

**CORPORATE WRONGDOING: INTERACTIONS OF
LEGAL MANDATES AND CORPORATE CULTURE**

VINCENT DI LORENZO*

Abstract

In recent years, enforcement officials have imposed billions of dollars in sanctions on all major U.S. financial institutions and many major financial institutions abroad. Similar sanctions have been imposed on nonfinancial institutions. The 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 article explores these issues by examining the philosophy motivating regulatory policy and action in the United States and United Kingdom, using financial regulators as a case study. This article discusses the interaction between two institutions that influence corporate actors: government and corporate culture. That interaction is examined through the lens of behavioral decision theory and complexity theory. This article draws the conclusion that regulators in the United States continue to be blind to cognitive influences on corporate behavior. Enforcement policy in the United States has ignored the multiple influences on corporate behavior that interact and lead to nonlinear outcomes. The only change made in U.S. enforcement strategy, if any, has been a greater emphasis on large penalties to deter future misconduct. This emphasis continues to reflect a linear, reductionist view of corporate behavior. By contrast, regulators in the United Kingdom have begun to recognize cognitive influences, and are rethinking their enforcement strategy based, in part, on recognition of multiple influences on corporate decision-making. U.S. enforcement policy's regulatory blindness appears likely to lead to recurring issues of noncompliance.

* Vincent Di Lorenzo is a Professor of Law at St. John's University School of Law, and Senior Research Fellow, Vincentian Center for Church and Society at St. John's University.

Table of Contents

<i>I.</i>	<i>Introduction</i>	208
<i>II.</i>	<i>Traditional Regulatory Philosophy</i>	212
	A. The Law-Abiding Decision Maker	212
	B. The Rational Decision Maker	217
	C. The Outcome: Recurrent and Recidivist Corporate Behavior.....	220
<i>III.</i>	<i>A Modest Evolution in Regulatory Philosophy</i>	229
	A. Recognition of Complexity and Behavioral Influences in Consumer Decision Making	229
	B. Regulatory Blindness Toward Corporate Decision Making.....	236
	1. Influences on Industry Compliance Decisions.....	236
	2. Countrywide As a Test Case	241
	3. Continued Regulatory Blindness in the United States.....	246
	4. Modest Recognition in the United Kingdom	250
<i>IV.</i>	<i>Conclusion and Next Step</i>	251

I. Introduction

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.¹ In some industries, such as the financial services industry, legal violations occur across large segments of the industry.² Enforcement officials have imposed billions of dollars in sanctions against all the major U.S. financial institutions and many major financial institutions abroad.³ The large sanctions are the result of findings of recurrent violations of law as well as recidivism.⁴ Why have existing regulatory standards and enforcement policies led to repeated violations of law? Will the recent

¹ See *infra* Part II.C.

² See *infra* Part II.C.

³ See *infra* Part III.B.3.

⁴ See generally Gretchen Morgenson, *At Big Banks, A Lesson Not Learned*, N.Y. TIMES (Dec. 12, 2014), <http://www.nytimes.com/2014/12/14/business/at-big-banks-a-lesson-not-learned.html> [https://perma.cc/2Z6Q-SFVR].

billion dollar sanctions deter future wrongdoing? This article explores these issues by examining the philosophy motivating regulatory policy and action on the part of financial regulators in the United States and United Kingdom.

Regulatory philosophy in the United States and United Kingdom long reflected an assumption of corporate commitment to law-abiding behavior.⁵ Mainstream corporations were viewed as embracing an ethical obligation to comply with legal mandates.⁶ 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.⁷ When law-abiding behavior was absent and a breach of legal standards was substantial, recurrent, or systemic, only then were financial penalties imposed.⁸ More recently, regulatory philosophy has been modified to embrace the view that corporate actors are rational decision makers, choosing to comply with, evade, or violate legal obligations based on cost-benefit evaluations.⁹ This regulatory philosophy reflects a neoclassical economic view of cost-benefit evaluations, under which it is assumed that corporate actors will comply with legal requirements if all potential costs of noncompliance exceed its benefits.¹⁰ 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.¹¹ This is both a reductionist and a linear view of human decision making. The 2008 financial crisis has revealed flaws in both of these viewpoints.¹² This article applies decision theory and complexity theory to explore why increased sanctions alone will likely not deter

⁵ See IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* 19–20 (1992); cf. *infra* note 212 and accompanying text.

⁶ *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 2.01 (AM. LAW INST. 1994).

⁷ See *id.*; *infra* Part II.A–II.B.

⁸ See Margaret Cole, *The U.K. FSA: Nobody Does It Better?*, 12 *FORDHAM J. CORP. & FIN. L.* 266, 270 (2007); *infra* Part II.C.

⁹ See *infra* Part II.A.

¹⁰ See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 *J. POL. ECO.* 169, 177 (1968); *infra* Part II.B.

¹¹ See *infra* note 299 and accompanying text.

¹² See *infra* Part II.C.

future corporate misconduct. Specifically, it explores the multiple influences on corporate decision making. These influences include: reason, reflected in cost-benefit evaluations; internal and external market conditions; cognitive influences on decision making, including the role of decision-making heuristics; and other influences such as firm or industry corporate culture.¹³ This article also explores the interaction of various influences on corporate behavior resulting in nonlinear outcomes, and the likely effect of a heightened level of fines on corporate behavior as this factor interacts with other influences on future corporate decisions.¹⁴

Following this Introduction, Part II of this article examines the assumptions of law-abiding behavior and rational decision making in past formulations of regulatory standards and enforcement policy in the United States and United Kingdom. The actions and policies of financial services regulators provide a case study.¹⁵ 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.¹⁶ Market experience confirmed academic criticisms; regulators, however, did not embrace this change in viewpoint.¹⁷ Instead, regulatory authorities in the United States and United Kingdom 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 reined in through monetary sanctions.¹⁸ In recent years, regulatory philosophy was modified to reflect the role of reason in corporate compliance decisions.¹⁹ This regulatory philosophy assumes full recognition of all long-term and short-term risks of misconduct by corporate actors. The heightened reliance on financial penalties to

¹³ See *infra* Part III.B.1–III.B.2.

¹⁴ See *infra* Part III.B.3.

¹⁵ See *infra* Part II.A.

¹⁶ See generally Bruce A. Green, *After the Fall: The Criminal Law Enforcement Response to the S&L Crisis*, 59 FORD. L. REV. S155, S156 (1991).

¹⁷ See *infra* Part II.B.

¹⁸ Niel Willardson & Jackie Brunmeier, *Types of Enforcement Actions*, THE REGION (Sept. 1, 2006), <https://www.minneapolisfed.org/publications/the-region/types-of-enforcement-actions> [<https://perma.cc/J6HE-LUWP>]; see *infra* Part II.B.

¹⁹ See *infra* Part II.C.

deter future misconduct reflects this change. Nonetheless, regulatory authorities in the United States 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.²⁰

Part III explores evidence that corporate decisions are determined by multiple interacting influences. Government as an institution, reflected in legal standards and enforcement policy and actions, is one influence.²¹ Accepted business models, cognitive factors, and behavioral tendencies are components of corporate culture as an institution, and also play an important role in shaping corporate decisions.²² Such influences interact in a dynamic system in which outcomes are nonlinear. As a result, nongovernmental influences can and have become dominant influences, overshadowing directives in law and the influence of higher fines and similar sanctions.²³ Regulatory agencies in the United States have largely ignored these nongovernmental influences in shaping regulatory policy. The change, if any, in U.S. enforcement strategy is rather a greater emphasis on large penalties to deter future misconduct, which continues to reflect a linear, reductionist view of corporate behavior. This regulatory blindness seems likely to lead recurring issues of noncompliance.²⁴ In contrast, regulatory authorities in the United Kingdom are rethinking their enforcement strategy based, in part, on recognition of multiple influences on corporate decision making including cognitive influences.²⁵

²⁰ See *infra* Part III.A.

²¹ Vincent Di Lorenzo, *Business Ethics: Law as a Determinant of Business Conduct*, 71 J. BUS. ETHICS 275, 288 (2007); see *infra* Part III.B.1–III.B.2.

²² See generally Di Lorenzo, *supra* note 21.

²³ See generally *id.*

²⁴ See *infra* Part III.B.3. See generally Press Release, U.S. Dep't of Justice, Federal and State Partners Secure Record \$13 Billion Global Settlement with JPMorgan for Misleading Investors About Securities Containing Toxic Mortgages (Nov. 19, 2013), <http://www.justice.gov/opa/pr/2013/November/13-ag-1237.html> [<https://perma.cc/4JZH-2S4D>].

²⁵ See FIN. SERVS. AUTH., ENFORCEMENT FINANCIAL PENALTIES 5 (2009) (UK), http://www.fsa.gov.uk/pubs/cp/cp09_19.pdf [<https://perma.cc/A7ZM-S2NL>]; *infra* Part III.B.4.

II. *Traditional Regulatory Philosophy*

The academic literature has explored and debated the proper goal of regulatory enforcement policy—whether it is restitution, deterrence, and/or retribution.²⁶ It has also examined individual influences on corporate commitment to legal compliance.²⁷ Scholarly debate has focused on the cognitive and behavioral influences on human decision making, but the debate has focused on consumer decision making.²⁸ Less attention has been paid to cognitive influences on organizational behavior.²⁹ More importantly, the academic literature has largely ignored whether regulators have recognized cognitive influences on organizational behavior. This article explores this issue, and 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.³⁰ Noncompliance was viewed as limited to situations

²⁶ See generally Max Minzner, *Why Agencies Punish*, 53 WM. & MARY L. REV. 853 (2012) and articles cited therein.

²⁷ See Tomas R. Giberson et al., *Leadership and Organizational Culture: Linking CEO Characteristics to Cultural Values*, 24 J. BUS. & PSYCHOL. 123, 123–37 (June 2009).

²⁸ See, e.g., Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1476–81 (1998); Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23, 43–56 (2000); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1075–102 (2000); DAVID DE MEZA ET AL., FIN. SERVS. AUTH., FINANCIAL CAPABILITY: A BEHAVIOURAL ECONOMICS PERSPECTIVE (2008) (UK), <https://www.fca.org.uk/static/fca/documents/research/fsa-crpr69.pdf> [<https://perma.cc/65TV-N2WG>] (discussing cognitive biases identified in behavioral economics as they relate to a national strategy for better financial capability among the population of the United Kingdom).

²⁹ See *infra* notes 205–12 and accompanying text (discussing various cognitive influences on legal compliance).

³⁰ See AYRES & BRAITHWAITE, *supra* note 5, at 19–20 (describing most regulators as being in the compliance camp—namely, that “most corporate actors will comply with the law most of the time simply because it is the law . . .” and embracing that viewpoint).

involving rogue organizations or individuals, or occasional negligent wrongdoing.³¹ Both regulatory requirements and enforcement policy reflected this viewpoint.³² The American Law Institute's Principles of Corporate Governance reflect this perspective.³³ Section 2.01 recognizes that a corporation should have as "its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain."³⁴ 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" ³⁵ This obligation to comply with the law did not depend on cost-benefit evaluations.³⁶ Section 2.01 was first tentatively approved in 1984.³⁷ Its objective was accepted by financial services regulators.³⁸

For example, in 1983 the U.S. Comptroller of the Currency declined to impose explicit limitations on national banks' real estate lending activities, and rescinded then-current regulations that did impose precise limits.³⁹ 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.⁴⁰ This principles-based approach relied on bank management to determine which practices did not meet the safety and soundness and prudence principles.⁴¹ The Comptroller justified this decision on the following grounds:

³¹ *Id.* at 26.

³² *Id.* at 21.

³³ See generally PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 6.

³⁴ *Id.* at § 2.01(a).

³⁵ *Id.* at § 2.01(b)(1).

³⁶ *Id.* at § 2.01 cmt. g ("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.")

³⁷ See Donald E. Schwartz, *Defining the Corporate Objective: Section 2.01 of the ALI's Principles*, 52 GEO. WASH. L. REV. 511 (1984).

³⁸ *Id.* at 512.

³⁹ Real Estate Lending by National Banks, 48 Fed. Reg. 40,698, 40,699–700 (Sept. 9, 1983) (codified at 12 C.F.R. § 7).

⁴⁰ *Id.* at 40,700.

