Compliance By Fire Alarm: Regulatory Oversight Through Information Feedback Loops

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"They paint a deeply disturbing picture of the lengths Boeing was apparently willing to go to in order to evade scrutiny from regulators, flight crews and the flying public . . . even as its own employees were sounding alarms internally."[1]

This Article contributes to the growing body of compliance law theory and scholarship. It does so by introducing a new and third approach to compliance called the fire-alarm approach. This approach is grounded in the theoretical perspectives of negotiated governance and director primacy. It also contrasts but complements two other well-known compliance approaches discussed by scholars: the policing and architectural approaches. The fire-alarm approach is executed throughout the compliance system that includes regulators, firms, executives, and third-party relationships. A virtue of the fire-alarm approach is that it helps reduce agency costs by increasing transparency and information flows across the various system elements. This is achieved through what are called information feedback loops. These information flows, or feedback loops, reduce agency costs that lead to opportunism, shirking of duties, and conflicts of interest. This, in turn, promotes the goals of regulation that are designed to ensure trust in the marketplace and the protection and integrity of public welfare, health, and safety.

Part I discusses the fundamental problem of compliance as an agency cost problem related to information asymmetries. This part will examine how each subsystem within the compliance system generates its own unique set of agency costs. This part will also highlight the need for information feedback loops to address the significant information asymmetries created by the various principal-agent relationships that inure within the compliance system. Part II discusses the policing and architectural compliance approaches. These two approaches are vital yet fail to capture the entire portrait of effective compliance. Part III introduces the fire alarm approach to compliance that the scholarly literature has neglected. Part IV describes information loops and provides a list of examples that can reduce agency costs and improve the compliance system. Part V discusses various theoretical, normative, and policy implications that flow from this analysis.

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1. Natalie Kitroeff, *Boeing Employees Mocked F.A.A. and 'Clowns' Who Designed 737 Max*, N.Y. TIMES (Jan. 29, 2020), https://www.nytimes.com/2020/01/09/business/boeing-737-messages.html [https://perma.cc/AB78-BAC3] (referencing Boeing's internal employee messages and quoting U.S. Representative Peter Defazio).

I. INTRODUCTION

The inability to maintain an effective regulatory and corporate compliance system can be costly to firms and society.[2] Compliance is the set of internal processes used by firms to adapt behavior to applicable norms and regulations.[3] For example, the aerospace giant Boeing is under investigation for its failure to install updated crew alert systems in its recently introduced, and now grounded, MAX 737 jets.[4] The MAX 737 was grounded after two airplane crashes caused the deaths of 346 people.[5] In both cases, contributing factors in these tragic events included failed sensors related to the aircraft's flight control system

2. *See generally* PONEMON INST., LLC, THE TRUE COST OF COMPLIANCE 2 (Jan. 2011), http://www.ponemon.org/local/upload/file/True_Cost_of_Compliance_Report_copy.pdf [https://perma.cc/EA33-4GCY] (offering a survey of firms and revealing that the cost of noncompliance is more than double the price of complying with the law).

3. GEOFFREY P. MILLER, THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE 3, 137 (Vicki Been et al. eds., 2014); Sean J. Griffith, *Corporate Governance in an Era of Compliance*, 57 WM. & MARY L. REV. 2075, 2082 (2016).

4. Dominic Gates et al., *Boeing Pushed FAA to Relax 737 MAX Certification Requirements for Crew Alerts*, SEATTLE TIMES (Oct. 3, 2019), https://www.seattletimes.com/business/boeing-aerospace/boeing-pushed-faa-to-arelax-737-max-certification-requirements-for-crew-alerts/ [https://perma.cc/94E5-C238].

5. *Id.*

and an outdated crew alert system.[6] According to Boeing, the crew alert system was not updated to comply with more stringent federal regulations due to excessive costs.[7] This was done despite indicators that the alert system would definitely fail under certain circumstances.[8]

This case, and many others, highlight a critical but often overlooked pattern that has emerged in compliance. This missing piece is the role of information channels or information feedback loops that are necessary to maintain a strong and effective compliance system.[9] In the Boeing case, the first information failure involved corporate governance. Boeing's board of directors was not properly apprised of the company's aggressive managerial culture that prioritized cost-cutting and speed-to-market over aircraft safety and regulatory compliance. Boeing's board has since changed the company's internal reporting structure to directly oversee regulatory safety and compliance issues to avoid these kinds of information breakdowns.[10]

The second information failure occurred under existing administrative law procedures. Boeing avoided notice-and-comment rulemaking by requesting an exemption from updated Federal Aviation Administration regulations related to its aging crew alert system.[11] Adherence to the traditional public notice-and-comment rulemaking process would likely have alerted stakeholders such as watchdogs, competitors, and suppliers of the potential risks of failing to update the alert system. Both types of information feedback loops could have alerted authorities internal and external to the firm and may have helped avoid the fatal crashes. Information feedback loops are vital to maintaining an effective and efficient compliance system and are associated with what is known as a fire-alarm approach to regulation.[12]

The Boeing case is not an isolated example where information feedback loops could have averted a disaster. Wells Fargo, for example, experienced a compliance failure when fraudulent bank accounts were opened for unwitting customers.[13] In that case, information related to this problem surfaced but was internally suppressed.[14] In another case, General

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6. *Id.*

7. *Id.*

8. *Id.*

9. *See generally* David Orozco, *A Systems Theory of Compliance*, 22 U. PA. J. BUS. L. 244 (2020) (discussing how compliance is a complex system comprised of regulators, firms, executives, and inter-organizational relationships).

10. Jon Hemmerdinger, *Boeing to Begin Internal Overhaul Aimed at Improving Safety*, FLIGHTGLOBAL (Sept. 30, 2019), https://www.flightglobal.com/airframers/boeing-to-begin-internal-overhaul-aimed-at-improving-safety/134531.article [https://perma.cc/4T8C-KQJA].

11. Gates et al., *supra* note 4.

12. *See generally* Matthew D. McCubbins & Thomas Schwartz, *Congressional Oversight Overlooked: Police Patrols Versus Fire Alarms*, 28 AM. J. POL. SCI. 165 (1984) (detailing and differentiating the police patrol regulation style from the fire alarm regulation style).

13. *See, e.g.*, Bethany McLean, *How Wells Fargo's Cutthroat Corporate Culture Allegedly Drove Bankers to Fraud*, VANITY FAIR (May 31, 2017), https://www.vanityfair.com/news/2017/05/wells-fargo-corporate-culture-fraud [https://perma.cc/KPU2-38M7] (describing how Wells Fargo's corporate culture led to bankers creating fraudulent bank accounts).

14. *See generally* INDEP. DIRS. OF THE BD. OF WELLS FARGO & CO., SALES PRACTICES INVESTIGATION REPORT 10 (2017), https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf [https://perma.cc/VE4F-2TV4] (discussing how a decentralized corporate structure at Wells Fargo prevented senior leadership from properly monitoring and implementing controls that would have flagged the pervasive account fraud practices practiced at that bank).

Motors neglected public information related to its faulty ignition switch and airbag systems.[15]

In light of heightened regulatory requirements to protect the public, compliance now occupies a central position within corporate law. Many aspects of compliance have become criminalized, leading to what scholars characterize as "a quiet revolution" in corporate governance.[16] Compliance has risen to the foreground concerning regulation, corporate governance, white-collar crime, corporate social responsibility, and ethics since compliance failures such as the one at Boeing have yielded significant, sometimes devastating, losses borne by individuals and society. Other high-profile compliance failures such as British Petroleum's oil spill in the Gulf of Mexico,[17] Volkswagen's emission regulations cheating scandal,[18] and the fraudulent opening of customer accounts at Wells Fargo[19] are just a few of the more prominent and recent examples of corporate compliance failures with high social costs.

Significant strides have been taken to better understand compliance in theory and in practice. The American Law Institute (ALI), for example, has undertaken an important effort to distill the general principles of compliance as an effort that integrates risk management, corporate governance, and enforcement.[20] The ALI's effort distills best practices in a broad array of compliance-related subjects such as the overall governance of compliance and risk management, the board of directors, executive management, internal control officers, and the compliance function.[21]

Scholars have made significant contributions to the field of compliance.[22] Professor

15. ANTON VALUKAS, REPORT TO BOARD OF DIRECTORS OF GENERAL MOTORS COMPANY REGARDING IGNITION SWITCH RECALLS 115–27 (2014).

16. Todd Haugh, *The Criminalization of Compliance*, 92 NOTRE DAME L. REV. 1215, 1219 (2017). *See also* Veronica Root, *Coordinating Compliance Incentives*, 102 CORNELL L. REV. 1003, 1004 (2017) (stating that "[c]ompliance is king, and its subjects—regulators, prosecutors, courts, corporations, and academics—are quick to tout its power and potential for good."); Griffith, *supra* note 3, at 2077 (identifying how "American corporations have witnessed the dawn of a new era: the era of compliance."); Robert C. Bird & Stephen Kim Park, *Turning Corporate Compliance Into Competitive Advantage*, 19 U. PA. J. BUS. L. 285, 338 (2017) (noting that a "growing array of regulatory mandates and modes of regulatory enforcement" has contributed to compliance as a significant area of focus for legal and business activity and academic and industry-related interest); Jennifer M. Pacella, *The Regulation of Lawyers in Compliance*, 95 WASH. L. REV. 947, 948 (2020) (discussing the new corporate focus on compliance).

