountability has taken the form of record-breaking penalties. The large penalties imposed are to ensure "the penalty is [not] of such a level that it could be regarded by shareholders and management as merely the 'cost of doing business'."[112]

Similarly, in July, 2014 the Justice Department announced a $7 billion settlement with Citigroup to resolve RMBS claims, including a $4 billion civil penalty. At the time this was the largest civil penalty under the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). Again, the Justice Department emphasized that "the size and scope of this resolution goes beyond what could be considered the mere cost of doing business."[113] One month later, the Justice Department announced a $16.65 billion settlement with Bank of America, which included a $5 billion penalty under FIRREA. The settlement is the largest civil settlement with a single entity in U.S. history, and the penalty is the largest penalty ever imposed under FIRREA.[114] This settlement again involved RMBS claims.

In June, 2014 the Justice Department announced an $8.9 billion settlement with BNP Paribas for illegally processing financial transactions for countries subject to U.S. economic sanctions. FBI Director James Comey explained "the significant financial penalties imposed on

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[111] Press Release, U.S. Department of Justice, Federal and State Partners Secure Record $13 Billion Global Settlement with JPMorgan for Misleading Investors About Securities Containing Toxic Mortgages (November 19, 2013), http://www.justice.gov/opa/pr/2013/November/13-ag-1237.html.

[112] Associate Attorney General Tony West Outlines Justice Department's Approach to Toxic Mortgage Cases (July 16, 2014), http://www.justice.gov/iso/opa/asg/speeches/2014/asg-speech-140716.html.

[113] Press Release, U.S. Department of Justice, Federal and State Partners' Secure Record $7 Billion Global Settlement with Citigroup for Misleading Investors About Securities Containing Toxic Mortgages (July 14, 2014), http://www.justice-gov/opa/pr/2014/July/14-ag-733.html.

[114] Press Release, Bank of America to Pay $16.65 Billion in Historic Justice Department Settlement for Financial Fraud Leading up to and During the Financial Crisis (August 21, 2014), http://www.justice.gov/opa/pr/bank-america-pay-1665-billion-historic-justice-department-settlement-financial-fraud-leading.

BNP Paribas sends a powerful deterrent message to any company that places its profits ahead of its adherence to the law."[115]

The Justice Department's statements concerning all of these settlements reflect a continuing embrace of rational decision making as the touchstone of corporate decisions, namely the view that cost-benefit evaluations are the primary determinant of corporate decisions. They also reflect the view that there is a linear relationship between the size of fines and long-term corporate commitment to legal compliance. The influence of cognitive barriers and complexity in future compliance decisions are all ignored.

Corporate evaluations of recent enforcement actions may not necessarily lead to greater commitment to legal compliance due, in part, to the influence of the representativeness heuristic. The representativeness heuristic can be outer-directed or inner-directed. In its outer-directed manifestation the corporate actor evaluates external actions directed at the corporation, such as monetary sanctions imposed for particular violations of law. The evaluation is made in light of the external environment in which the sanction is imposed. For example, the recent imposition of very large sanctions can be characterized as primarily a response to the 2008 mortgage crisis. The settlements related to the 2008 mortgage crisis all emphasize that the banks' conduct caused a crisis in the U.S. housing market that led to staggering losses to U.S. consumers and an international financial crisis.[116] The size of the sanctions are deemed to be unique to this crisis. This viewpoint was witnessed in the past with respect to the substantial number of lawsuits, including criminal prosecutions, following the savings and loan crisis. The likelihood of significant sanctions imposed for future wrongdoing will be judged in light of similarity or dissimilarity solely with a course of conduct that led to hundreds of billions of dollars of losses to U.S. consumers and the U.S. economy.

Even if a comparison is made to a broader, recent set of violations of law, namely conspiracies to fix the LIBOR and foreign exchange rates, and violations of money laundering or economic sanctions laws, it is likely that other future violations will be judged as dissimilar. The large number of participants involved in the violations, and the importance of money laundering and economic sanctions laws to U.S. government officials, all limit the conclusion that these cases are similar to other, future legal violations. Money laundering or economic sanction violations will be deemed not representative of most future violations. Therefore, future violations will be judged unlikely to lead to similarly large sanctions.

The possible fallacy in this assessment is that it is based on judgments regarding representativeness, and not the true underlying determinants of the likelihood and size of future sanctions sought in enforcement actions. If the government's enforcement policy has changed, such that it is more likely to seek substantial sanctions for all legal violations, the

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[115] Press Release, BNP Paribas Agrees to Plead Guilty and to Pay $8.9 Billion for Illegally Processing Financial Transactions for Countries Subject to U.S. Economic Sanctions (June 30, 2014), http://www.justice.gov/opa/pr/2014/June/14-ag-686.html.