⁴¹ *Id.*

[T]he 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.⁴²

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.⁴³ 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 United Kingdom.⁴⁴

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.⁴⁵ Under this approach, when a violation was uncovered, the offender was required to agree to refrain from further violations of law.⁴⁶ Substantial fines or other sanctions were not thought necessary to ensure future compliance on the part of most industry members, including most violators, due to the assumption that a law-abiding culture characterized most organizations.⁴⁷

⁴² *Id.* at 40,699.

⁴³ *Id.*

⁴⁴ FIN. SERVS. AUTH., PRINCIPLES-BASED REGULATION: FOCUSING ON THE OUTCOMES THAT MATTER 4 (2007) (UK), <http://www.fsa.gov.uk/pubs/other/principles.pdf> [<https://perma.cc/DD7Y-WRJZ>] (“We want to give firms the responsibility to decide how best to 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 towards a greater reliance on principles . . .”).

⁴⁵ FIN. SERVS. AUTH., THE TURNER REVIEW: A REGULATOR RESPONSE TO THE GLOBAL BANKING CRISIS 88 (2009) (UK), http://www.fsa.gov.uk/pubs/other/turner_review.pdf [<https://perma.cc/39E6-4HGN>].

⁴⁶ *See* FIN. SERVS. AUTH., THE FSA'S ROLE UNDER THE PAYMENT SERVICES REGULATIONS 2009: OUR APPROACH 123–25 (2012) (UK), <https://www.fca.org.uk/publication/archive/fsa-psd-approach-latest.pdf> [<https://perma.cc/8VND-JEE6>].

⁴⁷ *See* Cole, *supra* note 8, at 270.

For example, the enforcement policy of 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.⁴⁸ Under this policy, when firms failed to comply with legal mandates they faced an agreement or order to cease the activities in question.⁴⁹ Firms did not face fines for past violations and, in fact, typically retained all the profits earned through past practices conducted in violation of legal mandates.⁵⁰

U.S. federal banking regulators' actions in response to examinations revealing unsafe or unfair mortgage lending activities before the 2008 mortgage crisis provide a revealing case study. Federal banking regulators rarely brought supervisory actions to address unfair or unsafe mortgage lending practices.⁵¹ When an agency encountered any legal violation, usually the only enforcement measure taken would be an agreement with or order against an individual bank to stop unsafe or unsound practices.⁵² When regulators would bring

⁴⁸ U.S. DEP'T OF THE TREASURY, OFFICE OF THE COMPTROLLER OF THE CURRENCY, PPM 5310-3, OCC POLICIES & PROCEDURE MANUAL 4-7 (2011).

⁴⁹ *Id.* at 5.

⁵⁰ Willardson & Brunmeier, *supra* note 18.

⁵¹ See Vincent Di Lorenzo, *Principles-Based Regulation and Legislative Congruence*, 15 N.Y.U. J. LEGIS. & PUB. POL'Y 45, 95-98 (2012).

⁵² See *Federal and State Enforcement of Financial Consumer and Investor Protection Laws: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 64-68 (2009) (testimony of John C. Dugan, Comptroller of the Currency) [hereinafter Dugan] (stating that most bank problems are resolved through the supervisory process, without resort to an enforcement action, and that 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). See also Willardson & Brunmeier, *supra* note 18, for a description of the types of enforcement actions utilized by the federal banking agencies. Regulatory actions related to the mortgage crisis exemplify this light-touch approach. See Todd Davenport, *OCC's New Predator Rule*, AM. BANKER (Feb. 3, 2005), http://www.americanbanker.com/issues/170_24/-241453-1.html [<https://perma.cc/ZW6U-AYHT>] (explaining how the 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); Greg Ip & Damian Paletta, *Regulators Scrutinized in Mortgage Meltdown*, WALL ST. J. (Mar. 22, 2007), <http://www.wsj.com/articles/SB117449440555444249> [<https://perma.cc/G58J-TTJJ>] (observing that federal banking agencies had issued relatively few public disciplinary actions in the two years preceding the

enforcement actions, such actions typically involved a written agreement to correct past violations and, occasionally, a cease and desist order.⁵³ Both written agreements and cease and desist orders merely outline corrective actions a financial institution's management and directors must take to address deficiencies in the institution's operations.⁵⁴

This light-touch approach to enforcement by U.S. banking agencies is also reflected in the "deferred prosecution agreement" and "non-prosecution agreement" policies of the U.S. Justice Department and Securities and Exchange Commission (SEC).⁵⁵ In such agreements, no actions are commenced if firms investigate their own past wrongdoing and promise to change their behavior.⁵⁶ In fact, this policy became the official policy of the Justice Department in 2008, just as the financial crisis unfolded.⁵⁷

In the United Kingdom, the FSA had embraced a similar, light-touch enforcement policy for when noncompliance with legal

article's publication, and that most discipline was in the form of cease-and-desist orders). Civil money penalties are available in addition to supervisory actions and cease and desist orders, but are rarely imposed for consumer violations generally, let alone for unfair mortgage practices specifically. Neil Willardson & Jackie Brunmeier, *Supervisory Enforcement Actions Since FIRREA and FDICIA*, THE REGION (Sept. 1, 2006), <https://www.minneapolisfed.org/publications/the-region/supervisory-enforcement-actions-since-firrea-and-fdicia> [<https://perma.cc/2YF5-DC29>] (observing that between 1999 and 2005 U.S. bank regulators issued only one civil monetary penalty attributable to consumer protection weaknesses).

⁵³ See Di Lorenzo, *supra* note 51, at 97.

⁵⁴ See Willardson & Brumeier, *supra* note 18 (discussing trends in civil monetary penalties between 1989 and 2005 and finding that 1 percent of all civil money penalties imposed between 1999 and 2005 were based on consumer protection violations, while enforcement activity was most heavily concentrated on cease and desist orders and written agreements).

⁵⁵ See Memorandum from Deputy Attorney Gen. Mark Filip to Heads of Dept. Components U.S. Attorneys (Aug. 28, 2008), <https://www.justice.gov/sites/default/files/dag/legacy/2008/11/03/dag-memo-08282008.pdf> [<http://perma.cc/RF2E-EL4X>]; U.S. SEC. & EXCH. COMM'N, ENFORCEMENT COOPERATION PROGRAM (2016), <https://www.sec.gov/spotlight/enfcoopinitiative.shtml> [<https://perma.cc/RH4E-DXHR>].

⁵⁶ Gretchen Morgenson & Louise Story, *As Wall St. Policies Itself, Prosecutors Use Softer Approach*, N.Y. TIMES (July 7, 2011), <http://www.nytimes.com/2011/07/08/business/in-shift-federal-prosecutors-are-lenient-as-companies-break-the-law.html> [<https://perma.cc/YFM6-K6DH>].

⁵⁷ See *id.*

requirements was uncovered.⁵⁸ Namely, the FSA's policy provided that when a firm acted promptly in taking remedial action agreed to with its supervisors, the FSA could decide against taking formal disciplinary action.⁵⁹ If the firm did not act promptly, then FSA would take disciplinary or other enforcement action.⁶⁰

The light-touch approach in enforcement policy seemed reasonable in an era in which regulatory policy assumed a law-abiding corporate culture. The regulators' primary roles were to (1) 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, (2) bring the violations to the corporation's attention, and (3) secure a promise of future compliance. These roles would, and should continue to, evolve as the assumptions underlying corporate behaviors changed.

B. The Rational Decision Maker

To some degree, the assumption of the law-abiding corporate actor was being reconsidered as early as 1989.⁶¹ For example, in response to the savings and loan crisis, the U.S. Congress significantly increased the level of permissible civil penalties that banking regulators could impose.⁶² When faced with repeated violations of law, or significant and systemic violations, regulators did impose large monetary sanctions, including civil penalties.⁶³ When they did so, regulatory policy assumed that substantial penalties would help to deter further misconduct.⁶⁴ However, deterrence was not the primary aim of the sanctions imposed.⁶⁵ Rather, monetary sanctions sought

⁵⁸ See FIN. SERVS. AUTH., THE ENFORCEMENT GUIDE 5 (2009) (UK), https://www.handbook.fca.org.uk/handbook/document/EG_20091101_20100305.pdf?date=2009-12-06 [<https://perma.cc/Y6UK-AQFG>].

⁵⁹ See *id.*

⁶⁰ See *id.*

⁶¹ See Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. 101-73, § 907(a) 103 Stat. 183, 462-63 (1989) (codified at 12 U.S.C. § 1818(i)(2)).

⁶² See *id.* (explaining that the former fine of \$1,000 per day was modified to provide for first-tier penalties of up to \$5,000 per day, second-tier penalties of up to \$25,000 per day, and third-tier penalties of up to \$1 million per day).

⁶³ See Dugan, *supra* note 52, at 68-71.

⁶⁴ See *id.* at 68.

⁶⁵ See Press Release, Sec. & Exch. Comm'n, SEC, N.Y. Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices: \$1.4 Billion Global Settlement Includes

primarily to provide restitution, and, at times, to fund structural changes in the industry.⁶⁶ Nonetheless, regulators continued to rely primarily on a light-touch approach to enforcement until the outbreak of the 2008 mortgage crisis.⁶⁷

The regulatory assumption of corporate ethical commitment to law-abiding behavior was brought into question by market experience in the 1980s and 1990s.⁶⁸ 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 25 to 40 percent.⁶⁹ Some wrongdoing was criminal, as 1,100 criminal prosecutions of individuals involved in major savings and loan fraud resulted in 839 convictions.⁷⁰ Yet, financial regulators have exhibited sustained path dependence. Apart from actions related to the savings and loan crisis, a light-touch approach to regulation persisted, in spite of the wrongdoing that led to the mortgage crisis of 2008.⁷¹

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, with the more recent statements accompanying settlements made between 2012 and 2015. The 2002 settlements highlighted the structural changes in the industry as the means to ensure future legal compliance.⁷² The main goals of the \$1.4 billion monetary sanctions imposed in 2002 were to provide restitution to investors and to fund some of the structural changes that would help ensure future compliance with legal mandates.⁷³ Contrary to what

Penalties and Funds for Investors (Dec. 20, 2002), www.sec.gov/news/press/2002-179.htm. [<https://perma.cc/6GJU-3BSX>].

⁶⁶ *Id.*

⁶⁷ See *supra* note 52 and accompanying text (discussing the light-touch approach to enforcement).

⁶⁸ See Green, *supra* note 16, at S156.

⁶⁹ See *id.* at S162–S163.

⁷⁰ *Two Financial Crises Compared: The Savings and Loan Debacle and the Mortgage Mess*, N.Y. TIMES (Apr. 13, 2011), <http://www.nytimes.com/interactive/2011/04/14/business/20110414-prosecute.html> [<https://perma.cc/4K4D-CCNU>].

⁷¹ See *supra* note 52 and accompanying text (detailing the regulatory approach leading up to the financial crisis).

⁷² See William H. Donaldson, Speech by Sec. & Exch. Comm'n Chairman: Prepared for Delivery at SEC Press Conference Regarding Global Settlement (Apr. 28, 2003), www.sec.gov/news/speech/spch042803whd.htm [<https://perma.cc/8R32-VL8N>].

⁷³ *Id.*

might be assumed, deterrence of future wrongdoing was not, in fact, emphasized as the purpose of the monetary sanctions.⁷⁴ This reflects a regulatory philosophy that continued to be shaped by the assumption of a law-abiding corporate culture in the industry generally.

By contrast, in recent settlements U.S. regulators have emphasized the expectation of a deterrent effect produced by significant monetary sanctions.⁷⁵ The sanctions seek to deter not only the violator, but also other members of the industry.⁷⁶ Accordingly, while restitution remains a regulatory goal,⁷⁷ deterrence has become an equally important goal.⁷⁸

The increased emphasis on deterrence reflects two underlying changes in regulatory philosophy. One change is a rejection of the assumption of a law-abiding corporate culture.⁷⁹ Regulators now recognize that corporations comply with, evade, or decide to violate legal mandates based on cost-benefit evaluations.⁸⁰ Commitment to legal compliance will not be robust if the benefits of noncompliance exceed its costs.⁸¹ This evaluation system reflects a view that the decisions of corporate actors are entirely, or at least primarily, determined by reason. 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.⁸²

Such a viewpoint ignores, among other influences, cognitive influences on evaluation of risks and benefits. It also ignores the concept of complexity, including the multiple influences on human

⁷⁴ See *id.* (“[A]lthough the monetary relief secured in the settlement is substantial . . . the losses that investors suffered . . . far exceeds the ability to compensate them fully [T]he structural reforms required are, in my view, more significant.”); Press Release, *supra* note 65.