17. *See generally* ABRAHAM LUSTGARTEN, RUN TO FAILURE: BP AND THE MAKING OF THE DEEPWATER HORIZON DISASTER (2012) (describing how compliance failure led to BP's oil spill in the Gulf of Mexico).

18. *See* J. S. Nelson, *Disclosure-Driven Crime*, 52 U.C. DAVIS L. REV. 1487, 1544 (2019) (describing how the compliance function at Volkswagen was complicit in hiding information from regulators).

19. McLean, *supra* note 13.

20. PRINCIPLES OF THE L. COMPLIANCE, RISK MGMT., AND ENF'T § 301 (AM. LAW INST., Tentative Draft No. 1, 2019).

21. *Id*. at xii–xix.

22. *See, e.g.*, Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation Through Nonprosecution*, 84 CHI. L. REV. 323 (2017) (discussing the transformation in corporate criminal enforcement policy); Miriam H. Baer, *Insuring Corporate Crime*, 83 IND. L.J. 1035, 1036 (2008) (indicating that firms will over-invest in compliance to avoid formal criminal charges even if this practice is inefficient); Kimberly D. Krawiec, *Organization Misconduct: Beyond the Principal-Agent Model*, 32 FLA. ST. U. L. REV. 571, 591–96 (2005) (questioning whether compliance programs are effective at all); Robert C. Bird & Stephen Kim Park, *Organic Corporate Governance*, 59 B.C. L. REV. 21, 44–45 (2018) (stating that "[t]he influence of the compliance function on corporate decision-making has become so significant that it has prompted legal scholars to declare compliance 'the new corporate governance' and 'a universal corporate governance activity.'"); Donald C. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 939 (2017) (articulating a framework that characterizes the

Miriam Baer, one of the leading scholars in this area, theoretically conceptualized two principal approaches to address corporate fraud and compliance issues within companies. These include the policing and architectural compliance approaches.[23] The policing approach reduces corporate crime by empowering regulators and internal compliance officers to identify, punish, and deter transgressors.[24] Under this approach, compliance is a command-and-control endeavor with a centralized regulatory, enforcement, and discipline system.

The architectural approach is different since it encourages the regulated entity and corporate personnel to seek out, prevent, and mitigate problematic situations rather than individuals.[25] Compliance is achieved through design and prevention by increasing the costs of a violation or by eliminating the choices that might yield non-compliance.[26] To achieve its goals, the architectural approach emphasizes pre-commitment devices and cognitive psychology techniques, such as nudging, to structure individual choices and eliminate negative biases to prevent a legal violation.[27] A pre-commitment device or strategy involves an actor who has eliminated or reduced the attractiveness of engaging in certain choices.[28] Nudging refers to features developed by a "choice architect" structured within an environment in which choices are made to alter behavior.[29] The purpose of nudging is to deliberately structure choices to help people make better decisions, benefiting themselves and society.[30]

The scholarly literature, however, has neglected a third and vital compliance approach. This article introduces this third approach: The use of information feedback loops within what is known in political science literature as a fire-alarm approach to regulation.[31] Information feedback loops are information conduits distributed amongst the

important components of compliance programs within firms); Veronica Root, *The Compliance Process*, 94 IND. L. J. 203, 219–27 (2019) (distilling a four-stage compliance process that utilizes process frame analysis); Veronica Root Martinez, *Complex Compliance Investigations*, 120 COLUM. L. REV. 249, 255–56 (2020) (focusing "on the detection and investigative stages [of compliance] and the continuum between them. [Also, demonstrating that] many recent compliance failures within organizations might have been avoided if more robust processes—meaning the actions, practices, and routines that firms can employ to communicate and analyze information—had been in place to ensure investigations were conducted in a manner that allowed the firm to analyze information from diverse areas within the firm."); Todd Haugh, *Nudging Corporate Compliance*, 54 AM. BUS. L.J. 683, 683–741 (2017) (providing a detailed analysis of the role of behavioral ethics as a form of nudging in corporate compliance).

23. Miriam Baer, *Confronting the Two Faces of Corporate Fraud*, 66 FLA. L. REV. 87, 125–26 (2015); *See* Martinez, *Complex Compliance Investigations*, *supra* note 22, at 257 (stating that "[i]n large part, the focus on compliance is a result of the firm's self-policing responsibilities").

24. Baer, *supra* note 23, at 93.

25. *Id.* at 93–94.

26. *Id.* at 102–03.

27. *Id.* at 91, 118. *See* Haugh, *supra* note 22, at 686 (introducing the concept of behavioral ethics nudging. According to Professor Haugh, this technique involves "the private use of choice architecture specifically aimed at making employees more ethical. This behavioral tool offers a new approach to foster ethical decision making within the corporation to lessen the compliance risk associated with employee wrongdoing.").

28. *See* Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1, 4 (2003) (describing four basic ways that a precommitment strategy can be affected).

29. *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 3–4, 6 (2008) (describing how nudging can affect peoples' decisions).

30. *Id.* at 6.

31. McCubbins & Schwartz, *supra* note 12, at 165–79.

various participants of the compliance system. These information pathways are designed to trigger a response of detection, prevention, investigation, and remediation.[32]

The fire-alarm approach to regulation and compliance advocated in this article is different from the policing and architectural approaches since it relies on different actors and works in an altogether different manner. The policing and architectural approaches focus on the dyadic relationship between firms and regulators and emphasize structural and process-based reforms within the firm to achieve effective levels of compliance. In contrast, the fire-alarm approach relies on regulators, the firm, and external third parties to create a distributed network of compliance-related alarms. The fire-alarm approach is also unique since it incentivizes and empowers these external stakeholders in ways that are not possible under the policing or architectural approaches. In an era of decreased regulatory budgets and industry capture, the fire-alarm style methods of compliance will increasingly be necessary to maintain effective oversight over industry and promote the public aims of regulation.

The fire-alarm approach to compliance also contributes to corporate governance theory, such as the debate concerning the effectiveness of board-level structures versus processes.[33] From a corporate governance theory standpoint, the fire-alarm approach prioritizes company-level processes rather than structures or composition.[34] Information feedback loops rely on effective governance structures and individuals, however, their main emphasis is to deliver information that reduces agency costs and thus are process-oriented. This approach supports the view held by scholars that the most effective forms of governance that reduce the agency costs that arise from information asymmetries result from process-oriented reforms rather than structural changes.[35]

The article will proceed as follows. Part II discusses the fundamental problem of compliance as an agency cost problem related to information asymmetries. This part will examine how each subsystem within the compliance system generates its own unique set of agency costs. This part will also highlight the need for information feedback loops to address the significant information asymmetries created by the various principal-agent relationships that inure within the compliance system. Part III discusses the policing and architectural compliance approaches. These two approaches are vital yet fail to capture the entire portrait of effective compliance. Part IV introduces the fire-alarm approach to compliance that has been neglected in the scholarly literature. Part V describes information loops and provides a list of examples that can reduce agency costs and improve the compliance system. Part VI discusses normative and policy implications that flow from this analysis. Following this section, the article concludes.

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32. Root, *The Compliance Process*, *supra* note 22, at 219–28.

33. *See generally* Nicola Faith Sharpe, *Process Over Structure: An Organizational Behavior Approach to Improving Corporate Boards*, 85 S. CAL. L. REV. 261 (2012) (advocating for a focus on management monitoring in corporate regulatory reform).

34. *Id*. *See also* Martinez, *Complex Compliance Investigations*, *supra* note 22, at 262 (stating that "[y]et, in addition to structure and composition, there is a third component available for those charged with designing compliance programs—process.").

35. *See* Martinez, *Complex Compliance Investigations*, *supra* note 22, at 256 (arguing that firms must "adopt[] process-based reforms").

II. PERVASIVE AGENCY COSTS WITHIN THE COMPLIANCE SYSTEM

It is well-recognized that compliance faces significant agency costs. For example, the law and economics literature considers corporate fraud as an example of a classic agency cost problem.[36] This is because corporate agents sometimes abuse their discretion and authority to engage in self-dealing in a way that harms and takes advantage of their principal.[37] "Agency costs exist whenever a principal entrusts power to an agent to act on [his or] her behalf."[38] Agency costs are borne to the principal who must now monitor the agent to ensure faithful and adequate behavior (monitoring costs) or pay additional amounts to ensure that the agent behaves in an appropriate manner (bonding costs).[39] As recognized by one scholar, "[m]ost current regulation and regulatory reform proposals attempt to reduce corporate failure by reducing agency costs."[40]

To understand how compliance information feedback loops are integrated within compliance it is necessary to clarify two things. First, how compliance operates within a system and systems theory.[41] Second, how each sub-system unit within the compliance system creates its own specific set of agency costs. Information feedback loops, on the other hand, will provide an important mechanism to address the agency costs created by these various sub-system parts.

Compliance stands as its own field of inquiry and operates as a complex system.[42] As recognized by scholars, systems are complex interwoven tapestries that often elude definition and conceptual separation from the broader environment.[43] A critical aspect of any system is its ability to sustain itself and adapt over time to achieve homeostasis and adaptability.[44] Information feedback loops provide a means for all the compliance system elements to sustain themselves over time and create opportunities for learning and adaptation.[45]

In prior work, I argued that the compliance system is comprised of the dynamic and

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36. Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2182 (2010).

37. *See, e.g.*, Usha Rodrigues, *From Loyalty to Conflict: Addressing Fiduciary Duty at the Officer Level,* 61 FLA. L. REV. 1, 3 (2009) (stating that the self-interested actions and policies of corporate agents contributed to the Enron, WorldCom, and HealthSouth fraud cases).

