Inside v. Outside? A Question for White-Collar Criminal Policy

In 1991, the US Sentencing Commission promulgated guidelines for sentencing organizations convicted of federal crimes. These rules reduced the culpability score for an entity defendant if the organization had “an effective program to prevent and detect violations of law.” The logic behind this policy is straightforward: if firms can prevent, detect, and punish violations of laws at lower cost than external regulators (e.g., the DOJ), then giving them incentives to adopt the means of doing so is sensible. Of course, if this efficiency assumption is not true, then the cost-benefit calculation may suggest the policy is not desirable.

More generically, one object of criminal sentencing policy is to achieve a certain amount of regulatory control or deterrence at the lowest possible cost. We can think of the amount of regulatory control as the sum of government regulatory activity plus the regulatory activity inside of firms. (For both government and firms, these activities include writing rules, monitoring employees, conducting investigations, bringing enforcement actions, and so on.)

One relatively minor point worth making is that firm activity that is a substitute for government activity or is undertaken only because of government incentives is “regulatory activity” that should be included in calculations of the size and cost of “regulation.” When assessing the amount of regulation, scholars typically count pages in the Code of Federal Regulations or the like. This metric does not take into account the fact that firms respond to federal rules with intrafirm regulatory actions. If the amount of firm response to a given amount of regulation, call this the “amplification factor,” is constant over time, then the relative amount of regulation over time would be accurate, but not the absolute amount of regulation. Moreover, there is reason to believe the amplification factor has increased over time, as discussed below. If this is the case, then the amount of regulation may be undercounted in both relative and absolute terms.

So, is inside or outside regulation more efficient? There are several reasons to believe that inside regulation can achieve the same level of control at lower overall cost. In ideal conditions, competition and the profit motive may provide constraints and more accountability on policing – we are likely to see firms expend resources on regulation if they are cost justified. In other words, political constraints on outside regulation may be less effective than the competitive market inside regulation. Also, firms have local knowledge and subject matter expertise, which can permit them to lower the overall costs at all stages of regulation. Moreover, inside regulation is not bound by the Constitution (e.g., warrants, 5th Amend right of silence, etc.). Finally, inside regulation can be tailored to firm-specific characteristics at lower costs; in fact, some outside regulation cannot be tailored at all, given the potential that tailoring may be looked at as suspect from a public choice perspective or as akin to a bill of attainder.

But inside regulation is subject to conflicts of interest, and this will depend in complex ways on the clarity of the outside regulation and the overall firm transparency, as well as the possibility of whistle blowers and the like (ex post transparency). Inside is also subject to the same interest group pressures as outside, which means that it isn’t really that much different in theory than government regulation on this front. (More on this below.) Moreover, having inside regulation may increase firm complexity, which could have negative spillover effects.
This is a point that has been made to explain the apparent under sheltering phenomenon — firms seem to engage in less tax sheltering than we'd expect. One reason firms under shelter may be because it adds complexity inside the firm, and that this complexity creates the potential for bad behavior that can bleed into other corporate functions, and these may be difficult to monitor or police. Although in the tax case, the fear may be that shelterers are bad guys who will do other bad stuff, this isn't the case for compliance, which is generally viewed (wrongly I think) as a good thing. But I think a similar phenomenon can lead to too much compliance or, at least, inefficient compliance. For instance, it may be that when compliance is a separate function from sales, that there is more cheating because sales role changes from sales and compliance to sales, with the compliance role being external to sales. Firms may also just be harder to govern when they have these large compliance obligations — JPM has hired 25,000 compliance staff since 2009! Inside might also be a way that politicians can extract rents and/or create more revolving door opportunities.

It is worth unpacking the dynamics within firms that were unleashed or at least intensified via, among other things, government sentencing policies. These dynamics may distort both inside and outside regulation in socially suboptimal ways. I view the dynamic inside firms as a variant of public choice -- a public choice dynamic may be at work within the regulated firms themselves. If there is a powerful group within a regulated firm that wants, for its own reasons that diverge from the interests of the firm or its customers, a more governmental form of self-regulation, then it will act to enable the process of governmentalization. Certain constituencies within a firm may prefer more regulation, more strict or bureaucratic rules for a given amount of regulation, and so on. This may be in their interest because it enhances their personal or group interests, say because it means more interesting work, more budgetary authority, more control, or for other reasons. This dynamic may be at work in the dramatic growth of compliance departments over the past two decades in the broker-dealer industry, as an example.