⁷⁵ See *infra* note 297 and accompanying text (discussing expected deterrent effects of penalties imposed).

⁷⁶ See *infra* note 297 and accompanying text (discussing how the financial penalties imposed are intended to deter other companies).

⁷⁷ See Donaldson, *supra* note 72.

⁷⁸ See *infra* note 297 and accompanying text.

⁷⁹ See *infra* note 297 and accompanying text (suggesting that one bank’s criminal actions are potentially indicative of other corporate banks).

⁸⁰ See *infra* note 297 and accompanying text (discussing one bank’s conscious decision to commit thousands of violations despite many opportunities to adhere to regulations).

⁸¹ See FIN. SERVS. AUTH., *supra* note 44, at 2. The type of rational decision making assumed to exist is cost-benefit evaluations in neoclassical economic terms. See Becker, *supra* note 10, at 177.

⁸² See FIN. SERVS. AUTH., *supra* note 44, at 10–13.

behavior that interact to shape decisions.⁸³ Instead, U.S. regulatory philosophy continues to reflect a reductionist and linear view of human decision making. 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 violated repeatedly particular laws over extended periods of time,⁸⁴ while others have violated numerous legal standards.⁸⁵ Second, numerous members of the financial services industry have simultaneously violated laws.⁸⁶ In some cases, the wrongdoing appears to have become systemic.⁸⁷ Third,

⁸³ 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. Therefore, the existence and influence of each force is not constant. See GREGOIRE NICOLIS & ILYA PRIGOGINE, *EXPLORING COMPLEXITY* 6 (W.H. Freeman & Co. ed., 1989); Donald T. Hornstein, *Complexity Theory, Adaptation, and Administrative Law*, 54 DUKE L. J. 913, 917–18 (2005) (defining complexity theory as “the study of many actors and their interactions”); Glenn Harlan Reynolds, *Chaos and the Court*, 91 COLUM. L. REV. 110, 113–14 (1991) (applying the concept of complexity to the interaction of the multiple justices on the U.S. Supreme Court); J.B. Ruhl & Harold J. Ruhl, Jr., *The Arrow of the Law in Modern Administrative States*, 30 U.C. DAVIS L. REV. 405, 417–18 (1997) (explaining that complexity theory’s main properties consist of “the behavior of a system” described “according to the community of its components . . . , mechanics of evolution in the system . . . [and] overall direction of change”).

⁸⁴ See Michael Corkery, *Finra Fines Citigroup Over Acts by Analysts*, N.Y. TIMES: DEALBOOK (Nov. 24, 2014, 1:20 PM), <http://dealbook.nytimes.com/2014/11/24/citigroup-fined-15-million-for-failing-to-properly-supervise-analysts/> [<https://perma.cc/8N92-AF34>].

⁸⁵ Green, *supra* note 16; see also Morgenson, *supra* note 4 (discussing several financial institutions’ violation of the same FINRA regulation while bidding on the Toys “R” Us IPO).

⁸⁶ See Morgenson, *supra* note 4.

⁸⁷ *Id.*

industry members have demonstrated recidivist behavior by repeating violations after being subject to significant sanctions, or failing to comply with the terms of earlier settlements.⁸⁸

There are many recent examples of recurrent violations of law. In 2012, HSBC admitted to violations of both money laundering laws and laws prohibiting the transfer of funds for countries subject to U.S. economic sanctions.⁸⁹ These violations occurred from 2006 to 2010.⁹⁰ HSBC agreed to forfeit \$1.256 billion and to pay \$665 million in civil penalties.⁹¹ Assistant Attorney General Breuer noted that “[t]he record of dysfunction that prevailed at HSBC for many years was astonishing.”⁹² Also 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.⁹³ The violations occurred over a period of years.⁹⁴ The Justice Department described the violations as deliberate and flagrant, and the bank had also made misleading statements to regulators to conceal its misconduct.⁹⁵ It agreed to pay \$227 million, and the settlement required it to remediate anti-money-laundering compliance problems.⁹⁶ 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

⁸⁸ *See id.* (discussing the \$43.5 million settlement of 10 financial firms for the violation of FINRA’s research rules in 2014, many of which were part of a similar settlement in 2003 for the same violation of FINRA’s research rules).

⁸⁹ Press Release, U.S. Dep’t of Justice, HSBC Holdings Plc. and HSBC Bank USA N.A. Admit to Anti-Money Laundering and Sanctions Violations, Forfeit \$1.256 Billion in Deferred Prosecution Agreement (Dec. 11, 2012), <https://www.justice.gov/opa/pr/hsbc-holdings-plc-and-hsbc-bank-usa-na-admit-anti-money-laundering-and-sanctions-violations> [http://perma.cc/P6XX-JKWA].

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.*

⁹³ Press Release, U.S. Dep’t of Justice, Standard Chartered Bank Agrees to Forfeit \$227 Million for Illegal Transactions With Iran, Sudan, Libya and Burma (Dec. 10, 2012), <https://www.justice.gov/opa/pr/standard-chartered-bank-agrees-forfeit-227-million-illegal-transactions-iran-sudan-libya-and-burma> [http://perma.cc/4LUE-77L6].

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Id.*

on the same violations.⁹⁷ Standard Chartered agreed to pay an additional \$300 million fine in August 2014 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.”⁹⁸

Then, 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.⁹⁹ The bank concealed the identities of clients in at least 3500 transactions with the knowledge of senior employees, including the heads of money laundering and global banking services for Europe, the Middle East, and Africa.¹⁰⁰

BNP Paribas settled with the Justice Department in 2014 for violating U.S. laws prohibiting the transfer of funds for countries subject to U.S. economic sanctions.¹⁰¹ 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.¹⁰²

Most recently, in 2015 Crédit Agricole agreed to sanctions totaling more than \$787.3 million to settle charges brought by the U.S. Attorney’s Office of the District of Columbia, the Federal Reserve, the Treasury Department, and the New York Department of Financial

⁹⁷ Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Board Issues Consent Cease and Desist Order, and Assesses Civil Money Penalty Against Standard Chartered PLC and Standard Chartered Bank (Dec. 10, 2012), <https://www.federalreserve.gov/newsevents/press/enforcement/20121210a.htm> [<https://perma.cc/V4X9-HG2L>].

⁹⁸ Chad Bray, *Standard Chartered Agrees to 3-year Extension of Nonprosecution Agreements*, N.Y. TIMES: DEALBOOK (Dec. 10, 2014, 4:53 AM), <http://dealbook.nytimes.com/2014/12/10/standard-chartered-extends-deferred-prosecution-agreements-for-3-years/> [<https://perma.cc/9R77-T3BX>].

⁹⁹ Sarah Todd, *RBS to Settle Foreign Sanctions Probe for \$100 Million*, AM. BANKER (Dec. 12, 2013), http://www.americanbanker.com/issues/178_237/rbs-to-settle-foreign-sanctions-probe-for-100-million-1064215-1.html [<https://perma.cc/FAV9-28EF>].

¹⁰⁰ *Id.*

¹⁰¹ Press Release, U.S. Dep’t of Justice, 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), <https://www.justice.gov/opa/pr/bnp-paribas-agrees-plead-guilty-and-pay-89-billion-illegally-processing-financial> [<http://perma.cc/MQP2-KMNV>].

¹⁰² Press Release, U.S. Dep’t of Treasury, Treasury Reaches Largest Ever Sanctions-Related Settlement with BNP Paribas SA for \$963 million (June 30, 2014), <https://www.treasury.gov/press-center/press-releases/Pages/jl2447.aspx> [<https://perma.cc/C99Z-7RXZ>].

Services for violations of the International Emergency Economic Powers Act and the Trading With the Enemy Act.¹⁰³ The violations occurred between August 2003 and September 2008.¹⁰⁴ 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.¹⁰⁵ These violations occurred from 2002 to 2008.¹⁰⁶ Also in 2015, Deutsche Bank 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.¹⁰⁷ The violations occurred from 1999 to 2006.¹⁰⁸

Presently, charges for violations of money laundering and/or economic sanctions laws brought by U.S. authorities are pending against Société Générale and Unicredit.¹⁰⁹ All of these actions are evidence of 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.¹¹⁰ Citigroup has been charged with repeated violations of federal securities laws regulating research analysts' conduct.¹¹¹ Citigroup was fined by the Financial Industry Regulatory Authority (FINRA) in 2014 for violating laws concerning research analysts' communications with respect to the planned Toys

¹⁰³ Press Release, U.S. Dep't of Justice, Crédit Agricole Corporate and Investment Bank Admits to Sanctions Violations, Agrees to Forfeit \$312 Million (Oct. 20, 2015), <https://www.fbi.gov/contact-us/field-offices/newyork/news/press-releases/credit-agricole-corporate-and-investment-bank-admits-to-sanctions-violations-agrees-to-forfeit-312-million> [https://perma.cc/4C7W-3FC5].

¹⁰⁴ *Id.*

¹⁰⁵ Ben Protes, *Commerzbank of Germany to Pay \$1.5 Billion in U.S. Case*, N.Y. TIMES: DEALBOOK (Mar. 13, 2015), <http://www.nytimes.com/2015/03/13/business/dealbook/commerzbank-pays-1-45-billion-to-settle-us-investigations.html> [https://perma.cc/SZB4-ADLH].

¹⁰⁶ *Id.*

¹⁰⁷ Liz Moyer, *Deutsche Bank to Pay \$258 Million and Fire 6*, N.Y. TIMES: DEALBOOK (Nov. 5, 2015), <http://www.nytimes.com/2015/11/05/business/dealbook/deutsche-bank-to-pay-258-million-and-fire-6-in-settlement.html> [https://perma.cc/9ZYW-8N2N].

¹⁰⁸ *Id.*

¹⁰⁹ See Moyer, *supra* note 107.

¹¹⁰ See Corkery, *supra* note 84.

¹¹¹ *Id.*

“R” Us initial public offering.¹¹² In 2013, Citigroup was charged when an analyst shared unpublished research about Apple with hedge funds and a fund manager.¹¹³ It was similarly charged in 2012 for a research analyst sharing nonpublic information concerning Facebook, and in 2011 for violating FINRA rules concerning research analysts’ assisting issuers in the preparation of road show presentations.¹¹⁴ 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.¹¹⁵

Additional recent violations of law involving research analyst activities are further evidence of recidivist conduct. In 2003, the SEC, state prosecutors, and market regulators reached a \$1.4 billion settlement with ten 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.¹¹⁶ Ten years later, ten 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.¹¹⁷ FINRA concluded that flouting these securities regulations was the norm for every one of the firms.¹¹⁸

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

¹¹² *10 Wall Street Firms Fined over Conflicts in Toys ‘R’ Us I.P.O.*, N.Y. TIMES: DEALBOOK (Dec. 11, 2014, 11:56 AM), <http://dealbook.nytimes.com/2014/12/11/10-wall-street-firms-fined-over-conflicts-in-toys-r-us-i-p-o/> [https://perma.cc/Z76L-T2QC].

¹¹³ Corkery, *supra* note 84.

¹¹⁴ *Id.*

¹¹⁵ Philip Mattera, *Citigroup: Corporate Rap Sheet*, CORP. RES. PROJECT <http://www.corp-research.org/citigroup> [https://perma.cc/74H3-KE3B].

¹¹⁶ Stephen Labaton, *Wall Street Settlement: The Overview; 10 Wall Street Firms Reach Settlement in Analyst Inquiry*, N.Y. TIMES (Apr. 29, 2003), <http://www.nytimes.com/2003/04/29/business/wall-street-settlement-overview-10-wall-st-firms-reach-settlement-analyst.html?pagewanted=all> [https://perma.cc/BQP4-4J3P].

¹¹⁷ Morgenson, *supra* note 4.

¹¹⁸ *Id.*

bond sales leading to the 2008 mortgage crisis.¹¹⁹ They found improper actions occurred “not only occasionally, but in the end, with almost every deal examined.”¹²⁰

For example, Citigroup’s \$7 billion settlement was based on misrepresentations that violated federal laws in various RMBS offerings in 2006 and 2007.¹²¹ Settlements were also reached in November 2013 for similar violations by J.P. Morgan Chase and two institutions it had acquired, Bear Stearns and Washington Mutual.¹²² Likewise, Bank of America and two institutions it had acquired, Merrill Lynch and Countrywide Financial, reached settlements in August 2014 for similar federal securities law violations.¹²³ 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.¹²⁴ 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 2007.¹²⁵ Credit Suisse was charged with violations in seventy-five

¹¹⁹ See Jody Shenn, *Flaws Found in ‘Almost Every’ Mortgage-Bond Deal as Crash Began*, 102 BANKING REP. (BNA) No. 21, at 967 (2014).