38. Usha Rodrigues, *Entity and Identity*, 60 EMORY L.J. 1257, 1267 (2011).

39. *See* Joseph E. Murphy, *Using Incentives in Your Compliance and Ethics Program*, SOC'Y CORP. COMPLIANCE & ETHICS 1, 21 (2011), https://assets.hcca-info.org/Portals/0/PDFs/Resources/library/814_0_IncentivesCEProgram-Murphy.pdf [https://perma.cc/YHE6-9V53] (discussing how at one organization "business unit leaders are rated on 25–30 elements tied to the Sentencing Guidelines standards for effective compliance and ethics programs. Their rating in these categories acts as a threshold for determining eligibility to participate in the incentive program each year.").

40. Sharpe, *supra* note 33, at 265.

41. *See generally* Lynn M. LoPucki, *Systems Approach to Law*, 82 CORNELL L. REV. 479 (1997) (discussing the use of systems theory for legal concepts); *see also* Tamara Belinfanti & Lynn Stout, *Contested Visions: The Value of Systems Theory for Corporate Law*, 166 U. PA. L. REV. 579, 583 (2018) (applying systems theory to the theory of the corporation).

42. Orozco, *supra* note 9, at 244.

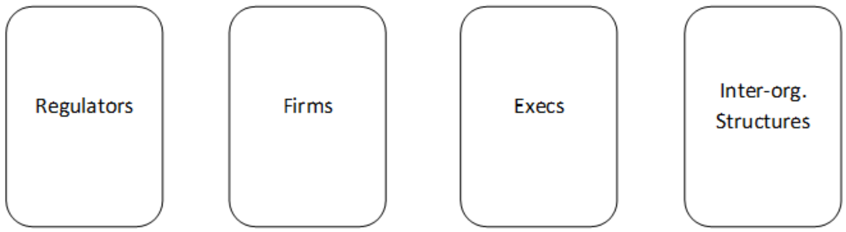
43. LoPucki, *supra* note 41, at 498 (stating that "[d]istinguishing social systems, including law-related systems, from their environments is often difficult. Social systems are often interwoven in a rich, complex tapestry that can at first appear seamless. A single actor, element, or subsystem may contribute simultaneously to the functioning of several systems.").

44. Belinfanti & Stout, *supra* note 41, at 603–04.

45. *See infra* notes 181–83 and accompanying text.

complex relationships that interlock regulators, firms, executives, and inter-organizational structures.[46] Each of these distinct, although interrelated, sub-system components form the larger compliance system and will be discussed next in relation to agency costs. Figure 1 depicts the various interconnected sub-system elements that comprise the compliance system.

Figure 1.



A. Regulators

This section discusses the role of federal and state regulators and the unique agency costs attributed to these important sub-system elements of compliance.

1. Overview

From a compliance viewpoint, regulators may be broadly defined as institutions that have the public authority to create or enforce legal sanctions against a firm or an individual. This includes state and federal legislatures, courts, agencies, prosecutors, and law enforcement personnel.

Federal and state legislatures play an increasingly important role in compliance due to the expansion of civil and criminal statutory liability.[47] Entire domains of business can be subject to sweeping regulation as in the case of food and beverage, alcohol and tobacco, transportation, gaming, healthcare, and financial services.[48] Many other domains of business, such as the professions, are subject to narrower forms of legislative oversight that often relate to more tailored aspects of a profession. For example, a certified public accountant in Florida is required to obtain state licensure and demonstrate compliance with several other aspects of professional regulation.[49]

Federal courts have generally applied the *Chevron* doctrine to support the finding that a federal agency has discretion to interpret a statute due to a statute's ambiguity. If

46. *See generally* Orozco, *supra* note 9 (discussing the relationships between the different actors in a compliance system).

47. *See generally* Haugh, *supra* note 16 (detailing how the expansion of corporate regulation has "criminalized" corporate compliance).

48. For example, the FDA sets food quality standards, requires food manufacturing facilities to register with the agency, prohibits regulated manufacturers from placing adulterated food into interstate commerce, and holds companies liable if they place adulterated foods into interstate commerce. 21 U.S.C. §§ 333, 341, 342, 350 (2019).

49. FLA. STAT. § 473.308 (2020).

Congress has made its statutory intentions clear, this will trump any agency's interpretation. This is known as step one of the analysis.[50] Under step two, if the statute is ambiguous or silent on the issue at hand, the judiciary will uphold the agency's interpretation as long as the agency's interpretation is based on a permissible construction of the statute.[51] A recent empirical study affirms that deferential results occur when federal courts apply the *Chevron* doctrine to administrative behavior.[52] State courts, on the other hand, exhibit substantial variance in terms of their level of deference to state administrative rulemaking and agencies' interpretation of state statutes.[53]

Under administrative law theory, agencies derive their legitimacy and regulatory authority from the legislative process.[54] The consensus among scholars is that regulations should strive to uphold the normative goals of efficacy, legitimacy, and accountability.[55] Yet, the scope of agency authority may expand or "drift" over time since, under traditional principal-agent theory, whenever Congress delegates authority to an agency the delegation will grant the agency some level of discretion that may change over time.[56]

Regulation results from a political process and reflects the public's desire to constrain market activities. From an economic standpoint this may be done to lessen the negative social externalities created by a market failure.[57] How and whether those goals are implemented at the regulatory level requires an analysis of regulatory behavior within agencies. The rich body of administrative law theory provides a strong foundation to examine regulatory behavior in practice.[58]

A key regulatory practice is to define the scope of regulation, taking into account legislative goals and the legislative delegation of authority.[59] The scope of delegated

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

51. *Id.* at 843.

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

53. *See* Aaron Saiger, Chevron *and Deference in State Administrative Law*, 83 FORDHAM L. REV. 555, 558 (2014) (discussing the case of Delaware and how that state's supreme court holds the view that "[s]tatutory interpretation is ultimately the responsibility of the courts" (quoting Pub. Water Supply v. DiPasquale, 735 A.2d 378, 382 (Del. 1999))).

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

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

56. Jody Freeman & Jim Rossi, *Agency Coordination in Shared Regulatory Space*, 125 HARV. L. REV. 1131, 1187 (2012) (discussing that policy drift may result in shirking of responsibilities or the pursuit of expanded policymaking objectives not originally contemplated by legislation).

57. *See generally* R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960) (discussing the role of transaction costs as the primary source of analysis for the justification of regulation). *See, e.g.*, Lydie N.C. Pierre-Louis, *Hedge Fund Fraud and the Public Good*, 15 FORDHAM J. CORP. & FIN. L. 21, 90–93 (2009) (advocating for greater hedge fund regulation in light of major hedge fund-related scandals).

58. McCubbins et al., *supra* note 54, at 435–38.

59. This may trigger constitutional questions related to the proper role of congressional delegation of authority to administrative agencies and the potential problems this creates due to the constitutional principle of the separation of powers. Related concerns involve agencies that overstep their authority or interpret statutes in

authority may depend on several factors, such as the legislative intent to distribute authority among several agencies, judicial decision making that contracts or expands administrative authority, and bureaucratic policy drift that occurs over time.[60] Additionally, agencies can expand their authority through a collaborative rulemaking process such as negotiated rulemaking.[61] In the process, agencies may implement regulatory innovations that result from active participation and information-sharing among impacted stakeholders.[62] Scholars have demonstrated how agencies may informally expand their authority and freedom from judicial review through the adoption of best practices or through the issuance of non-binding guidance.[63]

Regulators housed within administrative agencies may be authorized to enforce the law; otherwise, they refer cases to the appropriate law enforcement authority. Law enforcement authorities such as the Department of Justice (DoJ) or state attorneys general have sole discretionary authority to decide whether to charge a company and can recommend the penalties and remedial actions that should be imposed by the courts.[64] They also have the power to craft settlement agreements with firms and individuals under investigation.[65] Law enforcement authorities also have the ability to design incentives as part of their discretion to cease investigations and settle disputes. This can greatly alter the cost-benefit calculation of compliance performed within companies. For example, the DoJ's Federal Sentencing Guidelines are an important aspect of compliance law.[66] The guidelines technically apply only to criminal enforcement actions; however, they have been vigorously used by prosecutors to craft civil settlements.[67] In the guidelines, the DoJ provides reduced fines and penalties and the ability to enter a deferred prosecution agreement if the company under investigation has a well-defined compliance program and

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an overly broad manner that, for example, create rights and obligations that are not grounded in any intelligible principle and thus extend beyond what a statute contemplated or authorized. *See* Whitman v. Am. Trucking Ass'ns, 531 U.S. 457, 472 (2001) ("We have never suggested that an agency can cure an unlawful delegation of legislative power by adopting in its discretion a limiting construction of the statute."); J. W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 409 (1928) ("If Congress shall lay down by legislative act an intelligible principle to which the person or body authorized to fix such rates is directed to conform, such legislative action is not a forbidden delegation of legislative power."). *See generally* Gary Lawson, *The Rise and Rise of the Administrative State*, 107 HARV. L. REV. 1231 (1994) (discussing the design of the modern administrative state and the gap between constitutional meaning and constitutional practice).

60. Freeman & Rossi, *supra* note 56, at 1139–43.

61. *See* Philip J. Harter, *Negotiating Regulations: A Cure for Malaise*, 71 GEO. L.J. 1, 1 (1982) (proposing "a negotiating process, which [the author] believes would provide incentives and opportunities to resolve issues during rulemaking and would result in better rules").