Within each broker-dealer there is a group of individuals, known colloquially as “compliance,” whose job it is “to supervise the day-to-day conduct of business unit activities and to have in place policies and procedures reasonably designed to achieve compliance with applicable laws and regulations.” Compliance typically provides the following functions: to give advice to business units about rules and regulations; to develops internal policies and procedures that help the firm to comply with external rules; to help train business personnel regarding their legal duties; to help monitor business functions for compliance with legal rules; to conduct internal investigations; to handle licensing and registration of business professionals; to manage relationships with regulators; and so on. In all of these functions, the role and importance of compliance, as a stand-alone function, is greater the greater the amount of external regulation. Moreover, holding the amount of regulation constant, the more intense, complex, bureaucratic, and adversarial the regulation, the greater the need for effective compliance. In other words, whether compliance personnel are designing training programs, offering advice to business units, or handling internal audits, their importance within the firm is proportional to the governmentalness of the external regulation. Where the regulation is aggressive, high risk, adversarial, and “other” in a sense, compliance is a more vital function than when the regulation is less so. All else being equal, compliance experts are relied upon more under government regulation rather than self-regulation.
Notwithstanding this implicit preference for more governmental-like regulation, compliance operates within a firm, and therefore must operate within the constraints set by the firm. In other words, firms may recognize this tendency and exert pressure for compliance to be structured and act in a way that privileges the interest of the firm (which may be for more self-regulatory regulation) over the interests of a particular department.

For several reasons, compliance departments may be successful at breaching their firms’ constraints in the long term. First, compliance professionals are typically segregated in the organizational structure from the rest of their business to ensure that business interests or short-term profit motives do not corrupt the firm’s internal regulatory processes. One industry white paper, for instance, describes as a best practice “separating Compliance Department functions from the supervisory functions of line managers, as well as distinguishing the roles of the Compliance Department from other control functions.” The logic here is powerful, since the overlap of regulated and regulator in a particular firm may give the firm less credibility with external regulators in the event of an investigation of the firm. Note, however, that the compliance subcommittee of the industry trade group, called SIFMA, wrote this white paper. As such, this position might simply be an effort by the compliance professionals to entrench their interests and to protect themselves from the scrutiny of the broader business. In either case, compliance is isolated and viewed as a stand-alone department. From such a position, compliance may be able to define and to exert its interests more easily than integrated departments within a firm. If compliance heads in a direction the rest of the business finds troubling, the ability to control it may be limited by concern about interfering – or appearing to interfere – with legal obligations.

Second, the actions of compliance are likely difficult and costly for business managers to monitor. Compliance is largely a legal function, and typical business managers in a broker-dealer do not possess similar training or experience. Compliance employees may use their specialty knowledge, the unique nomenclature and patois of law, as well as unfamiliarity with legal process to insulate their work from rigorous business oversight. The mantra of compliance professionals – to create and foster a “culture of compliance” – is consistent with this account. “Culture” is a particularly malleable and powerful explanation for a range of activities. Any pushback on a “culture of compliance,” as defined by compliance, can be countered with concerns about legality and a FINRA rulebook that is, as of the 2012 printing, 1374 pages of 8 point font.

Such factors as these might still not permit an overly independent compliance department, however, if business managers of broker-dealers found it worthwhile to invest in disciplining compliance departments. But there is little reason for a rational firm to do so. For one, the compliance departments at all broker-dealers face the same incentives to influence outsiders setting the rules of the game, and therefore disciplining only one department would likely have little impact. What would be needed is a common effort by all or a critical mass of broker-dealers, which would be difficult to organize and perhaps subject to antitrust constraints.

Another reason firms are unlikely to try to counter the move toward greater complexity and governmentalization is that all similarly situated broker-dealers face the same increased cost as a result of the change, and therefore no individual broker-dealer would reap any advantage from halting the trend. All other firms would benefit freely through such efforts, and therefore no firm has an incentive to invest in countering the
push because of the free-rider problem. Instead, broker-dealers reasonably may perceive increased compliance costs as an industry-wide tax, which they can likely pass on to their customers. Any such burden applies to every broker-dealer, and broker-dealers have a monopoly on executing stock transactions. So long as the firm keeps compliance costs within the range of competitive firms, there is no business disadvantage, no matter how much compliance costs.