[116] *E.g.* Press Release, $13 Billion Global Settlement with JP Morgan, *supra* note 111; Press Release, Bank of America $16.65 Billion Settlement, *supra* note 114.

possible deterrent influence of the new policy will be short circuited by the representativeness heuristic.

The representativeness heuristic can also be inner-directed. In this manifestation it affects internal corporate evaluations of the similarity or dissimilarity of actions taken by various departments or individuals within a corporation. Tracey McDermott, director of enforcement and financial crime at the Financial Conduct Authority explained : "[i]t is a source of some concern to me that firms are still not reading across the root causes of misconduct in one area and ensuring that the same issues don't exist in another."[117]

4. Modest recognition in UK

Regulatory authorities in the U.K. have revisited their enforcement policies in the wake of the 2008 mortgage crisis. In doing so, they have recognized behavioral influences on corporate decision makers.

The Financial Services Authority (FSA), and its successors, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority, have embraced increased penalties as a mechanism to deter further breaches of legal standards by wrongdoers and deter other persons from committing similar breaches.[118] However, they have also begun to recognize multiple influences on corporate behavior beyond the influence of financial penalties. They have recognized the influence of corporate culture[119] , as well as behavioral influences. Thus, FSA recognized that rational decision making did not fully and accurately predict and determine corporate outcomes. It noted:

> There are…insights from behavioural economics, cognitive psychology and neuroscience, which reveal that people often do not make decisions in the rational front of brain…assumed in neoclassical economics, but make decisions which are rooted in the instinctive part of the brain, and which at the collective level

[117] FCA Enforcement and the Wholesale Markets, Tracey McDermott, Speech delivered at the 13th Annual FX Week Europe, London (November, 26, 2014), http://www.fca.org.uk/news/fca-enforcement-and-the-wholesale-markets. *See also* Jeff Bater, *Top Justice Department Official Urges Banks To Create 'A Culture of Compliance'*, Bloomberg BNA Banking Report, November 26, 2013 (Deputy Attorney General James Cole discussing the old saw of "It's an isolated instance of bad actors in a single business unit").

[118] FIN. SERVS AUTH., CP 09/10 ENFORCEMENT FINANCIAL PENALTIES at 7 (July 2009); HM Treasury, A New Approach to Financial Regulation: Building a Stronger System at 72 (February 2011) (FCA will carry forward FSA's strategy of credible deterrence and a willingness to impose high fines, in order to encourage better conduct across the industry); Prudential Regulation Authority, Statement of Policy, The Prudential Regulation Authority's Approach to Enforcement: Statutory Statements of Policy and Procedure, Statement of the PRA's Policy on the Imposition and Amount of Financial Penalties Under the Act ¶ 12 at 23 (January 2016) (where appropriate an upward adjustment of a punitive penalty to ensure the penalty has an appropriate and effective deterrent effect). The PRA first announced its policy in April, 2013.

[119] Prudential Regulation Authority, Strengthening Accountability in Banking: A New Regulatory Framework for Individuals, Consultation Paper FCA CP 14/13, PRA CP 14/14 at 5 (July 2014).

> are bound to produce herd effects and thus irrational momentum swings."[120]

Among other cognitive influences recognized is the representativeness heuristic.[121] It remains to be seen if or how this recognition shapes enforcement actions.

Conclusion and Next Step

Will recent, large financial sanctions, including large civil penalties, imposed by U.S. regulators deter future wrongdoing by the firms subject to the sanctions and by other firms in the industry? Behavioral decision and complexity theory advise that there are many factors that will influence future corporate assessments and decisions on legal compliance. Corporate culture presents an important set of influences, as important as the influence of government policies and actions. The many influences on corporate behavior include internal and external market conditions of which corporate culture is a part, as well as cognitive influences and decision making heuristics. These cognitive influences and heuristics shape corporate assessments of risk, including the risk of legal sanctions for noncompliance. These influences are dynamic. They change over time, a change that is not identical in each firm, and they also interact differently within each firm. Whether a large fine today will lead to legal compliance next year or years later in the same firm, and other firms in the industry, is therefore unpredictable.

To achieve the goal of deterrence, the first step would be for U.S. regulators to recognize the multiple influences on corporate decisions, including cognitive influences. This is a step British regulators have begun to take. In turn, regulators need to modify enforcement policies to reflect such multiple influences, especially cognitive influences and including decision making heuristics. Regulators must recognize that, as a result of cognitive influences, an increase in monetary penalties may not alone lead to consistent or resolute commitment to legal compliance. This next step in an effort to achieve greater legal compliance is to determine how to modify enforcement policy to reflect the complex, dynamic nature of corporate decisions. The aim is to modify enforcement policy in such a manner that cognitive influences, including heuristics, incline the corporate actor toward greater commitment to corporate compliance.