62. *See generally* Freeman, *supra* note 55 (proposing a model of collaborative governance as an alternative to the model of interest representation in regulatory reform).

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

64. United States v. Nixon, 418 U.S. 683, 693 (1974) ("[T]he Executive Branch has exclusive authority and absolute discretion to decide whether to prosecute a case . . . .").

65. *See* U.S. DEP'T OF JUST., PRINCIPLES OF FEDERAL PROSECUTION OF BUSINESS ORGANIZATIONS (2018) (proposing a set of recommended penalties for business organizations). *See generally* Lawrence A. Cunningham, *Deferred Prosecutions and Corporate Governance: An Integrated Approach to Investigation and Reform*, 66 FLA. L. REV. 1 (2014) (arguing for the integration of the role of corporate governance into prosecutions).

66. U.S. SENTENCING GUIDELINES MANUAL (U.S. SENT'G COMM'N 2016).

67. Root, *The Compliance Process*, *supra* note 22, at 215.

follows what are deemed to be good corporate governance practices.[68]

2. Agency Costs

Scholars have identified the agency costs associated with representative politics and elections,[69] more specifically lawmakers and their inability to exercise effective oversight over a sprawling federal and state bureaucracy.[70] These agency costs filter down from the general electorate to elected officials, administrative agencies, and enforcement personnel. Legislators tend to resort to either policing or fire-alarm style methods of agency oversight.[71] The legislative oversight techniques adopted within the policing approach include conducting public hearings and commissioning investigative reports such as those prepared by congressional staff members or the Government Accountability Office (GAO).[72] In contrast, legislative oversight that employs a fire-alarm approach involves processes that allow interested parties such as consumers, watchdogs, or competitors to submit a complaint or lobby the legislature.[73]

Administrative agencies face agency costs since they are bureaucratic organizations. They also, however, increasingly face coordination difficulties. For example, agencies often possess fragmented or overlapping authority within a shared regulatory space.[74] This increases coordination costs and the ability for legislators to exercise oversight. Administrative law scholars have recently conceptualized what they call shared regulatory spaces, that is, the coordination challenges presented by overlapping and fragmented delegations of power to multiple agencies and the mechanisms employed by agencies to overcome these difficulties.[75] According to these scholars:

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

68. Cunningham, *supra* note 65, at 18; *see also* U.S. DEP'T OF JUST. CRIM. DIV., EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 1, 6 (June 2020) (recommending that prosecutors consider the effectiveness of a company's compliance program and history in incorporating governance mechanisms when determining what charges to bring and whether to offer a plea deal).

69. *See* Robert J. Barro, *The Control of Politicians: An Economic Model*, 14 PUB. CHOICE 19, 22–26 (1973) (explaining that in the absence of electoral consequences, a politician will seek to maximize his own utility); *see generally* John Ferejohn, *Incumbent Performance and Electoral Control*, 50 PUB. CHOICE 5 (1986) (arguing that voters should pay more attention to actual performance than to campaign promises and presenting a model by which to do so).

70. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 ("[The agency cost problem] exists in all organizations and in all cooperative efforts—at every level of management in firms, in universities, in mutual companies, in cooperatives, in governmental authorities and bureaus, in unions, and in . . . agency relationships . . ." (footnote omitted)).

71. *See generally* McCubbins & Schwartz, *supra* note 12 (detailing and differentiating the police patrol regulation style from the fire alarm regulation style).

72. *Id.* at 166.

73. *Id.* at 173.

74. *See generally* Freeman & Rossi, *supra* note 56 (discussing that policy drift may result in shirking of responsibilities or the pursuit of expanded policymaking objectives not originally contemplated by legislation).

75. *Id.* at 1133–36 ("Many areas of regulation and administration are characterized by fragmented and overlapping delegations of power to administrative agencies.").

law. It requires an appreciation of shared regulatory space.[76]

From a compliance law theory standpoint, this suggests regulatory agencies face constraints related to institutional design that result in agency costs borne by the public and policymakers such as monitoring and coordination costs.[77]

Additional regulatory agency costs arise in the area of enforcement. Law enforcement and prosecutors are resource-constrained and must prioritize cases that can be successfully prosecuted, achieve the highest social impact, and make the best use of scarce public resources.[78] This means that not all statutes and regulations will be given the same weight in terms of enforcement.[79] For example, some federal statutes related to white-collar crime, such as trade secret theft, are underenforced.[80]

B. Firms

Firms are the second sub-system component within the larger compliance system.[81] They are a critical nexus of activity since they are charged with internalizing the regulations necessary to ensure compliance and are tasked to develop a coherent and feasible compliance infrastructure, risk management approach, and corporate governance framework.[82]

1. Overview

Under a theory of agency and vicarious liability due to employee behavior firms must comply with regulations, or pay criminal and civil penalties.[83] As a result, firms are responsible for establishing firm-wide compliance programs that are meant to prevent, detect, investigate, and remediate compliance failures.[84] As the architects of internal

76. *Id.* at 1138.

77. Root, *supra* note 16, at 1029–32 ("Governmental enforcement agencies and actors are also subject to the information and coordination complexities that confront many regulatory agencies within the current administrative state.").

78. *See* PRINCIPLES OF FED. PROSECUTION § 9-27.230 (U.S. DEP'T OF JUST. 2018)

> Federal law enforcement resources are not sufficient to permit prosecution of every alleged offense over which federal jurisdiction exists. Accordingly, in the interest of allocating its limited resources so as to achieve an effective nationwide law enforcement program, from time to time the Attorney General may establish national investigative and prosecutorial priorities. These priorities are designed to focus federal law enforcement efforts on those matters within the federal jurisdiction that are most deserving of federal attention and are most likely to be handled effectively at the federal level, rather than state or local level.

79. *Id.*

80. James H.A. Pooley et al., *Understanding the Economic Espionage Act of 1996*, 5 TEX. INTELL. PROP. L.J., 177, 215 (1997).

81. Orozco, *supra* note 9.

82. PRINCIPLES OF THE L. COMPLIANCE, RISK MGMT., AND ENF'T § 301 (AM. LAW INST., Tentative Draft No. 1, 2019).

83. *See* Jennifer Arlen, *Removing Prosecutors from the Boardroom: Limiting Prosecutorial Discretion to Impose Structural Reforms*, *in* PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT 1–2 (Anthony S. Barkow & Rachel E. Barkow eds. 2011) (discussing potential criminal and civil liability of a corporation and its directors for employee misconduct).

84. *See generally* Root, *supra* note 16 (analyzing the regulatory incentivizes for firms to adopt firm-wide compliance programs).

policies that digest regulations and internalize them to achieve the appropriate levels of risk, firms are also the decision makers with respect to the overall risk management and compliance strategy that is to be pursued.[85] Firms adopt compliance approaches that range from a culture of oversight and corruption to proactive engagement with regulators in ways that exceed legal or statutory mandates.[86]

What is meant by the firm, however, is not entirely clear. As discussed by Professor Sean Griffith, "[c]ompliance thus presents a profound challenge to theories of corporate law and corporate governance."[87] For example, is a definition of the firm in compliance law theory to include large shareholders who have voting power, individual board members who have the power to direct firm policies and activities, board sub-committees entrusted with overseeing particularized compliance-related issues such as auditing, the board as a whole, or top-level executives who can impact corporate policy and strategy? From an analytical perspective, a line must be drawn to theoretically define the firm as the separate legal entity (the principal) and those who have the highest level of decision-making authority to direct the affairs of this principal entity. From a systems approach to compliance, the board of directors is the body that best represents the firm.[88]

The ALI, in its recent draft of the principles of compliance, stresses the vital role of the board as the ultimate authority related to firm-wide compliance management practices and leadership. In its draft, the ALI states that the board "must oversee the organization's compliance, risk-management, and internal-audit functions."[89] This oversight should include: staying apprised of major legal obligations, reviewing and approving the compliance program, remaining informed of any material risks, reviewing and approving a risk management framework, approving the appointment and terms of employment of a chief compliance officer and directing investigations related to compliance failures.[90]

This perspective of the board as the appropriate and ultimate source of authority reflects a theoretical perspective in corporate governance known as director primacy.[91] The director primacy theory views the board as the appropriate locus of corporate control

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85. For example, some firms are experimenting with nudges as a behavioral compliance strategy. *See* Haugh, *supra* note 22, at 686 (stating that "behavioral ethics nudging finds itself on the cutting edge of corporate compliance strategy. Some of America's largest and most respected companies see nudging as the future of their compliance initiatives.").

86. *See generally* BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM (2003) (detailing how Enron fomented a culture of corruption and self-interest); Anna M. Phillips & Tony Barboza, *California Reaches Climate Deal with Automakers, Spurning Trump*, L.A. TIMES (July 25, 2019) https://www.latimes.com/politics/story/2019-07-25/california-reaches-climate-deal-with-automakers-spurning-trump (discussing how automakers reached an agreement with state regulators to exceed federal emissions standards).

87. Griffith, *supra* note 3, at 2079 (discussing how compliance subverts traditional notions of corporate governance and theories of the firm since regulators and compliance officers have supplanted the traditional role of shareholders, boards and executives in the execution of corporate governance within firms).

88. *Id.* ("Seen through the prism of compliance, the corporation no longer resembles a nexus of contracts but rather a real entity, subject to punishment and rehabilitation at the pleasure of a sovereign.").

89. PRINCIPLES OF THE L. COMPLIANCE, RISK MGMT., AND ENF'T 36 (AM. L. INST., Tentative Draft No. 1, 2019).

90. *Id.* at 36–37.

91. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550 (2003) (stating that "director primacy asserts that neither . . . shareholders nor managers control corporations—boards of directors do . . . . [D]irector primacy claims that shareholders are the appropriate beneficiaries of director fiduciary duties.").

subject to important checks such as shareholder voting.[92] From this perspective, a large modern corporation that wants to limit collective action problems and agency costs can only exist if broad decision-making authority rests in a single body, that is, the board of directors.[93]

There is a scholarly debate, however, whether boards are actually responsible for most regulatory and compliance failures.[94] Nonetheless, the perspective among regulators is to attribute these failures to this top decision-making body and regulators increasingly seek to impose structural remedies at the highest levels of corporate governance.[95] Corporate governance scholars also often point to the board as an element necessary to monitor senior executives.[96] The underlying premise of this agency view of the board is that executives are rational actors who seek to maximize their own utility and that the firm and its shareholders will suffer unless managers are monitored to decrease their opportunistic behaviors.[97]

One of the chief compliance-related activities of the firm is to establish a compliance culture and infrastructure that will ensure adequate levels of controls and risk-taking.[98] These responsibilities filter throughout the organization and impact its agents and top fiduciaries in different ways. For example, the top decision makers such as the board and senior executives have the fiduciary responsibility to create and implement a sound and reliable compliance program within the organization.[99] As the Delaware Chancery Court said in *In re Caremark*, "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses."[100] The highest company fiduciaries are also tasked with setting the "tone at the top" to instill a sense of values within the organization. Those below will often look to these leaders for guidance and will emulate the values promulgated at

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92. *Id.* at 548.

93. *Id.* at 550–51.

94. *See* Sharpe, *supra* note 33, at 265 (stating that "[m]ost current regulation and regulatory reform proposals attempt to reduce corporate failure by reducing agency costs, and they attempt to do this by making compositional and structural changes to corporate boards of directors").

95. *Id.*

96. *See* Bainbridge, *supra* note 91, at 555–60 (discussing the hierarchical nature of corporations).

97. *See* Jensen & Meckling, *supra* note 70, at 309–10 (asserting that expecting an agent to act in the best interests of the principal's welfare can be problematic).

98. *See* Root, *The Compliance Process*, *supra* note 22, at 218 (recognizing that firms are not expected to achieve perfect levels of compliance).

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

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

that highest level.[101]

These top fiduciaries also have the power to decide agency structures that directly impact the working aspects of compliance. For example, the board and chief executive officer (CEO) have the authority to alter reporting lines among compliance officers. This can have dramatic consequences.[102] As described in cases of compliance failures, centralizing the compliance function and burying its reporting authority to another executive other than the CEO or the board can prevent critical information from reaching the highest levels of the organization, perhaps by design.[103]

Company fiduciaries such as the board have the broadest authority to impact organizational compliance structures. For example, they may create a hybrid decentralized compliance department that spreads across the organization and reports to a Chief Compliance Officer (CCO).[104] In some cases, statutes or a regulatory body mandate the appointment of a CCO as an example of structural governance reform. For example, the Securities and Exchange Commission (SEC) requires this for investment companies such as mutual funds and investment company advisors.[105] Increasingly, the consensus within the compliance industry is that large enough companies should create a separate compliance department with oversight over general and regulatory compliance matters.[106] This decision will trigger additional important considerations related to organizational design that impact the effectiveness of compliance practice.

2. Agency Costs

Decision-making at the highest levels within the firm generates agency costs associated with corporate governance.[107] Large organizations generate agency costs borne by diffused shareholders who own an interest in the principal firm yet are rationally ignorant and face a collective action problem to adequately monitor the board, senior executives, and other employees down the organizational hierarchy.[108] Within firms, it may be that the board, senior executives, and compliance officers are not always faithfully fulfilling the principal's mission. For example, some compliance officers may have a

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

102. *See* Orozco, *supra* note 9, at 260–64 (discussing the case of MF Global as a scenario where that company's CEO altered the reporting line of the company's chief risk officer to avoid hearing risk-related warnings issued by that officer).

103. *See* Nelson, *supra* note 18, at 1544 (2019) (describing how the compliance function at Volkswagen was complicit in hiding information from regulators).

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

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

106. *See* Usnick et al., *supra* note 104, at 205, 214 (discussing various approaches to compliance management).

107. Jensen & Meckling, *supra* note 70, at 309.

108. Simply put, diffused shareholders lack the incentive to effectively monitor board members and top officers. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 7 (Routledge, 2d ed. 2017) ("The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear.").

check-the-box mentality and may seek to appease superior officers rather than ensure adequate levels of compliance or risk management.[109]

Compliance activities are complex activities that involve thousands of people and a dizzying array of laws and regulations.[110] This amplifies the agency costs associated with compliance-related information flows. As recognized by prominent compliance law scholar, Professor Veronica Root Martinez, "there is often a failure to share information across organizational units, leading to the creation of information silos. These silos damage compliance efforts because they impede a firm's effort to prevent, detect, and, importantly . . . fully investigate the nature and scope of misconduct within the organization."[111]

Information agency costs can be mitigated through centralized compliance, yet, oversight may be hampered if that department is not given adequate resources to monitor a sprawling organization with various moving and interacting parts.[112] Decentralized structures may fail to achieve an effective compliance mission if the head of that compliance unit reports to the business unit head or another individual within that decentralized unit.[113] Also, decentralized corporate structures may generate unintended consequences that amplify the risk of non-compliance, for example, an overly-aggressive sales culture.[114]

Directors are not principals—however, they are the ultimate fiduciaries and retain many of the powers associated with principals.[115] For example, under Delaware's General Corporation Law the board is the exclusive body that can initiate fundamental transactions such as merging the company, acquiring another company, issuing a dividend, or changing the purpose of the corporation or altering its capital structure.[116] Board members impose agency costs on the organization since they often face cognitive overloads due to demanding time pressures. One study found that professionally overcommitted directors withdraw from corporate decision-making, tend not to challenge management, and experience attention shocks that distract them from company business.[117] Another survey of corporate board members found that directors tend to overestimate their confidence when it comes to regulatory compliance issues.[118] This leads to overreliance on senior

109. *See* MCCLEAN & ELKIND, *supra* note 86, at 115–18 (discussing how the head of corporate risk at Enron would continually capitulate to the business executives).

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

111. Martinez, *Complex Compliance Investigations*, *supra* note 22, at 266–67.

112. *See* PRINCIPLES OF THE L. COMPLIANCE, RISK MGMT., AND ENF'T § 3.08, cmt. f (AM. L. INST., Tentative Draft No. 1, 2019) (discussing the provision of adequate resources for the internal-control and compliance departments).

113. *See* INDEP. DIRS. OF THE BD. OF WELLS FARGO & CO., *supra* note 14, at 10 (2017) (discussing how a decentralized corporate structure at Wells Fargo prevented senior leadership from properly monitoring and implementing controls that would have flagged the pervasive account fraud practices practiced at that bank).

114. *See id.* at 7–8 (discussing managers encouraging wrongdoing for the sake of sales).

115. *See* Bainbridge, *supra* note 91, at 560 ("Put another way, to the limited extent to which the corporation is properly understood as a real entity, it is the board of directors that personifies the corporate entity.").

116. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 968 (Del. Ch. 1996) ("Legally, the board itself will be required only to authorize the most significant corporate acts or transactions: mergers, changes in capital structure, fundamental changes in business, appointment and compensation of the CEO, etc.").

117. Jeremy C. Kress, *Board to Death: How Busy Directors Could Cause the Next Financial Crisis*, 59 B.C. L. REV. 877, 880 (2018).

118. INST. INTERNAL AUDITORS, ONRISK 2020: A GUIDE TO UNDERSTANDING, ALIGNING, AND OPTIMIZING

executives to handle compliance matters who might have incentives to filter or suppress regulatory information that may or may not reach boardroom-level discussions.[119]

Directors are also likely to impose agency costs since they may have self-interested reasons for not effectively monitoring senior executives. For example, outside directors are often nominated by the CEO and this creates a disincentive to challenge the CEO.[120] Also, interlocking directorships, where CEOs and other senior executives serve on the boards of other companies, may reduce the independence of outside directors.[121] The fear among these directors is that if they challenge senior executives they will lose valuable business opportunities for their own respective businesses.[122]

Corporate governance law has tended to insulate boards from personal liability when it comes to compliance failures. Until recently, boards have typically escaped personal liability under the *Caremark* and *Stone v. Ritter* framework created by the Delaware Supreme Court.[123] These cases largely exempt boards from liability if the company adopts a risk management framework and the board is periodically apprised of its performance. This legal immunity has in many cases resulted in boards delegating much of the compliance oversight function to senior executives.

C. Senior Executives

Senior executives comprise the third sub-system component within the compliance system and are the agents tasked with the execution of a compliance approach and strategy. These actors importantly serve as gatekeepers since they allow or inhibit compliance-related information to be disseminated to important stakeholders such as regulators, the board, external auditors, and investors.

1. Overview

Professor Daniel Sokol noted that compliance means different things to different people at various levels within the firm, such as board members, top executives, and mid-level executives.[124] What all these individuals share in common, however, is their need to operationalize compliance. The highest fiduciaries—such as board members under Delaware's *Caremark* corporate governance standard—must ensure that there is an effective compliance system, and they have a duty to periodically monitor its performance.[125] Top officers are tasked with ensuring that the organizational design works, which often includes creating the role of a CCO, ensuring adequate reporting lines to top

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RISK 13–14 (2019) https://dl.theiia.org/AECPublic/OnRisk-2020-Report.pdf [https://perma.cc/6DGY-NHW3].