¹²⁰ *Id.*

¹²¹ Press Release, U.S. Dep’t of Justice, Justice Department, Federal and State Partners Secure Record \$7 Billion Global Settlement with Citigroup for Misleading Investors About Securities Containing Toxic Mortgages (July 14, 2014), <https://www.justice.gov/opa/pr/justice-department-federal-and-state-partners-secure-record-7-billion-global-settlement> [<https://perma.cc/KH8T-6HTQ>]. See generally Financial Institutions Reform, Recovery, and Enforcement Act of 1989, 1 Fed. Banking L. Rep. (CCH) ¶3152 (Aug. 9, 1989) (containing the civil penalty provision of the FIRREA).

¹²² See *infra* note 284 and accompanying text (discussing a \$13 billion settlement with J.P. Morgan to resolve federal and state civil claims arising out of the issuance of mortgage-backed securities by J.P. Morgan, Bear Stearns, and Washington Mutual after J.P. Morgan acknowledged that it made misrepresentations).

¹²³ See *infra* notes 276, 294 and accompanying text (discussing a \$16.65 billion settlement with Bank of America Corporation as well as Countrywide Financial Corporation and Merrill Lynch in relation to ongoing civil investigation related to issuance, underwriting, and origination of mortgage loans).

¹²⁴ Press Release, Sec. & Exch. Comm’n, SEC Charges J.P. Morgan and Credit Suisse with Misleading Investors in RMBS Offerings (Nov. 16, 2012), <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171486012> [<https://perma.cc/AC47-5ENX>].

¹²⁵ *Id.*

different RMBS transactions issued from 2005 to 2010.¹²⁶ Following a trial, Nomura Securities and Royal Bank of Scotland were found liable in May 2015 for misleading Fannie Mae and Freddie Mac in their sales of mortgage-backed securities.¹²⁷ Judge Cote wrote in a May 11, 2015 ruling in the case that “[t]he magnitude of falsity, conservatively measured, is enormous.”¹²⁸

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, forty-nine 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).¹²⁹ This was to resolve violations of state and federal law with respect to loan servicing and foreclosure practices.¹³⁰ A year later recidivist conduct was uncovered.¹³¹ 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.¹³² In 2015, the Comptroller of the Currency again found noncompliance with earlier foreclosure settlements on the part of J.P. Morgan Chase, Wells Fargo, and other banks, and restricted their purchases of mortgage servicing rights.¹³³ 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

¹²⁶ *Id.*

¹²⁷ Bob Van Voris, *Nomura, RBS Slammed by Judge for ‘Enormous’ Mortgage Deception*, 104 BANKING REP. (BNA) No. 20, at 975 (May 19, 2015).

¹²⁸ *Id.* (quoting *Fed. Hous. Fin. Agency v. Nomura Holding Am., Inc.*, 104 F. Supp. 3d 441, 453 (S.D.N.Y. 2015)).

¹²⁹ Press Release, U.S. Dep’t of Justice, \$25 Billion Mortgage Servicing Agreement Filed in Federal Court (Mar. 12, 2012), <https://www.justice.gov/opa/pr/25-billion-mortgage-servicing-agreement-filed-federal-court> [<http://perma.cc/BPM2-BCLE>].

¹³⁰ *Id.*

¹³¹ Andrew M. Ballard, *Compliance Deficiencies Remain After \$25 billion Mortgage Settlement, Monitor Says*, 101 BANKING REP. (BNA) No. 22, at 925 (Dec. 10, 2013).

¹³² *Id.*

¹³³ Jesse Hamilton, *OCC Limits Servicing Rights Purchases: JPMorgan, Wells Fargo Among Targets*, 104 BANKING REP. (BNA) No. 25, at 1170 (June 23, 2015).

remediating mortgage servicing deficiencies.¹³⁴ Due to these violations, Ocwen agreed to host a monitor for up to three years and pay \$150 million in restitution.¹³⁵

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. Four banks—Citigroup, J.P. Morgan Chase, Barclays, and Royal Bank of Scotland—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.¹³⁶ The wrongdoing occurred from 2007 to 2013.¹³⁷ The Federal Reserve imposed a separate fine on the four banks of \$1.6 billion, as well as a fine on UBS, which committed similar manipulation of LIBOR rates.¹³⁸ Barclays settled related claims with U.S. and U.K. authorities and agreed to pay a combined penalty of approximately \$1.3 billion.¹³⁹ Adding earlier settlements with U.S. and European regulators, the five banks have been subjected to fines and penalties of nearly \$9 billion.¹⁴⁰

U.S. and European regulators have imposed \$6 billion in fines on ten banks and brokerage firms for manipulating the London interbank offered rate (LIBOR) and the European interbank offered rate (EURIBOR).¹⁴¹ Three additional banks—HSBC, J.P. Morgan Chase, and Crédit Agricole—have been similarly charged, but refused to settle.¹⁴² Barclays, for example, admitted to misconduct between 2005 and 2009 and agreed to pay both a \$160 million penalty in its agreement with the Justice Department and a \$200 million penalty in

¹³⁴ Stephen Joyce, *Ocwen Agrees to Pay \$150 million, Finance On-Site Independent Monitor in Lawsby Order*, 104 BANKING REP. (BNA) No. 1, at 10 (Jan. 6, 2015) (quoting Consent Order Pursuant to New York Banking Law § 44, N.Y. State Dep't of Fin. Serv. (Dec. 19, 2014)).

¹³⁵ *Id.*

¹³⁶ Press Release, U.S. Dep't of Justice, *Five Major Banks Agree to Parent-Level Guilty Pleas* (May 20, 2015), <https://www.justice.gov/opa/pr/five-major-banks-agree-parent-level-guilty-pleas> [<https://perma.cc/EG8J-36LZ>].

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ Foo Yun Chee, *EU Commission Charges HSBC, JPMorgan, Credit Agricole with Rigging*, REUTERS (May 20, 2014), <http://in.reuters.com/article/uk-eu-banks-eurorigging-idINKBN0E01AS20140520> [<https://perma.cc/JV7B-33Q8>].

¹⁴² *Id.*

its agreement with the CFTC.¹⁴³ One scheme flourished from 2005 to 2007 and continued sporadically through 2009.¹⁴⁴ A second scheme took place from August 2007 to January 2009.¹⁴⁵ 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 2009.¹⁴⁶ UBS Securities Japan also agreed to plead guilty to felony wire fraud.¹⁴⁷ 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 2011.¹⁴⁸ In the LIBOR manipulation investigations the Justice Department concluded that, “certain institutions condoned a culture of illegal behavior.”¹⁴⁹

These many examples of corporate misconduct demonstrate the financial services industry’s pattern of recurrent violations of law and recidivist behavior.

¹⁴³ Press Release, U.S. Dep’t of Justice, 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 27, 2012), <https://archives.fbi.gov/archives/washingtondc/press-releases/2012/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> [<https://perma.cc/L7FQ-BSHB>].

¹⁴⁴ *Id.*

¹⁴⁵ James B. Stewart, *A Calculated Deal in an Investigation into Rate-Rigging*, N.Y. TIMES (July 14, 2012), <http://www.nytimes.com/2012/07/14/business/in-barclays-inquiry-the-calculation-in-making-a-deal-common-sense.html> [<https://perma.cc/7LVE-PDPF>].

¹⁴⁶ Press Release, U.S. Dep’t of Justice, UBS Securities Japan Co. Ltd. to Plead Guilty to Felony Wire Fraud for Long-Running Manipulation of LIBOR Benchmark Interest Rates (Dec. 19, 2012), <https://www.justice.gov/opa/pr/ubs-securities-japan-co-ltd-plead-guilty-felony-wire-fraud-long-running-manipulation-libor> [<https://perma.cc/3TJN-T3Z4>].

¹⁴⁷ *Id.*

¹⁴⁸ *Deutsche Bank to Pay Record \$2.5 Billion, Fire Employees to End U.S.-U.K. Libor Probes*, 104 BANKING REP. (BNA) No. 17, at 813 (Apr. 28, 2015).

¹⁴⁹ Jeff Bater, *Top Justice Department Official Urges Banks To Create ‘A Culture of Compliance’*, 101 BANKING REP. (BNA) No. 20, at 848 (Nov. 26, 2013) (showcasing statements made by Deputy Attorney General James Cole).

III. 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 lengths to document the multiple influences on consumer decisions, including cognitive limitations and decision-making heuristics.¹⁵⁰ As a result, regulatory policy was modified in recognition of these influences and the resultant limits to self-protection by consumers.¹⁵¹ 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 United Kingdom. There, cognitive influences on both consumer decisions and corporate decisions have been acknowledged, and regulatory policy, including enforcement policy, is evolving in response.¹⁵²

Before 2008, the regulatory approach to consumer protection relied on a rational decision-maker model.¹⁵³ Namely, consumers could protect themselves against unfair or unsafe financial products by weighing all the risks and the benefits of the product in question.¹⁵⁴ 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.¹⁵⁵ The Federal Reserve Board recognized this state of affairs

¹⁵⁰ See *infra* notes 156–57 and accompanying text (discussing how the Federal Reserve Board and FSA recognized consumer behaviors in implementing regulations and policies).

¹⁵¹ See *infra* notes 185–86 and accompanying text (noting that regulators recognize that timing or manner of disclosures will not lead to effective self-protection if consumers are overloaded with information).

¹⁵² See FIN. SERVS. AUTH., *supra* note 25.

¹⁵³ See *supra* Part II.B.

¹⁵⁴ See *id.*

¹⁵⁵ See Truth in Lending, 73 Fed. Reg. 44,522, 44,524–26 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226); FIN. SERVS. AUTH., PRODUCT

when it modified real estate lending regulations in July 2008.¹⁵⁶ Similarly, the FSA recognized that behavioral biases on the part of consumers have a significant impact on what can be achieved through disclosure, education, and counseling.¹⁵⁷ Both regulators, therefore, considered greater product intervention.¹⁵⁸

The Federal Reserve Board and the FSA 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: (1) the market characteristic of limited transparency, particularly in the market for subprime loans, which prevents comparison shopping;¹⁵⁹ (2) 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;¹⁶⁰ (3) the behavioral

INTERVENTION 16 (2011) (UK), http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf [<https://perma.cc/KFA6-855L>].

¹⁵⁶ *See id.*

¹⁵⁷ *See* HM TREASURY, A NEW APPROACH TO FINANCIAL REGULATION: BUILDING A STRONGER SYSTEM, 2011, Cm. 8012, at 70–71 (UK), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81411/consult_newfinancial_regulation170211.pdf [<http://perma.cc/YES5-DTVF>] (discussing an early intervention policy, an array of powers to impose product requirements and standards, and even to ban products or product features); FIN. SERVS. AUTH., MORTGAGE MARKET REVIEW 72–75 (2009) (UK), <https://www.fca.org.uk/publication/discussion/fsa-dp09-03.pdf> [<http://perma.cc/4RRM-8MYW>] [hereinafter MORTGAGE MARKET REVIEW]; FIN. SERVS. AUTH., CONSUMER RESPONSIBILITY 16–19 (2008) (UK), http://www.fsa.gov.uk/pubs/discussion/dp08_05.pdf [<http://perma.cc/APQ7-CFGJ>] [hereinafter CONSUMER RESPONSIBILITY] (discussing cognitive biases on the part of consumers).

¹⁵⁸ *See* FIN. SERVS. AUTH., *supra* note 155.

¹⁵⁹ *See* Truth in Lending, 73 Fed. Reg. at 44,524 (“[S]ubprime rates, which can vary significantly based on the individual borrower’s risk profile, are not broadly advertised and are usually obtainable only after application and paying a fee.”); FIN. SERVS. AUTH., *supra* note 155, at 24 (observing that it can be difficult for consumers to compare products, in part due to opaque charging structures).