One possible change is an enforcement policy that makes greater use of market based sanctions such as suspensions directed at the corporation. The suspension might be of a particular product, process or line of business. Faced with a business model emphasizing the importance of short-term profits and a decision making heuristic of skewed risk perception,

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[120] FIN. SERVS. AUTH., THE TURNER REVIEW at 41 (March 2009) (citing the work of Kaheneman, Slovic and Tversky discussing economic agents making decisions on the basis of rough heuristics).

[121] "An important lesson of history is that bankers, regulators and politicians alike repeatedly failed to learn the lessons of history: this time, they say, it is different." Parliamentary Commission on Banking Standards – Fifth Report – Changing Banking for Good (2013), http://www.publications.parliament.uk/pa/jtselect/jtpcbs/27/2702.htm.

suspensions in lines of business, products or operations transform profits from primarily a benefit of noncompliance to a significant cost of noncompliance. This alters immediate assessments of risk. The length of any particular suspension would be uncertain. This magnifies the significance of the loss in a cost-benefit evaluation that embraces cognitive influences. The sanction would be in addition to other possible sanctions.

This is a modification in enforcement policy that has been largely rejected by federal regulators in the U.S.[122], although federal regulators have occasionally utilized this enforcement measure recently when faced with violations of earlier settlements or recidivist behavior.[123] It is a change in enforcement policy that has been embraced by regulators in the U.K.[124], and has been imposed by New York State's financial regulator.[125] What is required, however, is consistency in resort to suspensions so as to avoid the effects of simplified decision making and the representativeness heuristic.

Consistent resort to suspensions is one of several changes in enforcement policy that proper recognition of complexity and cognitive influences on corporate behavior may justify. The ideal would be to modify enforcement measures in such a manner that they interact with the multiple influences on corporate behavior so as to incline the corporate decision maker

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[122] *E.g*. Citicorp, JP Morgan Chase, Barclays and Royal Bank of Scotland pleaded guilty to criminal charges of conspiring to fix foreign currencies, but only after obtaining waivers from the SEC and the Labor Department allowing them to conduct business as usual managing mutual funds and managing pensions. Neil Weinberg, *JP Morgan's Guilty Plea Puts Wealth Management Unit in Spot with Regulators*, 104 Bloomberg BNA Banking Report 1044 (June 2, 2015). *See also* Andrew Ackerman and Christina Rexrode, *SEC Grants Bank of America Short-term Waiver from Hedge-Fund Restrictions*, WALL ST. J. November 25, 2014 (waiver granted to avoid sales restrictions in hedge funds, startups and other private offerings that would be triggered by fraud settlement regarding mortgage-backed securities); Ben Protess, *S.E.C Commissioners Split on Waiving Financial Industry Punishment*, N.Y.TIMES, February 4, 2015 (Oppenheimer has been the subject of at least 30 regulatory actions in the last decade, but was granted a waiver by the SEC from disqualification from private offerings after settlement of additional case involving securities misconduct).

[123] *E.g*. Jesse Hamilton, *OCC Limits Servicing Rights Purchase; JP Morgan, Wells Fargo Among Targets*, 104 Bloomberg BNA 1170 (June 23, 2015) (Comptroller of the Currency restricts six lenders in their purchases of mortgage servicing rights because they have not met the terms of the 2013 settlements over mortgage foreclosure abuses); Ben Protess and Matthew Goldstein, *S& P to Pay Nearly $80 million to Settle Fraud Cases*, N.Y. TIMES, January 21, 2015 (Standard& Poor's settlement with the SEC includes a one-year "time out" from rating certain commercial mortgage investments, and involved improper behavior in 2011 that that "seems ripped from the same playbook that led S&P to help enable the mortgage crisis of 2008").

[124] *See* FIN. SERV. AUTH., DECISION PROCEDURE AND PENALTIES MANUAL at 6A.1.3, 6A.2.3 and 6A.3.2 (2010). *See also* FIN. SERV. AUTH., CONSULTATION PAPER 10/11, IMPLEMENTING ASPECTS OF THE FINANCIAL SERVICES ACT 2010 at 17 (2010); the Prudential Regulation Authority, Statement of Policy, *supra* note 118 at 35.

[125] *E.g.* Danielle Douglas-Gabriel, *Standard Chartered To Pay $300 Million for Violating Money Laundering Settlement,* WASH. POST, August 19, 2014 (Standard Chartered's ability to conduct dollar clearing operations are suspended due to violations of its 2012 money laundering settlement. New York's Department of Financial Services had earlier exacted a year-long suspension of its dollar- clearing operations from BNP Paribas in its settlement concerning violations of economic sanction laws). Similarly, the New York Department of Financial Services imposed a two year suspension on PricewaterhouseCoopers, a one year suspension from consulting work at New York regulated financial institutions on Deloitte, and a six month suspension on Promontary Financial. Ben Protess and Jessica Silver-Greenberg, *Promontory Financial Settles With New York Regulator*, N. Y. TIMES, August 18, 2015.

toward greater commitment to legal compliance. How to best accomplish this goal becomes the subject of further study.