119. A common factor among many compliance failures at large organizations is that the boards were largely ignorant of the activities that generated liability. *See* Orozco, *supra* note 9, at 261–63 (discussing a case where top executives suppressed compliance information and prevented compliance-related information from reaching the board).

120. *See* Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 158 (2010) (stating that CEOs tend to dominate the director-nomination process, causing directors to feel beholden to the CEOs).

121. *Id.* at 158–59.

122. *Id.*

123. Stone v. Ritter, 911 A.2d 362, 373 (Del. 2006); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 972 (Del. Ch. 1996).

124. D. Daniel Sokol, *Teaching Compliance*, 84 U. CIN. L. REV. 399, 401–02 (2018).

125. *In re Caremark Int'l Inc. Derivative Litig*., 698 A.2d at 961.

decision-makers, and ensuring that the system provides adequate information flows.[126] Mid-level managers are tasked with executing the program to ensure the law is followed within the parameters established by the program and to report information to the relevant officers who have authority to take action in the event of a compliance-related issue.

A significant portion of the compliance and risk management activities within large firms is delegated further down the hierarchy. Increasingly, senior executives have authorized the creation of a separate compliance department led by a CCO.[127] In an increasing number of cases, the CCO reports to the CEO, yet competing arguments can be made that the CCO should have either a direct or indirect reporting line to the board of directors.[128] In some cases, which are criticized, the CCO reports to the chief financial officer, chief operating officer, or chief legal officer. A current debate in the compliance world is whether the CCO should have independence from in-house legal counsel.[129] Large companies such as Wal-Mart have decided to separate the compliance department from in-house legal.[130] Creating various levels of reporting below the CEO is also likely to increase agency costs and weakens the CCO's power and efficacy.[131]

At the firm level, top decisionmakers must not only conceptualize and then oversee the execution of an effective compliance program and infrastructure; they also must staff this function appropriately and allocate resources so it can achieve the intended goals of risk management and in some cases, value creation.[132] As discussed by legal management scholars, the quality of personnel can vastly impact the range of legal decision-making options, and this also extends to the area of compliance.[133]

In its draft principles of compliance, the ALI places considerable responsibility on senior executives to oversee the implementation and oversight of an effective compliance department. Although the overall regulatory oversight responsibility falls on the board, senior executives and the CEO in particular are the primary overseers of compliance.[134] According to the ALI:

> How the senior executives apportion the responsibilities for compliance, risk management and internal audit in an organization is left to their discretion,

126. *See* Griffith, *supra* note 3, at 2101–02 (describing the role, responsibility, and importance of the CCO).

127. *Id.*

128. *Id.* (contemplating the CCO as a standalone position versus a position reporting to a legal department or CEO).

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

130. *See* Donna Boehme, *Walmart Rolling out Big Compliance Reforms*, COMPLIANCE STRATEGISTS BLOG (Apr. 29, 2014), http://compliancestrategists.com/csblog/2014/04/29/walmart-rolling-big-compliance-reforms/ [https://perma.cc/Z4KZ-CQBX] (discussing Wal Mart's decision to change its compliance department); Michele DeStefano, *Creating a Culture of Compliance: Why Departmentalization May Not Be the Answer*, 10 HASTINGS BUS. L.J. 71, 78–79 (2014) (expounding the arguments for and against the departmentalization of the compliance function).

131. *See* Orozco, *supra* note 9, at 260–67 (discussing the MF Global case study as an example of increased organizational complexity designed to suppress information).

132. PRINCIPLES OF THE L., COMPLIANCE, RISK MGMT., AND ENF'T § 308 (AM. LAW INST. Tentative Draft No. 1, 2019).

133. *See* Robert C. Bird, *Pathways of Legal Strategy*, 14 STAN. J.L. BUS. & FIN. 1, 7–8 (2008) (discussing how different types of personnel affect change decision-making).

134. PRINCIPLES OF THE L., COMPLIANCE, RISK MGMT., AND ENF'T § 3.14 (AM. LAW INST. Tentative Draft No. 1, 2019).

> although applicable law and practice may dictate the allocation of certain tasks to specific executives. This Principle and its Comments, therefore, simply refer to "executive management" or to "senior executives" without allocating duties to senior executive positions. This Principle recognizes, however, that, given its paramount position in organizations, the chief executive officer bears the primary managerial responsibility for establishing effective compliance, risk management, and internal audit, although this officer is likely to direct other executives to assist in fulfilling this responsibility.[135]

2. Agency Costs

Executives and lower-level employees generate well-known agency costs recognized in the literature associated with shirking responsibilities, self-dealing, and suppressing information.[136] Each of these agency costs arises within a compliance scenario.

When an executive shirks responsibility, this can lead to intentional oversight or negligence that results in compliance failures. For example, in the Wells Fargo ghost account scandal, executives knowingly disregarded the legal mandate that forbade them from opening fraudulent customer accounts.[137] Self-dealing occurs when an executive enriches themself at the expense of the principal firm and its shareholders. The Enron debacle was a prime example of corporate insiders profiting at the expense of the company in clear cases that involved a conflict of interest through self-dealing.[138] In other cases, employees may suppress critical information that would lead to corrective action. During the Volkswagen emissions cheating scandal, several mid-level and high-level executives tried to suppress information from regulators to avoid being caught.[139]

A central feature of all these cases is the presence of agency costs that prevent the firm as principal from complying with regulations due to the non-compliant actions of its agents. The firm, overseen by the board, cannot overcome the agency costs despite efforts to do so through monitoring. These harmful actions not only damage the firm, but they also damage important stakeholders such as creditors, employees, suppliers, customers, and communities.[140] The efforts of regulation and compliance are aimed to serve broad public interests, protect large segments of society, and preserve trust in the marketplace.[141]

Large firms try to minimize agency costs by delegating compliance-related authority to top executives who, in turn, delegate this authority to a CCO. Creating a centralized

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135. *Id.*

136. *See* Baer, *supra* note 23, at 99 (stating that "[i]n large part, the focus on compliance is a result of the firm's self-policing responsibilities").

137. *See generally* INDEP. DIRS. OF THE BD. OF WELLS FARGO & CO., *supra* note 14 (detailing how executives opened fraudulent customer accounts despite knowing its unlawful nature).

138. *See generally* MCCLEAN & ELKIND, *supra* note 86 (detailing how Enron fomented a culture of corruption and self-interest).

139. Nelson, *supra* note 18.

140. *See generally* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (describing an alternative approach to explain legal doctrines applicable to public corporations and questioning whether principle-agent problems "provide special insight into the theory of the public corporations"); Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743, 747 (1999) (detailing corporate managers' need to balance the interests of shareholders with other stakeholders).

141. *See* Griffith, *supra* note 3, at 2124 (describing how compliance efforts serve broad public interests beyond those of the shareholders).

compliance function has benefits since it may allow broader levels of expertise, cross-pollination of ideas across departments, accountability, and reporting to senior management and the board. However, it may also amplify agency costs since it may lead to the conclusion by many within the organization that compliance issues should start and end in the compliance department. This perspective can create a silo effect that can generate significant non-compliance risks.[142]

Firms that create a decentralized compliance function or one that has reporting lines to business executives further below the corporate hierarchy amplify agency costs since the reporting structure is likely to suppress information and may lead to actions that present a conflict of interest or self-dealing.[143] The Wells Fargo ghost account scandal highlighted the weaknesses of a decentralized compliance approach. In that case, the compliance officer in charge of community banking, where the fraud took place, engaged in self-dealing and shirked her duties to report suspicions of fraud to the company-wide head of risk management.[144]

D. Inter-Organizational Structures

Inter-organizational structures are the fourth component of the compliance system and comprise external parties such as watchdogs, self-regulatory organizations, inter-agency collaborations, and contracting parties such as certification services, external auditors, and insurers.

1. Overview

From the lens of systems theory, compliance is impacted by structures and relationships that extend beyond the firm's boundaries or the regulator-firm dyad. These third-party relationships include shareholders, contracting parties, activists, non-governmental organizations, watchdog groups, self-regulatory organizations, and interagency collaborations. For example, agencies with fragmented or overlapping regulatory overlap must forge relationships within a shared regulatory space.[145] Another type of inter-organizational structure involves contracting. For example, indemnification and insurance contracts play a role in compliance since they effectively price the risk of non-compliance and transfer this risk to a third party. If transaction costs are low, under transaction cost economics theory, parties will outsource this risk to a third party in the most efficient way possible.[146]

Third-party organizational structures play an important, although under-appreciated role in compliance law theory. For example, firms may join an umbrella organization that

142. Martinez, *Complex Compliance Investigations*, *supra* note 22, at 272–75.

143. *See* Orozco, *supra* note 9, 260–67 (discussing the MF Global case study as an example of increased organizational complexity designed to suppress information).

144. *See* INDEP. DIRS. OF THE BD. OF WELLS FARGO & CO., *supra* note 14, at 47–48 (detailing the wrong-doings of the compliance officer).

145. *See generally* Freeman & Rossi, *supra* note 56 (analyzing the persistence and impact of shared regulatory spaces).