¹⁶⁰ *See* Truth in Lending, 73 Fed. Reg. at 44,524–25 (using adjustable rate mortgages as an example of a nontraditional loan product which “tend to be complex for consumers”); FIN. SERVS. AUTH., THE FCA’S USE OF TEMPORARY PRODUCT INTERVENTION RULES 10 (2012) (UK) (explaining that some financial products or features may be “so complex that most consumers . . . would be unable to understand, or would have difficulty understanding the

characteristic of limited shopping caused by the combined effect of limited transparency, complexity, and the cost of comparison shopping;¹⁶¹ (4) persistent negative beliefs concerning credit availability and ability to qualify for loans (pessimism bias) that prevent some consumers from shopping for more favorable terms;¹⁶² and (5) 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.¹⁶³

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.¹⁶⁴ One such belief is that lenders are required by law to provide the best possible rate on loans.¹⁶⁵ Another belief is that lenders or brokers will offer suitable products.¹⁶⁶ The FSA found that consumers assume that no firm will identify options that are not broadly appropriate for them.¹⁶⁷ This leads to limited comparison shopping or no comparison shopping.¹⁶⁸

risks or features of the product they are purchasing”); FIN. SERVS. AUTH., *supra* note 155, at 26 (positing that the complexity of financial products plus the behavioral biases of consumers can result in misleading views about a product).

¹⁶¹ See Truth in Lending, 73 Fed. Reg. at 44,525; Patricia McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. LEGIS. 123, 140–41 (observing that fees and interest rates are disclosed after the consumer pays a nonrefundable application fee).

¹⁶² See Truth in Lending, 73 Fed. Reg. at 44,525.

¹⁶³ *Id.*

¹⁶⁴ See MORTGAGE MARKET REVIEW, *supra* note 158, at 72–75; CONSUMER RESPONSIBILITY, *supra* note 158, at 8.

¹⁶⁵ The Fannie Mae National Housing Survey found that more than 40 percent of borrowers generally, almost two-thirds of African-American borrowers, and 75 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://fanniemae.com/resources/file/research/housingsurvey/pdf/survey2003.pdf> [https://perma.cc/CL5J-SYWC].

¹⁶⁶ See FIN. SERVS. AUTH., MORTGAGE MARKET REVIEW: DISTRIBUTION AND DISCLOSURE 12 (2010) (UK), http://www.fsa.gov.uk/pubs/cp/cp10_28.pdf [https://perma.cc/K4LY-RN26].

¹⁶⁷ See *id.*

¹⁶⁸ See *id.* The FSA reported that consumers see intermediaries more as a means for accessing available products because they assume all firms will offer appropriate options implying no need to comparison shop. See *id.*

Third, borrowers tend to pessimistically believe that they have poorer credit quality than they actually do.¹⁶⁹ A Freddie Mac Consumer Credit Survey found that 30 percent of white borrowers, approximately one-third of Latino borrowers, and approximately 50 percent of African-American borrowers who had good credit believed they had poor credit.¹⁷⁰ 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 a non-prime mortgage with a lower interest rate and fee structure.¹⁷¹

A fourth belief that prevents consumer self-protection is the misconception 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 communities or due to the lower quality of their credit history.¹⁷² Both U.S. and U.K. regulatory authorities uncovered this belief.¹⁷³

Pessimism concerning credit quality and/or availability of credit may be characterized as pessimism bias, the opposite of the optimism bias displayed in most situations by most individuals.¹⁷⁴ Pessimism bias is most prevalent among low-income and minority

¹⁶⁹ See Sheila D. Ards & Samuel L. Myers, Jr., *The Color of Money: Bad Credit, Wealth and Race*, 45:2, AM. BEHAV. SCIENTIST 223, 229–30 (2001) (citing FREDDIE MAC, 1999 CONSUMER CREDIT SURV. (1999)).

¹⁷⁰ See *id.*; FIN. SERVS. AUTH., THE FINANCIAL CONDUCT AUTHORITY: APPROACH TO REGULATION 24 (2011) (UK), http://www.fsa.gov.uk/pubs/events/fca_approach.pdf [<https://perma.cc/3222-72MR>] (stating there can be opportunities for firms to exploit consumer behavior such as lack of confidence or knowledge in retail markets).

¹⁷¹ See Ards & Myers, *supra* note 169, at 238.

¹⁷² See generally U.S. DEP'T OF HOUS. & URBAN DEV., OFFICE OF POLICY DEV. & RESEARCH, FR-5180-F-02, RESPA: REGULATORY IMPACT AND INITIAL REGULATORY FLEXIBILITY ANALYSIS 2–102 (2008), <http://www.hud.gov/offices/hsg/ramh/res/impactanalysis.pdf> [<https://perma.cc/4GLJ-82RA>] (“Finally, households in low-income and minority neighborhoods may perceive that there are fewer opportunities to find a mortgage because of a lack of prime lenders in their neighborhoods Subprime borrowers are more likely to believe that they have fewer opportunities because of their credit circumstances and brokers may reinforce their perceptions.”).

¹⁷³ See generally FIN. SERVS. AUTH., MORTGAGE EFFECTIVENESS REVIEW: STAGE 2 REPORT 9–10 (2008) (UK), http://www.fsa.gov.uk/pubs/other/MER2_report.pdf [<https://perma.cc/YR5E-2YK2>] (explaining that subprime consumers did not see traditional lenders as a realistic option).

¹⁷⁴ See *id.*

borrowers.¹⁷⁵ Regulators recognized that all of these beliefs undermine self-protection by serving as barriers to comparison shopping.¹⁷⁶ 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.¹⁷⁷

A final barrier to consumer self-protection recognized by regulators concerns the manner in which consumers make decisions in the mortgage market.¹⁷⁸ There has been a great deal of research concerning decision-making heuristics, including decision making in the mortgage loan process.¹⁷⁹ For example, regulators have recognized limited focus as a decision-making heuristic among consumers.¹⁸⁰ 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.¹⁸¹

¹⁷⁵ *See id.* at 10.

¹⁷⁶ *See id.* at 5.

¹⁷⁷ *Id.*

¹⁷⁸ *See* Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending*, 65 MD. L. REV. 707, 766–806 (2006).

¹⁷⁹ *See id.*

¹⁸⁰ *See generally* Truth in Lending, 73 Fed. Reg at 44,525–26.

¹⁸¹ *Id.* (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 to the bottom half of the income distribution of

Similarly, the FSA concluded that many consumers focus only on short-term costs, and are therefore seduced by an attractive initial interest rate.¹⁸² This is true even among relatively sophisticated borrowers, who focused on the initial monthly payment.¹⁸³

As a result of the many consumer barriers to self-protection, regulatory authorities in the United States and United Kingdom 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 as early as 2004, after discussions with federal officials and consumer advocates.¹⁸⁴ 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.¹⁸⁵ The FSA expressed similar doubt that increased disclosure will change consumer behavior.¹⁸⁶

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. *See* BRIAN BUCKS & KAREN PENCE, FED. RESERVE BD., DO HOMEOWNERS KNOW THEIR HOUSE VALUES AND MORTGAGE TERMS 20, 36 (2006), <http://www.federalreserve.gov/pubs/feds/2006/200603/200603abs.html> [<https://perma.cc/7EJH-7PRK>].

¹⁸² *See* FIN. SERVS. AUTH., MORTGAGE MARKET REVIEW: RESPONSIBLE LENDING 57–58 (2010) (UK), <https://www.fca.org.uk/publication/consultation/fsa-cp10-16.pdf> [<https://perma.cc/4KUH-WJRR>].

¹⁸³ *Id.*; *see also* FIN. SERVS. AUTH., *supra* note 155, at 26 (describing how consumers do not focus on costs that will arise later such as mortgage exit fees or mortgage arrears charges).

¹⁸⁴ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO 040280, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 94–98 (2004), <http://www.gao.gov/assets/160/157511.pdf> [<https://perma.cc/XLU2-USC7>].

¹⁸⁵ *Id.*; *see also* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 101, 127–30 (2008) (finding evidence of a lack of understanding of mortgage loan terms and products on the part of consumers).

¹⁸⁶ *See* FIN. SERVS. AUTH., *supra* note 182, at 73–74.

Indeed, additional disclosures may be counterproductive due to information overload, and, in any event, are likely to be ineffective due to limited focus.¹⁸⁷ 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, disclosing all features may "overload" consumers and make it more difficult for them to discern which features are most important.¹⁸⁸

It is interesting to note that regulators in the United Kingdom similarly have 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 behavioural drivers and the often multiple causes of poor outcomes for consumers. This will involve analysis of often complex chains of interaction.¹⁸⁹

All of these statements and actions regarding regulatory policy reflect recognition of the multiple influences on *consumer* decisions, including, but not limited to, cognitive barriers and decision-making

¹⁸⁷ Vincent Di Lorenzo, *Barriers to Market Discipline: A Comparative Study of Regulatory Reforms*, 29 ARIZ. J. INT'L & COMP. L. 517, 527 (2012).

¹⁸⁸ Truth in Lending, 73 Fed. Reg. at 44,526 (citation omitted); *see also* Willis, *supra* note 178, at 767 (discussing cognitive responses to information overload).

¹⁸⁹ FIN. SERVS. AUTH., *supra* note 170.

heuristics. Has a similar recognition 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.¹⁹⁰ Regulators in the United States 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.¹⁹¹ This deterrence strategy is based on the continuing assumption that corporate decisions reflect a complete evaluation of all short-term and long-term risks, and are determined by 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.¹⁹² Kagan, Cunningham, and Thornton's quantitative and qualitative analyses led them to conclude that "theories of corporate environmental behavior that focus on a single variable—whether legal, economic or attitudinal—are almost always doomed to be incomplete and inadequate."¹⁹³ Legal standards, policies, and actions are just one set of influences on corporate behavior. Another influence is the precision of the governing legal standards.¹⁹⁴ Yet another influence is

¹⁹⁰ See, e.g., Truth in Lending, 73 Fed. Reg. at 44,524–26.

¹⁹¹ See *infra* note 298 and accompanying text. See generally Part III.B.3.

¹⁹² See, e.g., Robert Kagan et al., *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, 770–71 (summarizing studies and perceived influences on corporate behavior).

¹⁹³ Kagan, *supra* note 192, at 76–78.

¹⁹⁴ See Vincent Di Lorenzo, *Business Ethics: Law As A Determinant of Business Conduct*, 71 J. BUS. ETHICS 275, 288 (2007) (“[I]n a regime with a vague legal standard the influence of law on corporate conduct is weakest.”);

the *frequency* of inspections and sanctions.¹⁹⁵ Studies and commentators have offered a difference of opinion on the significance of the *size* of legal sanctions on corporate decisions.¹⁹⁶ However, many studies have provided support for the influence of the frequency of inspections, and the frequency and severity of sanctions.¹⁹⁷ This debate is part of a broader debate about whether enforcement policy should assume rational decision making by corporate actors—rational decision making viewed through the lens of neoclassical economic analysis.¹⁹⁸

However, factors influencing legal compliance are not limited to the nature of the legal mandate and the severity and frequency of sanctions.¹⁹⁹ 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

Mark W. Nelson, *Behavioral Evidence on the Effects of Principles-and Rules-Based Standards*, 17 ACCT. HORIZONS 91, 99 (2003) (“[A] relatively large experimental literature provides evidence that the aggressiveness of reporting decisions increases with the imprecision of the relevant reporting standard.”).

¹⁹⁵ See Peter J. May, *Compliance Motivations: Affirmative and Negative Bases*, 38 L. & SOC’Y REV. 41, 45 (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).

¹⁹⁶ See John Braitwaite & Toni Makkai, *Testing an Expected Utility Model of Corporate Deterrence*, 25 L. & SOC’Y REV. 7, 35 (1991) (finding little support for the additive or multiplicative effects of the certainty of detection, certainty of punishment, and severity of punishment).

¹⁹⁷ See Wayne B. Gray & John T. Scholz, *Does Regulatory Enforcement Work? A Panel Analysis of OSHA Enforcement*, 27 L. & SOC’Y REV. 177, 199–202 (1993); Steven Klepper & Daniel Nagin, *Tax Compliance and Perceptions of the Risks of Detection and Criminal Prosecution*, 23 L. & SOC’Y REV. 209, 237 (1989); Di Lorenzo, *supra* note 51, at 95–102 (studying 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, *supra* note 193, 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).

¹⁹⁸ See generally Becker, *supra* note 10.