One final point is worth mentioning. For large broker-dealers, not only are compliance costs of little harm (if they amount to an industry-wide tax), but they may be valuable. If the compliance industry generates a demand for compliance services that has a large fixed cost per firm, then large firms can use this “culture of compliance” as a way to reduce the profit of smaller rivals or to create barriers for new entrants. Larger firms can spread any fixed costs over a larger asset base, and therefore bear any costs more easily. Assume, for example, two firms, one with 100 customers and assets at the firm of $100 each, and another firm with 50 customers with $100 each. Further assume compliance costs are $50, plus $2 per customer. In that case, total compliance costs for the first firm would be $250, and $150 for the second firm. As a percentage of assets under management, however, the first firm’s compliance costs are just 2.5 percent, while the second firms are 3 percent. If the firms pass on the costs to their customer, the second firm will have to outperform the first firm by 50 basis points to offer competitive services.

Another source of potential competitive advantage exists from the development of a “culture of compliance.” In a business environment in which returns from investment strategies are increasingly commodified and asset managers have greater difficulty differentiating themselves, regulatory adroitness can itself be a source of competitive advantage. Perversely, for firms that are particularly expert at compliance, the larger the burden and complexity of regulation, the better. A firm with a 10 percent cost advantage on legal compliance can differentiate itself more if compliance costs are, on average, $1000 per firm rather than if they are merely $100 per firm.

Importantly, this observation does not imply or require any conscious plan on the part of any individual. The process by which interest groups protect their interests, expand their influence, and pursue goals narrowly, while being integrated into a larger whole is well described in the public choice literature, and it does not require deliberate action. Rather, these developments may occur unintentionally in a manner difficult to observe or to counter in any individual case, but with substantial consequences nevertheless.

Anecdotal evidence about the compliance industry corroborates such observations. Compliance as a separate function began in the 1960s. (Before this time, compliance with rules and regulations was the responsibility of each professional broker. Although this is still true, the responsibility is now shared with a separate department focused entirely on rules.) Over the next three decades or so, the compliance industry remained relatively small, with even the largest broker dealers employing only a few individuals devoted to a separate compliance function. In part, this kind of slow growth can simply be explained by a rise in the size of the typical firm and the increasing complexity of its operations. But, according to interviews with compliance officers at large broker-dealers, starting in the mid-1990s, the number of compliance officers began to boom. At one large broker-dealer, just a handful of compliance officers worked in
1995, while today there are over 400 individuals. The timing of this explosion corresponds quite well with our account of the increasing governmentalization of the SROs for broker-dealers. The thrust of our argument in this section is simply that this temporal confluence is not a coincidence, but rather that the governmentalization has been driven in part by the private interests of “compliance” within and across firms, and that this growth creates a feedback loop in which the process of governmentalization increases over time. Putting aside issues of initial causality, once the process starts, increasing governmentalization begets more demand for compliance, which in turn fosters an interest in more rules and more government-like process. Given the importance of this feedback loop, as in other areas where feedback is important, the growth of compliance is unlikely to remain linear.

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The move toward crediting firms for self-policing is based on a simple and powerful logic—the total costs of a given level of deterrence may be lower if firms can provide more efficient regulation. The model is based on a model of regulation described vividly by William O. Douglas, an early SEC commissioner—self-regulation may be more efficient because it can reach conduct “beyond the periphery of the law,” but the government must stand behind private regulatory efforts: “Government [should] keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.”

But, and I think this is a massive “but,” there is a problem with the inside model of regulation. While there will always be some inside regulation, government policies encouraging it may have led to the creation of forces within firms that are not constrained by normal market constraints, and thus we may not be achieving the optimal regulatory intensity, especially since inside regulation may be less transparent than outside regulation. Shareholders may not even realize the costs of compliance. In addition, and perhaps more frightening, inside regulation may have caused outside regulation—both the content of the rules and the intensity of their enforcement—to be distorted in ways that benefit the constituencies inside firms doing the inside enforcement. The result may be worse law—less deterrence for a given cost—than had we not gone down the inside road to begin with.