146. *See* Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON. 233, 261 (1979) (discussing "[t]he importance of transaction costs to the organization of economic activity . . .").

self-regulates the industry through a self-regulating organization (SRO).[147] Some quasi-governmental SROs such as the Financial Industry Regulatory Authority (FINRA) may even have the stamp of public legitimacy and authority due to their authority derived from public agencies, in this case, the SEC.[148] Inter-firm committees such as the Committee of Sponsoring Organizations of the Treadway Commission (COSO) can create private industry-wide regulations that normatively induce firms to follow compliance best practices.[149] Trade associations of various types are designed to overcome collective action problems and coordination costs to effectively lobby regulators or file amicus briefs during litigation. Lastly, firms may join professional compliance societies such as the Society for Corporate Compliance and Ethics (SCCE) to share best practices and information that reify industry-wide compliance norms.[150]

2. Agency Costs

Inter-organizational structures face their own set of agency costs. For example, some administrative agencies exercise oversight of self-regulatory organizations and this yields additional agency costs related to monitoring. Certification services, external auditors, and insurance companies face significant information asymmetries. In these cases, firms have an incentive not to reveal damaging information since it may lead to a negative result such as decertification, red flags, or disclaimers in financial statements and higher insurance premiums.

III. THE POLICING AND ARCHITECTURAL APPROACHES TO COMPLIANCE

This Part will discuss two well-accepted compliance approaches: the policing and architectural approaches. Both approaches provide substantial utility, however, they cannot by themselves adequately address the agency costs that pervade each sub-system component of the compliance system. A third novel approach introduced in this article employs information feedback loops within what is called a fire-alarm approach to regulatory oversight. Firms, regulators, policymakers, and third-party stakeholders may employ any combination of the three approaches as complements or substitutes to achieve the correct mix and optimal levels of compliance.

A. The Policing Approach

1. Overview

The key aspect of the policing approach is its attempt to reduce fraud by identifying and sanctioning risky individuals. Professor Jennifer Arlen describes this approach as

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

148. *See* Jonathan Macey & Caroline Novogrod, *Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation*, 40 HOFSTRA L. REV. 963, 971 (2012) (discussing FINRA principles that give it the appearance of authority to compel rule following and sanctioning).

149. COSO develops "frameworks and guidance on enterprise risk management, internal control, and fraud deterrence." COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, https://www.coso.org [https://perma.cc/4PY3-CQ5Z] (last visited Nov. 25, 2019).

150. SOC'Y OF CORP. COMPLIANCE & ETHICS, https://www.corporatecompliance.org/ [https://perma.cc/QN5K-7ZR2] (last visited Nov. 25, 2019).

corporate policing and it includes: "(1) monitoring to detect wrongdoing; (2) investigating suspicious activities; (3) reporting violations to federal authorities; and (4) cooperating with [government] authorities to help them identify and sanction the individuals responsible for the violation."[151] The tools widely employed under this approach include screening risky individuals and expelling them from the firm or identifying them as targets for legal and compliance training. Tools such as background checks, periodic monitoring, audits, terminations, and external corporate monitors help to achieve these policing goals.[152]

Legislatures, administrative agencies, and enforcement personnel also operate under the policing theory of oversight and regulation.[153] This regulatory approach is centralized, active, and direct. Under this approach, an agency's discretion is limited by policymakers and supervised using reports, scientific studies, committee hearings, case law, and field observations. The threat of publicly conducted hearings, critical reports, and the threat of budgetary cuts are effective sanctions. Administrative agencies and law enforcement who follow the policing approach tend to rely on investigations, site inspections, and sting operations.

2. Agency Costs

The policing approach requires extensive investment in personnel to adequately police an agency or regulated entity. In an era of deregulation, decreasing public expenditures, and economic efficiency as a primary justification for administrative policy, it is unrealistic to assume this approach will prevail within our current administrative state.[154] Compliance expenditures have increased considerably within organizations, however, it is also unrealistic to assume organizations will develop sprawling compliance departments to eliminate every type of compliance risk. This is neither feasible nor advisable since firms have varying levels of risk tolerances, and the normative goal is to achieve an efficient level of compliance rather than perfect compliance, which in practice is impossible and inefficient.[155]

The costs of the policing approach within firms include the costs of staffing an adequate compliance department, investing in surveillance and detection methods, and

151. Jennifer Arlen, *The Failure of Organizational Sentencing Guidelines*, 66 U. MIA. L. REV. 321, 332 (2012).

152. Baer, *supra* note 23, at 127–28; *See* Rory Van Loo, *Regulatory Monitors: Policing Firms in the Compliance Era*, 119 COLUM. L. REV. 369, 381 (2019) (defining regulatory monitors as a unique category of personnel with a unique position within administrative agencies. According to Professor Van Loo, regulatory monitors include "an agency actor whose core power is to regularly obtain nonpublic information from businesses outside the legal investigatory process.").

153. McCubbins & Schwartz, *supra* note 12, at 165–67.

154. In the case of federal regulations, it has been the case since 1993 through Executive Order 12,866 that certain regulations should have financial efficiency as a primary criterion and policy objective. *See* Exec. Order No. 12,866, 3 C.F.R. § 638 (1994), *reprinted as amended in* 5 U.S.C. § 601 app. at 83–87 (2006) (establishing that certain federal regulations should have financial efficiency as a primary criterion and policy objective). President Trump also signed an executive order requiring that the passage of one new regulation must be accompanied with the proposed elimination of two existing regulations. *See also* Exec. Order No. 13,771, 3 C.F.R. § 284 (2017) (requiring that the passage of one new regulation must be accompanied with the proposed elimination of two existing regulations).

155. *See* Root, *The Compliance Process*, *supra* note 22, at 218 (recognizing that firms are not expected to achieve perfect levels of compliance).

employee education. These all may provide substantial benefits. Yet, they may also backfire in that some employees may be wrongfully terminated, an environment of mistrust might arise, a false sense of security through a "cosmetic compliance" department may result, and the compliance department may use these techniques to expand their power and footprint within the organization at the principal's expense.[156] These are all agency costs that may arise from over-reliance on the policing approach.

From a regulatory perspective, over-criminalizing activities as a deterrent is criticized as the wrong approach.[157] Over-criminalization will often lead to greater investments in evasion, or in scenarios where the firm's leaders may decide it is more efficient to simply avoid gaining knowledge of the compliance failure. An aggressive use of the policing approach and the related technique of criminalization will hamper business innovation or risk-taking and may also create distrust between the firm, regulators and compliance personnel.[158] The policing approach largely makes use of penalties, however, it may also integrate incentives in its approach. For example, the Federal Sentencing Guidelines offer the carrot of more lenient sentencing if a company has a compliance program and cooperates with investigators.[159]

3. Examples

The policing approach has several merits such as maintaining an active and continual system of oversight. However, as discussed in the prior section, the costs to maintain this system are often inordinate to achieve adequate levels of deterrence and compliance. Many examples of regulatory oversight are due to injured parties complaining to regulators and law enforcement under a more efficient and effective fire-alarm styled approach to regulation. For example, the FTC relies extensively on consumer complaints to trigger an investigation into deceptive and fraudulent business practices.[160] Given the size and scope of economic activity in the U.S. it is simply not feasible or efficient to adopt a policing approach to most regulatory scenarios.

The policing approach works best in cases where illegal activity is difficult to discern due to the actions of corporate agents who can conceal information from internal company oversight and injured consumers. For example, a food processing facility that operates within a large company structure may violate food safety regulations and escape detection from the company's highest levels of internal oversight if compliance operates in a decentralized manner.[161] Because the safety violation is difficult to discern outside of this

156. *See generally* Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487 (2003) (stating the evidence suggests compliance departments do not always stop noncompliant behavior).

157. Haugh, *supra* note 16, at 1218.

158. *See* Baer, *supra* note 23, at 127–30 (discussing how a policing approach can have many negative costs and unintended consequences).

159. Griffith, *supra* note 3, at 2084–86.

160. *See* Press Release, Fed. Trade Comm'n, FTC Charges Payday Lending Scheme with Piling Inflated Fees on Borrowers and Making Unlawful Threats When Collecting (Apr. 2, 2012), https://www.ftc.gov/news-events/press-releases/2012/04/ftc-charges-payday-lending-scheme-piling-inflated-fees-borrowers [https://perma.cc/H4XY-6TYW] (detailing how the FTC took action against certain payday lenders after being alerted by consumers that those lenders billed alleged undisclosed and inflated fees).

161. *See generally* Marchand v. Barnhill, 212 A.3d 805 (Del. 2019) (showing one instance of how decentralization in the form of failing to enact some kind of information and reporting system can enable companies to achieve industry violations).

environment consumers may not be able to submit complaints to regulators, thus a policing approach that involves unannounced site inspection visits is a better regulatory approach in these types of cases.