¹⁹⁹ See Di Lorenzo, *supra* note 192, at 770–71 n.17.

evaluations.²⁰⁰ Legal mandates are strictly followed or creatively ignored as a result of an evaluation of the benefits and risks of noncompliance.²⁰¹ In other words, resolute legal compliance is not a given, but rather a determination made by industry actors in a particular context. Frequency and level of legal sanctions contribute to the costs of non-compliance, but are not the only costs industry actors encounter.²⁰² Another cost is the adverse impact on the reputation of the corporation.²⁰³

Cost-benefit evaluation is not the only business model influencing corporate behavior. A related business model 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.²⁰⁴

In addition to the nature of the legal mandate, the nature of enforcement policy, and relevant market realities, corporate decisions are influenced by cognitive limitations and decision-making heuristics.²⁰⁵ These limit a complete recognition of long-term risks.²⁰⁶ Finally, personality traits of corporate actors have an influence on corporate behavior.²⁰⁷ Personality traits trigger emotional responses to market conditions and influence the overall corporate culture.²⁰⁸ Market realities, including accepted business models, cognitive limitations, and heuristics, as well as personality traits of corporate actors, all combine to create a corporate culture. This corporate culture is an important institutional influence on corporate behavior—an

²⁰⁰ See Di Lorenzo, *supra* note 51, at 91–100 (studying corporate decisions based on cost-benefit evaluations in the 2008 mortgage crisis and the period preceding it).

²⁰¹ See Di Lorenzo, *supra* note 51, at 103; Di Lorenzo, *supra* note 192, at 784.

²⁰² See Di Lorenzo, *supra* note 192, at 784.

²⁰³ See May, *supra* note 195, at 48. Reputational concerns enhance the sense of obligation to comply. *Id.*

²⁰⁴ See Sean Silverthorne, *The High Risks of Short-Term Management*, HARV. BUS. SCH. WORKING KNOWLEDGE (Apr. 11, 2012), <http://hbswk.hbs.edu/item/the-high-risks-of-short-term-management> [<https://perma.cc/FH4M-AFAJ>].

²⁰⁵ See Di Lorenzo, *supra* note 192, at 788; Susanna K. Ripken, *Predictions, Projections, and Precautions: Conveying Cautionary Warnings in Corporate Forward-Looking Statements*, 2005 U. ILL. L. REV. 929, 958–68 (2005) (explaining the impact of several decision-making heuristics on corporate decision making).

²⁰⁶ See Di Lorenzo, *supra* note 192, at 788.

²⁰⁷ See Giberson et al., *supra* note 27, at 123–37.

²⁰⁸ *Id.* at 133–35.

influence distinct and perhaps more important than the influence of government standards, policies and actions.²⁰⁹

Behavioral barriers to effective risk assessment among industry actors have been the subject of study far less frequently than behavioral barriers among consumers.²¹⁰ The studies conducted have found no difference between the use of decision-making heuristics in group decision making and organizational behavior in corporations.²¹¹ Accordingly, regulators must recognize that cognitive limitations and decision-making heuristics affect industry actors as much as they affect the general public.²¹²

Regulators must also recognize complexity in corporate decisions, specifically 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.²¹³

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.²¹⁴ When a significant benefit (e.g., substantial profits) is perceived to result from evasion or noncompliance with legal mandates, then any risk posed by the

²⁰⁹ See Michael D. Watkins, *What Is Organizational Culture? And Why Should We Care?*, HARV. BUS. REV. (May 15, 2013), <https://hbr.org/2013/05/what-is-organizational-culture> [https://perma.cc/MU9D-8W9H].

²¹⁰ Di Lorenzo, *supra* note 187, at 540.

²¹¹ Robert A. Prentice, *Chicago Man, K-T Man, and the Future of Behavioral Law and Economics*, 56 VAND. L. REV. 1663, 1714 (2003); see, e.g., JAMES MONTIER, BEHAVING BADLY 3–9 (Feb. 2, 2006), <https://poseidon01.ssrn.com/delivery.php> [https://perma.cc/XJ7N-8W98] (studying professional fund managers and revealing over-optimism, confirmatory bias, representativeness, framing, and loss aversion).

²¹² Di Lorenzo, *supra* note 187, at 540.

²¹³ *Id.*; see Di Lorenzo, *supra* note 187, at 541 (finding that complexity can cause people to use simplified decision making, which does not maximize their utility). 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).

²¹⁴ Di Lorenzo, *supra* note 187, at 541.

activity (e.g., legal sanction) is viewed as a low probability risk.²¹⁵ This holds true regardless of the actual objective level of risk that a disinterested third-party would perceive.²¹⁶

When individuals face complexities arising from many interacting variables and uncertainties regarding future outcomes, including potential initiation of lawsuits and exposure to liability, they resort to a simplified decision-making strategy.²¹⁷ In making such decisions, individuals give the highest value to the individual's most important choices,²¹⁸ such as preserving or increasing profits, and ignore risks they perceive as low probability, such as civil penalties imposed by regulators.²¹⁹

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" and "reflects the salient features of the process by which it is generated."²²⁰ Similarity in salient features leads to a conclusion of similar probability.²²¹ 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 outcome in the earlier event.²²²

These multiple influences on corporate decisions and decision-making heuristics affect corporate regulatory compliance, and should therefore factor into regulators' decisions about sanctions imposed in an effort to minimize corporate wrongdoing.

²¹⁵ See CASS R. SUNSTEIN, *RISK AND REASON: SAFETY, LAW, AND THE ENVIRONMENT* 40–41 (2002).

²¹⁶ See *id.*

²¹⁷ Di Lorenzo, *supra* note 187, at 541; see Korobkin & Ulen, *supra* note 28, at 1078–79.

²¹⁸ Di Lorenzo, *supra* note 187, at 541; see Korobkin & Ulen, *supra* note 28, at 1078–79.

²¹⁹ Di Lorenzo, *supra* 192, at 283 n.84.

²²⁰ Daniel Kahneman & Amos Tversky, *Subjective Probability: A Judgment of Representativeness*, 3 *COGNITIVE PSYCHOL.* 430, 431 (1972); see also Amos Tversky & Daniel Kahneman, *Judgments of and by Representativeness*, in *JUDGMENT UNDER CERTAINTY: HEURISTICS AND BIASES* 84, 97 (Daniel Kahneman et al. eds., 1982) (“[R]esults reported in preceding studies provide direct support for the hypothesis that people evaluate the probability of events by the degree to which these events are representative of a relevant model or process.”).

²²¹ See Kahneman & Tversky, *supra* note 220, at 431.

²²² See *id.* at 466.

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.²²³

Countrywide operated in a business environment that emphasized short-term profits and increasing market share.²²⁴ Prior to 2003, Countrywide's loan offerings reflected a commitment to the legal mandate to originate "safe" and "prudent" loans.²²⁵ After 2003, Countrywide changed its former policy and "increasingly offered 'innovative,' riskier products."²²⁶ Origination of riskier loan products increased profits, stock price, and executive compensation.²²⁷ 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.²²⁸ Due to the 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 2006.²²⁹ By 2005, Countrywide had become the largest mortgage lender in the United States, recognizing earnings of \$2.1 billion, \$2.4 billion, and \$2 billion in its loan production divisions in 2004, 2005, and 2006, respectively.²³⁰ The \$2.4 billion in earnings in 2005 represented an increase of 182 percent over earnings in 2002.²³¹ Countrywide's stock price increased 561 percent in the ten years

²²³ An earlier version of the Countrywide case study was presented in Di Lorenzo, *supra* note 187, at 541–45.

²²⁴ *Id.* at 541–42; *see also* Michael Simkovic, *Competition and Crisis in Mortgage Securitization*, 88 *IND. L.J.* 213, 216, 228 (2013).

²²⁵ 12 C.F.R. § 160.101 (2016) (stating that Federal savings associations are required to adopt real estate lending policies that are "consistent with safe and sound banking practices" and that reflect "[p]rudent underwriting standards . . ."); *see* Complaint at 7, *SEC v. Mozilo*, No. 09-03994 (C.D. Cal. June 4, 2009).

²²⁶ Di Lorenzo, *supra* note 187, at 542; *see* Gretchen Morgenson, *How Countrywide Covered the Cracks*, *N.Y. TIMES* (Oct. 17, 2010), <http://www.nytimes.com/2010/10/17/business/17trial.html> [<https://perma.cc/J4PV-G42V>].

²²⁷ Di Lorenzo, *supra* note 187, at 542.

²²⁸ *See* Complaint at 10–11, *SEC v. Mozilo*, No. 09-03994 (C.D. Cal. June 4, 2009); Morgenson, *supra* note 226.

²²⁹ Complaint at 10, *Mozilo*, No. 09-03994.

²³⁰ *Id.* at 7.

²³¹ *Id.* at 7–8.

ending in December 2006.²³² Based on increased profit, market share, and stock price, Countrywide CEO Angelo Mozilo received total compensation of \$391.9 million in the five years ending in 2008.²³³

Short-term profits and increased market share were realized via lending products and practices that posed long-term, and sometimes substantial, risks.²³⁴ These long-term risks were minimized or ignored due to the interplay of cognitive influences, decision-making heuristics, and ego.²³⁵ One loan product that posed substantial long-term risks was the payment option adjustable rate mortgage (option ARM).²³⁶ By 2005, option ARMs accounted for 19 percent of Countrywide's loan volume, making it the largest option ARM lender that year.²³⁷ A super-majority of Countrywide's option ARMs were "low documentation" loans in which the borrower did not fully document income or assets.²³⁸

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.²³⁹ Nonetheless, he actively promoted the company's option ARM loans to investors at a Wall Street conference.²⁴⁰ This was understandable in a corporate environment emphasizing short-term profits, since Countrywide's gross profit margin was more than 4 percent on option

²³² See Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N.Y. TIMES (Aug. 26, 2007), <http://www.nytimes.com/2007/08/26/business/yourmoney/26country.html> [<https://perma.cc/AN4P-EPQ2>].

²³³ Agustino Fontevicchia, *Mozilo Pays Record Penalty to Settle Securities Fraud Cases*, FORBES (Oct. 15, 2010), www.forbes.com/2010/10/15/mozilo-sec-fraud-equities-markets-securities.html [<https://perma.cc/C4FQ-UCQA>].

²³⁴ See generally FED. RESERVE BD., CONSUMER HANDBOOK ON ADJUSTABLE RATE MORTGAGES (ARM) (2005) (providing an overview of adjustable-rate mortgages).

²³⁵ Di Lorenzo, *supra* note 51, at 95.

²³⁶ See generally FED. RESERVE BD., *supra* note 234, at 2.

²³⁷ Ruth Simon & James Hagerty, *Countrywide's New Scare*, WALL ST. J. (Oct. 24, 2007), <http://www.wsj.com/articles/SB119318489086669202> [<https://perma.cc/23RC-QRJV>].

²³⁸ *Id.* ("Of the option ARMs it issued last year, 91% were 'low-doc' mortgages in which the borrower didn't fully document income or assets, according to UBS, compared with an industry average of 99% that year. In 2004, 78% of Countrywide's option ARMs carried less than full documentation.")

²³⁹ See Complaint at 20, SEC v. Mozilo, No. 09-03994 (C.D. Cal. June 4, 2009).

²⁴⁰ *Id.* at 37.

ARMs, double the 2 percent profit margin generated by standard loans backed by the FHA.²⁴¹ Securitized payment option ARM loans were sold by Countrywide and other originators to investors at higher prices, due to the higher interest rates they carried at reset and prepayment penalties.²⁴² In addition, payment option ARMs that were kept in portfolio generated immediate phantom profits because banks were able to report as current income the fully amortizing repayment amount even when borrowers made minimum payments.²⁴³ At Countrywide, such phantom income equaled \$654 million in 2006 and \$1.26 billion in 2007.²⁴⁴ Future risks were minimized or ignored.²⁴⁵ The hope was that risks would be shifted to purchasers of its mortgage-backed securities.²⁴⁶

Another risky underwriting practice was underwriting an ARM based on payments due at the initial, low interest rate.²⁴⁷ 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.²⁴⁸ In other words, these borrowers would be unable to afford the loans except in the short-term.²⁴⁹ Countrywide ignored this risk.²⁵⁰ These underwriting practices, as well as the practice of underwriting no documentation loans, increased short-term fee income from origination fees and increased market share since more borrowers “qualified” for such loan products.²⁵¹

Countrywide’s increased underwriting of risky loan products was also influenced by the personality and ego of Mr. Mozilo.²⁵² Mr.

²⁴¹ See Morgenson, *supra* note 232.

²⁴² See *id.*

²⁴³ See generally Mara Der Hovanesian, *Nightmare Mortgages*, BUS. WK. (Sept. 11, 2006), http://www.businessweek.com/magazine/content/06_37/b4000001.htm [<https://perma.cc/7CVP-3Z96>]

²⁴⁴ Complaint at 44, *Illinois v. Countrywide Fin. Corp.*, No. 08CH22994 (Ill. Cir. Ct. 2008) (asserting that the accumulated amortization income was \$654 million at year-end in 2006 and \$1.215 billion at year end in 2007).

²⁴⁵ *Id.* at 44.

²⁴⁶ *Id.* at 2.

²⁴⁷ See S. REP. NO. 111-176, at 11 (2010).

²⁴⁸ See *id.* at 13.

²⁴⁹ See *id.* at 11–12.

²⁵⁰ See *id.* at 13.

²⁵¹ See *id.* at 13–14.

²⁵² See generally Connie Bruck, *Angelo’s Ashes: The Man Who Became the Face of the Financial Crisis*, NEW YORKER (June 29, 2009),

Mozilo had been treated as an outsider by Wall Street's investment bankers who looked down on the flashy mortgage banker from Los Angeles.²⁵³ By 2003, Countrywide had become the third-largest residential loan originator in the U.S.,²⁵⁴ and had a market share of 10 percent when no originator had a market share greater than 13 percent.²⁵⁵ Mr. Mozilo, however, wanted it to be number one, and wanted to dazzle Wall Street investment bankers by capturing a market share of at least 30 percent,²⁵⁶ a larger share than any company had ever achieved.²⁵⁷ Mr. Mozilo announced the goal of 30 percent market share at a Lehman Brothers Financial Services Conference in 2003.²⁵⁸ Once he publicly stated that goal, there was enormous pressure inside Countrywide.²⁵⁹ The culture became: "[w]e got to do this."²⁶⁰ To gain market share, Countrywide expanded its offerings of loan products for which more borrowers could "qualify," such as no documentation loans.²⁶¹ By the end of 2004, Countrywide had surpassed Wells Fargo as the largest residential loan originator in the United States.²⁶²

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."²⁶³ In addition, risk assessment occurred in an environment in which legal compliance was not aggressively enforced.²⁶⁴ The multiple influences on Countrywide's behavior, including its skewed assessment of long-term risk, led it to ignore the

<http://www.newyorker.com/magazine/2009/06/29/angelos-ashes>
[<https://perma.cc/SHA7-43N3>].

²⁵³ *See id.*

²⁵⁴ *Id.*

²⁵⁵ *Id.*

²⁵⁶ *Id.*

²⁵⁷ Bruck, *supra* note 252.

²⁵⁸ *Id.*

²⁵⁹ *Id.*

²⁶⁰ *Id.* (quoting Eric Flamholtz, UCLA business professor and consultant to Countrywide since the late nineties).

²⁶¹ *Id.*

²⁶² Bruck, *supra* note 252.

²⁶³ *See* 12 C.F.R. § 365.2 (b)(1)–(2) (2016).

²⁶⁴ *See generally* Di Lorenzo, *supra* note 51, at 95–98 (discussing the relaxed environment that exists in the market for mortgages).

legal mandate of “prudent” lending operations and “safe and sound” products and practices.²⁶⁵

Countrywide’s actions from 2004 to 2007 reflect skewed risk perception. Long-term risks to Countrywide were downplayed or ignored by its corporate actors.²⁶⁶ It is sometimes assumed that the decision to downplay risks was rational, because risks were eliminated when the risky loans were sold to investors.²⁶⁷ In fact, this was not always or completely the case. Countrywide kept the riskiest portion of securitizations, the residuals, on its own balance sheet.²⁶⁸ By the end of 2006, it had \$2.8 billion of residuals on its balance sheet, equaling 15 percent of its equity.²⁶⁹ Additionally, 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.²⁷⁰ Countrywide also would be forced to repurchase some of the loans sold in the secondary market due to the loans’ risky characteristics that did not meet the underwriting requirements of some secondary market purchasers.²⁷¹ As Countrywide originated riskier loan products, a smaller percentage of loans that it did sell were eligible for sale on a nonrecourse basis.²⁷² Recourse loans allow the purchaser of loans that were sold in the secondary market to seek recourse against Countrywide when the borrowers defaulted.²⁷³ However, the large short-term profits produced by such loans caused Countrywide to ignore their long-term risks.²⁷⁴

Countrywide’s actions also evidence simplified decision-making. The mortgage crisis caused a significant number of lawsuits to later be filed against Countrywide or its acquirer, Bank of America.²⁷⁵ These lawsuits imposed substantial costs.²⁷⁶ However,

²⁶⁵ *Id.*

²⁶⁶ *Id.*

²⁶⁷ Scott Olster, *How the Roof Fell in on Countrywide*, FORTUNE (Dec. 23, 2010), <http://fortune.com/2010/10/23/how-the-roof-fell-in-on-countrywide/> [<https://perma.cc/UW9M-3DAJ>].

²⁶⁸ *Id.*

²⁶⁹ *Id.*

²⁷⁰ Complaint at 10, SEC v. Mozilo, No. 09-03994 (C.D. Cal. June 4, 2009).

²⁷¹ *Id.* at 3.

²⁷² *Id.* at 14–15.

²⁷³ *Id.* at 22–23.

²⁷⁴ *Id.* at 13–15.

²⁷⁵ James Sterngold, *B of A, Ex-CEO Lewis Settle Crisis-Era Suits*, WALL ST. J. (Mar. 26, 2014), <http://www.wsj.com/articles/SB10001424052702304688104579463562665472416> [<https://perma.cc/CB2T-UPT7>].

when Countrywide's loan practices were in place, the possibility of substantial liability in future litigation depended on a complex mix of factors.²⁷⁷ Substantial liability would require a substantial number of defaults.²⁷⁸ In addition, the possible total cost of future lawsuits, both private actions and government actions, was uncertain and subject to a complex set of possibilities.²⁷⁹ Considerations that contribute to uncertainty regarding the size and likelihood of litigation risks include: 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.²⁸⁰ 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.²⁸¹ This conclusion is one more likely to be drawn in light of the significant profits generated by the activity in question.²⁸²

3. Continued Regulatory Blindness in the United States

The recent response of U.S. financial regulators to significant and continuing violations of law has been to impose larger and larger monetary sanctions.²⁸³ For example, in November 2013, the Justice

²⁷⁶ 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, a \$16.65 billion settlement with the Justice Department to settle claims brought by federal and state authorities, and various suits brought by mortgage securities investors, including an \$8.5 billion settlement approved by the New York courts. *See id.*; Michael Corkery, *Bank of America Settlement on Bonds That Soured Is Approved*, N.Y. TIMES: DEALBOOK (Jan. 31, 2014, 12:47 PM), <http://dealbook.nytimes.com/2014/01/31/judge-approves-bank-of-america-mortgage-settlement/> [https://perma.cc/3BM2-TU7J]; Bruck, *supra* note 252.

²⁷⁷ Di Lorenzo, *supra* note 187, at 554.

²⁷⁸ *Id.*

²⁷⁹ *Id.* at 545.

²⁸⁰ *Id.*

²⁸¹ *Id.* at 541.

²⁸² Morgenson, *supra* note 232.

²⁸³ *See, e.g.*, Press Release, U.S. Dep't of Justice, 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->

Department announced a \$13 billion settlement with J.P. Morgan Chase, which included a \$2 billion civil penalty.²⁸⁴ At the time, this was the largest settlement with a single entity in U.S. history.²⁸⁵ The settlement resolved federal and state civil claims arising out of packaging, marketing, sales, and issuance of residential mortgage backed securities (RMBS) prior to January 1, 2009.²⁸⁶ The Justice Department has outlined its approach in its enforcement policy in the RMBS cases.²⁸⁷ It seeks accountability, transparency and redress,²⁸⁸ and has noted that accountability has taken the form of record-breaking penalties.²⁸⁹ The large penalties are imposed 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.’”²⁹⁰

Similarly, in July 2014, the Justice Department announced a \$7 billion settlement with Citigroup to resolve RMBS claims, including a \$4 billion civil penalty.²⁹¹ At the time, this was the largest civil penalty under the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA).²⁹² 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.”²⁹³ One month later, the Justice Department announced a \$16.65 billion settlement with Bank of America to resolve RMBS claims, which included a \$5 billion penalty under FIRREA.²⁹⁴ The settlement is the

speech-140716.html [<https://perma.cc/X2GY-REMT>]; Press Release, U.S. Dep’t of Justice, *supra* note 24.

²⁸⁴ Press Release, U.S. Dep’t of Justice, *supra* note 24.

²⁸⁵ *Id.*

²⁸⁶ *Id.* This is one of the suits brought by U.S. federal and state agencies that form the RMBS Working Group. *Id.*

²⁸⁷ Press Release, U.S. Dep’t of Justice, *supra* note 24.

²⁸⁸ *Id.*

²⁸⁹ *Id.*

²⁹⁰ *Id.*

²⁹¹ Press Release, U.S. Dep’t of Justice, *supra* note 121.

²⁹² *Id.*

²⁹³ *Id.*

²⁹⁴ Press Release, U.S. Dep’t of Justice, Bank of America to Pay \$16.65 Billion in Historic Justice Department Settlement for Financial Fraud Leading up to and During the Financial Crisis (Aug. 21, 2014), <http://www.justice.gov/opa/pr/bank-america-pay-1665-billion-historic-justice-department-settlement-financial-fraud-leading> [<https://perma.cc/XCB5-9WYU>].

largest civil settlement with a single entity in U.S. history, and the penalty is the largest penalty ever imposed under FIRREA.²⁹⁵

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.²⁹⁶ FBI Director James Comey explained “[t]he significant financial penalties imposed on BNP Paribas sends a powerful deterrent message to any company that places its profits ahead of its adherence to the law.”²⁹⁷

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.²⁹⁸ They also reflect the view that there is a linear relationship between the size of fines and long-term corporate commitment to legal compliance.²⁹⁹ The penalties and statements ignore the influence of cognitive barriers and complexity in future compliance decisions.³⁰⁰

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.³⁰¹ The representativeness heuristic can be outer-directed or inner-directed.³⁰² In its outer-directed manifestation, a corporate actor evaluates external actions directed at the corporation, such as monetary sanctions imposed for legal violations, in light of the external environment in which the sanction is imposed.³⁰³ For example, the recent imposition of very large sanctions against the financial services industry can be

²⁹⁵ *Id.*

²⁹⁶ Press Release, U.S. Dep’t of Justice, *supra* note 102.

²⁹⁷ *Id.*

²⁹⁸ See Press Release, U.S. Dep’t of Justice, *supra* note 294; Press Release, U.S. Dep’t of Justice, *supra* note 121.

²⁹⁹ See generally Press Release, U.S. Dep’t of Justice, *supra* note 294; Press Release, U.S. Dep’t of Justice, *supra* note 121; Press Release, U.S. Dep’t of Justice, *supra* note 102.

³⁰⁰ See generally Press Release, Dep’t of Justice, *supra* note 294; Press Release, U.S. Dep’t of Justice, *supra* note 121; Press Release, U.S. Dep’t of Justice, *supra* note 102.

³⁰¹ Di Lorenzo, *supra* note 192, at 788.

³⁰² See generally *id.*

³⁰³ See *id.* at 803.

characterized as primarily a response to the 2008 mortgage crisis.³⁰⁴ 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.³⁰⁵ The size of the sanctions is deemed to be a unique response to this crisis.³⁰⁶ The outer-directed representative heuristic was witnessed in the past with respect to the substantial number of lawsuits, including criminal prosecutions following the savings and loan crisis.³⁰⁷ 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.³⁰⁸

Even if a comparison is made to a broader set of violations of law and resultant sanctions, namely sanctions for conspiracies to fix the LIBOR and foreign exchange rates and violations of money laundering or economic sanctions laws, it is likely that industry members will judge other future violations as dissimilar. The large number of industry members 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.³⁰⁹ Money laundering or economic sanction violations will be deemed not representative of most future violations.³¹⁰ 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

³⁰⁴ See Press Release, U.S. Dep't of Justice, *supra* note 294 (reporting that the financial crisis was "precipitated by the unlawful conduct of Bank of America, Merrill Lynch and Countrywide").

³⁰⁵ *E.g.*, Press Release, U.S. Dep't of Justice, *supra* note 24; Press Release, U.S. Dep't of Justice, *supra* note 294.

³⁰⁶ *E.g.*, Press Release, U.S. Dep't of Justice, *supra* note 24; Press Release, U.S. Dep't of Justice, *supra* note 294.

³⁰⁷ See *Two Financial Crises Compared*, *supra* note 70 (showcasing the increase in criminal regulatory referrals after the savings and loans crisis).

³⁰⁸ See generally Press Release, U.S. Dep't of Justice, *supra* note 294 (stating that RMBS purpose is to investigate fraud that led to the financial crisis).

³⁰⁹ See generally Michael Levi, *Money Laundering and Its Regulation*, 582 ANNALS AM. ACAD. OF POL. & SOCIAL SCI. 181, 182 (2002).

³¹⁰ See generally *id.*

more likely to seek substantial sanctions for all legal violations, the possible deterrent influence of the new policy will be short circuited by the representativeness heuristic.³¹¹

The representativeness heuristic can also be inner-directed.³¹² In this manifestation it affects internal corporate evaluations of the similarity or dissimilarity of actions taken by various departments or individuals within a corporation.³¹³ Tracey McDermott, director of enforcement and financial crime at the Financial Conduct Authority (FCA) 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.”³¹⁴ Accordingly, in both its outer-directed and inner-directed manifestations, the representativeness heuristic is likely to limit the deterrent effect of regulatory sanctions.

4. Modest Recognition in the United Kingdom

Regulatory authorities in the United Kingdom have revisited their enforcement policies in the wake of the 2008 mortgage crisis.³¹⁵ In doing so, they have recognized behavioral influences on corporate decision-makers.³¹⁶

The FSA and its successors, the 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.³¹⁷

³¹¹ Di Lorenzo, *supra* note 192, at 770–71.

³¹² See Kahneman & Tversky, *supra* note 220, at 431 (indicating that individuals evaluate probability of an event based on the similarities between the properties of the parent population and the reflection of the features of the process).

³¹³ See *id.*

³¹⁴ Tracey McDermott, Dir. of Enf’t and Fin. Crime at the Fin. Conduct Auth., Speech at the 13th Annual FX Week Europe, London (Nov. 26, 2016), <http://www.fca.org.uk/news/fca-enforcement-and-the-wholesale-markets> [<https://perma.cc/YW26-QDM9>]; see also Bater, *supra* note 149.

³¹⁵ See generally HM TREASURY, *supra* note 157, at 3.

³¹⁶ See generally FIN. SERVS. AUTH., *supra* note 25, at 5.

³¹⁷ See PRUDENTIAL REG. AUTH., THE PRUDENTIAL REGULATION AUTHORITY’S APPROACH TO ENFORCEMENT 23 (2016) (UK), <http://www.bankofengland.co.uk/pru/Documents/publications/sop/2016/approachenforcementupdate.pdf> [<https://perma.cc/E764-B5R5>] (explaining that where appropriate an upward adjustment of a punitive penalty to ensure the

However, they have also begun to recognize multiple influences on corporate behavior beyond the influence of financial penalties, including corporate culture and behavioral influences.³¹⁸ Thus, the FSA acknowledged that rational decision making did not fully and accurately predict and determine corporate outcomes.³¹⁹ 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 are bound to produce herd effects and thus irrational momentum swings.³²⁰

Among other cognitive influences recognized is the representativeness heuristic, with officials acknowledging that both bankers and regulators have “failed to learn the lessons of history,” each time saying, “it is different.”³²¹ It remains to be seen whether or how this recognition shapes enforcement actions.

IV. 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 theory and complexity theory advise that there are many factors that will influence future corporate assessments and decisions on legal compliance.³²² Corporate culture influences corporate decision making as much as government policies and

penalty has an appropriate and effective deterrent effect); HM TREASURY, *supra* note 157, at 72. *See generally* FIN. SERVS. AUTH., *supra* note 25, at 7.

³¹⁸ *See generally* PRUDENTIAL REG. AUTH., STRENGTHENING ACCOUNTABILITY IN BANKING: A NEW REGULATORY FRAMEWORK FOR INDIVIDUALS 5 (2014) (UK), <https://www.fca.org.uk/publication/consultation/cp14-13.pdf> [<https://perma.cc/KYG5-RRQB>].

³¹⁹ *See generally* FIN. SERVS. AUTH., *supra* note 45, at 41.

³²⁰ *Id.*

³²¹ *See* PARLIAMENTARY COMM’N ON BANKING STANDARDS, CHANGING BANKING FOR GOOD, 2013–16, HC 175-1, at 15 (UK).

³²² *See* Di Lorenzo, *supra* note 192, at 769.

actions.³²³ Corporate culture is shaped by internal and external market conditions, including cognitive influences, decision-making heuristics, and accepted business models that perform cost-benefit evaluations with an eye toward maximizing short-term profits.³²⁴ Cognitive influences and heuristics shape corporate assessments of risk, including the risk of legal sanctions for noncompliance.³²⁵

Moreover, nongovernmental and governmental influences are dynamic. They change over time—a change that is not identical in each firm—and 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, U.S. regulators must take the first step of recognizing the multiple influences on corporate decisions, including cognitive influences and heuristics. This is a step regulators in the United Kingdom have begun to take.³²⁶ In turn, regulators need to modify enforcement policies to reflect such multiple influences. Regulators must recognize that an increase in monetary penalties may not alone lead to consistent or resolute commitment to legal compliance. The challenge in the 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, which could be imposed in addition to other sanctions, is an enforcement policy that makes greater use of market-based sanctions such as suspensions directed at the corporation.³²⁷ The suspension might be of a particular product, process, or line of business, and would alter the immediate assessments of risk. Faced with a business model emphasizing the importance of short-term profits and a decision-making heuristic of skewed risk perception, suspensions in lines of business, products or operations transform profits from primarily a *benefit* of noncompliance

³²³ See Kagan, *supra* note 192, at 82.

³²⁴ See generally *id.*

³²⁵ See generally *id.*

³²⁶ See FIN. SERVS. AUTH., *supra* note 45.

³²⁷ See generally Vincent Di Lorenzo, *Equal Economic Opportunity: Corporate Social Responsibility in the New Millennium*, 71 U. COLO. L. REV. 51, 94, 116–17 (2000).

to a significant *cost* of noncompliance.³²⁸ The length of any suspension would be uncertain, magnifying the significance of the loss in a cost-benefit evaluation that embraces cognitive influences.

Evidence of the effectiveness of this type of sanction is provided by the U.S. experience with the Community Reinvestment Act (CRA).³²⁹ The CRA, enacted in 1977, requires banking institutions to meet the credit needs of their local communities, including low- and moderate-income communities.³³⁰ The sanction authorized by the Act allows the governing agency to deny any “application for a deposit facility,” which includes an application to open new branches or to merge or acquire the assets of any regulated financial institution.³³¹ Through 1988, banks largely ignored the CRA’s requirements and rarely faced sanction. However, beginning in 1989, and with greater frequency during the Clinton administration, the federal banking regulators increasingly and with greater consistency denied applications for expansion on the part of banking institutions with poor CRA ratings.³³² This sanction, similar to the sanction of corporate suspension, had a direct impact on bank profits. The result was a dramatic commitment by banking institutions to CRA lending in a market in which banks sought expansion through interstate branching, and industry mergers and acquisitions. As of 1985, U.S. banks had committed \$3.7 billion to CRA lending.³³³ By 1993, such commitments exceeded \$30 billion, increased to more than \$397 billion by the first quarter of 1998, and reached \$1 trillion in the fall of 1998.³³⁴ This sanction demonstrates the dynamic interaction of government action and market forces when risk is assessed by corporate actors through a lens subject to cognitive and heuristic influence.

Imposition of corporate product, operations, or line of business suspensions for legal violations is a modification in

³²⁸ *See generally id.*

³²⁹ *See id.*

³³⁰ 12 U.S.C. §§ 2901, 2903 (2012).

³³¹ §§ 2902–03.

³³² *See* Di Lorenzo, *supra* note 327, at 100.

³³³ *Id.* at 113.

³³⁴ *Id.* at 116–17. The latest available figures regarding CRA commitments indicate that \$4.5 trillion was committed from 1992 through 2007, in contrast to \$8.8 billion from 1977 through 1991. NAT’L CMTY. REINVESTMENT COAL., CRA COMMITMENTS 5 (2007), http://www.ncrc.org/images/stories/whatWeDo_promote/cra_commitments_07.pdf [https://perma.cc/5WJH-L6D9].

enforcement policy that has been largely rejected by federal regulators in the United States,³³⁵ although federal regulators have recently occasionally utilized this enforcement measure when faced with violations of earlier settlements or recidivist behavior.³³⁶ It is a change in enforcement policy that has been embraced by regulators in the United Kingdom,³³⁷ and has been imposed by New York State's

³³⁵ Citigroup, J.P. 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. See Neil Weinberg, *JP Morgan's Guilty Plea Puts Wealth Management Unit in Spot with Regulators*, 104 BANKING REP. (BNA) No. 1044 (June 2, 2015); Andrew Ackerman & Christina Rexrode, *SEC Grants Bank of America Short-term Waiver from Hedge-Fund Restrictions*, WALL ST. J. (Nov. 25, 2014), <http://www.wsj.com/articles/sec-grants-bank-of-america-short-term-waiver-from-hedge-fund-restrictions-1416959591> [<https://perma.cc/NMW2-GL2J>] (stating that waiver was 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: DEALBOOK (Feb. 4, 2015, 9:28 PM), http://dealbook.nytimes.com/2015/02/04/s-e-c-commissioners-split-on-waiving-financial-industry-punishment/?_r=0 [<https://perma.cc/54DV-GY9M>] (discussing that Oppenheimer has been the subject of at least thirty 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).

³³⁶ E.g., Ben Protess & Matthew Goldstein, *S&P to Pay Nearly \$80 Million to Settle Fraud Cases*, N.Y. TIMES: DEALBOOK (Jan. 21, 2015, 10:09 PM), <http://dealbook.nytimes.com/2015/01/21/s-p-to-pay-nearly-80-million-in-settlements/> [<https://perma.cc/BWY3-37KN>] (describing how Standard & Poor's settlement with the SEC included 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"); Hamilton, *supra* note 133 (explaining how the Comptroller of the Currency restricted six lenders in their purchases of mortgage servicing rights because they have not met the terms of the 2013 settlements over mortgage foreclosure abuses).

³³⁷ See FIN. SERVS. AUTH., DECISION PROCEDURES AND PENALTIES MANUAL AND ENFORCEMENT GUIDE REVIEW (2010) (UK), http://www.fsa.gov.uk/pubs/cp/cp10_23.pdf [<https://perma.cc/XE6L-2JSD>]; FIN. SERVS. AUTH., IMPLEMENTING ASPECTS OF THE FINANCIAL SERVICES ACT 2010, 17 (2010) (UK), http://www.fsa.gov.uk/pubs/cp/cp10_11.pdf [<https://perma.cc/35XE-W9VQ>]; PRUDENTIAL REG. AUTH., *supra* note 318, at 35.

financial regulator.³³⁸ However, for this enforcement measure to be effective, consistency in resort to suspensions is necessary 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 many influences on corporate behavior so as to incline the corporate decision maker toward greater commitment to legal compliance. How to best accomplish this goal becomes the subject of further study.

³³⁸ See Danielle Douglas-Gabriel, *Standard Chartered To Pay \$300 Million for Violating Money Laundering Settlement*, WASH. POST (Aug. 19, 2014), <https://www.washingtonpost.com/news/business/wp/2014/08/19/standard-chartered-to-pay-300-million-for-violating-money-laundering-settlement/> [https://perma.cc/Q245-44MJ] (describing how 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 yearlong suspension of its dollar-clearing operations from BNP Paribas in its settlement concerning violations of economic sanction laws. *Id.* 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 Promontory Financial. See Ben Protess & Jessica Silver-Greenberg, *Promontory Financial Settles with New York Regulator*, N.Y. TIMES: DEALBOOK (Aug. 18, 2015), <http://www.nytimes.com/2015/08/19/business/dealbook/promontory-financial-settles-with-new-york-regulator.html> [https://perma.cc/KLE8-PUWT].