B. The Architectural Approach

1. Overview

The architectural compliance approach seeks to identify risky structures rather than individuals and prevents compliance failures through the use of nudging and precommitment devices.[162] The architectural approach, therefore, is linked to behavioral science and is designed to eliminate or reduce temptation by eliminating or raising the cost of bad individual choices.[163] In contrast to the policing approach which is adversarial and relies on centralized enforcement, the architectural approach is preventive, cooperative, and managerially focused.[164]

Some of the precommitment devices used by firms to achieve compliance under this approach include requiring or incentivizing individuals to reflect on the ethical aspects of a decision before acting on it, raising the cost of decision making, requiring individuals to obtain third-party certifications or audits, segregating information among different parties, and dividing tasks among individuals to include greater oversight and transparency.[165]

Regulators also make use of this approach. For example, Sarbanes-Oxley's requirement that officers certify financial statements is a regulatory precommitment device meant to ensure financial reporting accuracy that is certified by an external auditor.[166] This statute's requirement that an independent external auditor certifies the adequacy of internal controls is another aspect of this approach.[167] The requirement imposed by securities exchanges that listed companies employ a majority of independent directors is a type of structural pre-commitment device intended to ensure adequate corporate governance and reduce agency costs.[168]

2. Agency Costs

Like the policing approach, the architectural approach has its drawbacks. First, the architectural approach assumes a designer who can effectively create the appropriate pre-commitment devices. This introduces a level of bias into this compliance system from the very beginning that can yield costs that exceed benefits. A behavioral compliance approach may be excessively intrusive and regulate behavior in a way that limits innovation and risk-taking.[169] Behavioral compliance, or nudging, in its worst cases may even result in excessive control, loss of individual autonomy and privacy, and venture into unethical

162. Baer, *supra* note 23, at 133–35.
163. *Id.*
164. *Id.*
165. *Id.*
166. *Id.*
167. Baer, *supra* note 23, at 133–35.
168. *See* Sharpe, *supra* note 33, at 276–77 (detailing the election of independent directors in the hopes that their interests would align well with shareholders).
169. Baer, *supra* note 23, at 137.

conduct.[170] In some cases, the use of pre-commitment strategies can actually increase agency costs.[171] Regulatory actions that use an architectural approach and pre-commitment devices have also been perceived as ineffective and wasteful.[172] Shirking or suppressing information can neutralize the effects of architectural compliance. Therefore, the use of these techniques requires some level of investment in monitoring and policing.

3. Examples

Despite their limitations, companies are beginning to experiment with architectural compliance techniques with some measure of success. Also, policymakers have encouraged this type of compliance approach. For example, the U.S. Sentencing Guidelines refer to practices adopted by companies to incentivize corporate agents to comply with the law.[173] Prosecutors then apply the Sentencing Guidelines to determine the effectiveness of corporate compliance programs as a factor in their sentencing recommendations.[174] Two types of incentives companies use within the architectural approach are compensation incentives aligned with compliance and publicizing disciplinary actions internally.[175] The first technique links executive compensation with compliance success and metrics. Promotions, raises, and bonuses are thus linked to well-established compliance metrics. Compensation clawbacks are another pre-commitment device that can be used after a compliance failure to punish executives who engaged in illegal activity or failed to exercise appropriate oversight. The second technique is more of a behavioral approach that relies on social norms and shaming to induce compliance.

IV. THE FIRE-ALARM APPROACH TO COMPLIANCE

Nobel prize-winning economist Joseph Stiglitz argued that transparency is a tool that can address the principal-agent costs caused by information asymmetries.[176] Information feedback loops are an overlooked mechanism that can increase transparency and reduce agency costs within the entire compliance system. Information feedback loops fit within a third alternative approach to compliance known as the fire-alarm approach.

A. Overview

Compliance law theory has not adequately recognized the utility or importance of

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170. Haugh, *supra* note 22, at 688.

171. Bainbridge, *supra* note 28, at 7–9.

172. John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systematic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1038 (2012) (discussing how the attestation requirement in Sarbanes-Oxley led to a wasteful and duplicative “dual audit”).

173. U.S. SENT’G GUIDELINES MANUAL § 8B2.1(b)(6) (U.S. SENT’G COMM’N 2004) (“The organization’s compliance and ethics program shall be promoted and enforced consistently throughout the organization through (A) appropriate incentives to perform in accordance with the compliance and ethics program; and (B) appropriate disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct.”).

174. According to the DoJ, “[a]nother hallmark of effective implementation of a compliance program is the establishment of incentives for compliance and disincentives for non-compliance.” *See* U.S. DEP’T OF JUST., CRIM. DIV., *supra* note 68, at 13.

175. *Id.*

176. Joseph E. Stiglitz, *Information and the Change in the Paradigm in Economics*, 92 AM. ECON. REV. 460, 487 (2002).

compliance-related practices under a fire-alarm theory of oversight.[177] This type of oversight is unique since it is decentralized, involves less active and direct intervention, and relies on interested parties within and external to the firm to trigger a compliance-related alarm that yields an effective response. The policing and architectural approaches focus on the internal aspects of the firm or the dyadic relationship between an agency or enforcement official and the firm. The information feedback loops discussed below are integrated within the entire compliance system comprised of regulators, firms, executives, and third-party relationships called inter-organizational structures. From this perspective, compliance-related activities are not limited to the firm, agency, or regulator but as a distributed locus of activity within the entire compliance system and society in general.

The fire-alarm theory of regulation is recognized as having several distinct advantages, particularly in relation to the policing approach. One advantage is that it offers regulators, firms, and executives high levels of efficiency. Engaging in a policing effort requires a significant expenditure of money, personnel, and time, yet the rewards are often uncertain.[178] In contrast, the fire-alarm approach requires less expense and yields rewards since the regulator, firm, or executive can quickly respond and take credit for avoiding a disaster.[179] The cost of maintaining a fire-alarm approach is also distributed across parties, whereas the cost of a policing approach falls entirely on the regulator or firm.[180] Having said that, this article recognizes that the policing and architectural approaches to compliance play a vital role that can be used in conjunction with the fire-alarm method to achieve the most effective levels of compliance.

Information feedback loops play three vital roles within the compliance system. First, these mechanisms help establish redundancy within the compliance system. Redundancy involves devoting more resources than is necessary to achieve a purpose. Although it might appear wasteful, redundancy is an important failsafe device since not all policing or architectural safeguards operate as intended. The various information feedback loops discussed below rely on different processes and actors; therefore, they act as a failsafe in the event the violation is not detected through traditional policing or architectural means of oversight. The use of a redundancy failsafe is a risk management approach that proves to be effective in cases dealing with substantial risk, as is the case with many compliance issues.[181]

Second, information feedback loops help the compliance system achieve homeostasis. Homeostasis is the ability of a system to respond to disturbances in the external environment.[182] For example, it is often the case that compliance failures arise due to a crisis such as decreasing market share or a disruptive new competitor. These external shocks often stress the compliance function and increase the likelihood of opportunism by corporate agents who now face pressure to deliver positive results. Information feedback loops may restore homeostasis, however, by realigning efforts to thrive in a sustainable manner that complies with regulations.

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177. McCubbins & Schwartz, *supra* note 12, at 166.

178. *Id.*

179. *Id.*

180. *Id.*

181. *Cf.* YOSSI SHEFFI, THE POWER OF RESILIENCE: HOW THE BEST COMPANIES MANAGE THE UNEXPECTED (2017) (discussing how redundancy improves resilience in supply chains).

182. Belinfanti & Stout, *supra* note 41, at 603–04.

Lastly, information feedback loops promote system-wide adaptability and learning.[183] The DoJ recognizes that "[o]ne hallmark of an effective compliance program is its capacity to improve and evolve."[184] Policymakers and corporate leaders both need information to make choices under uncertainty. These choices can benefit from the data provided by information feedback loops. For example, in the MF Global case, FINRA tipped off federal regulators that MF Global inappropriately used a financial risk calculation technique.[185] The CFTC later changed its regulation to forbid this practice.[186]

Compliance failures are often characterized as corporate governance failures, ethical lapses, or regulatory blindness yet what unites these characterizations is the presence of information asymmetries. Information asymmetries arise from the agency costs borne from the principal-agent relationship and opportunistic agent behavior that exploits these costs. At its core, compliance failures are an information asymmetry problem intricately connected to agency costs. The fire-alarm theory of oversight and resulting information feedback loops discussed in greater detail below can help relieve this source of systematic failure.

B. Agency Costs

The fire-alarm method of compliance will not eliminate agency costs; however, it will likely decrease them under certain conditions. First, since it does not follow the hierarchical and centralized approach of the policing method it will not require substantial monitoring costs. Second, the costs will be distributed more efficiently across many actors within the system. Lastly, the information feedback loops work well in cases where stakeholders have incentives to use them. Since information feedback loops are a distributed network of information pathways within the compliance system, some stakeholders arise as interested parties who will benefit from their use.

For example, class action lawyers are an institutional solution that addresses collective action and rational ignorance problems in litigation.[187] These stakeholders may benefit from the use of information feedback loops to help marshal a case against an offending company and its board in the hopes of a settlement or jury verdict. Other stakeholders such as activist investors, hedge funds, and short-sellers might use information feedback loops to exploit a litigation investment strategy and the information asymmetry created by opportunistic corporate insiders.[188] Other stakeholders such as watchdog groups, consumer and environmental activists, and non-governmental organizations may have social objectives and likewise further their agenda through their use of information feedback loops.[189] If these groups uncover a compliance failure they may generate more media

183. *Id.* at 603.

184. U.S. DEP'T OF JUSTICE CRIM. DIV., *supra* note 68, at 15.

185. Orozco, *supra* note 9, at 263.

186. *Id.*

187. *See generally* Stephen C. Yeazell, *Collective Litigation as Collective Action*, 1989 U. ILL. L. REV. 43 (1989) (describing how class action lawsuits solve problems with collective action).

188. *See* Bert Huang, *Litigation Finance: What Do Judges Need to Know?*, 45 COLUM. J. L. & SOC. PROBS. 525, 526 (2012). (". . . the use of 'alternative litigation financing' or 'third-party litigation funding' in the United States appears to be growing. Specialty firms are multiplying. Hedge funds and major banks are also getting involved.").

189. The FTC's investigation into Facebook for privacy violations was triggered through complaints filed with the FTC by the Electronic Privacy Information Center and a coalition of consumer groups. Press Release,

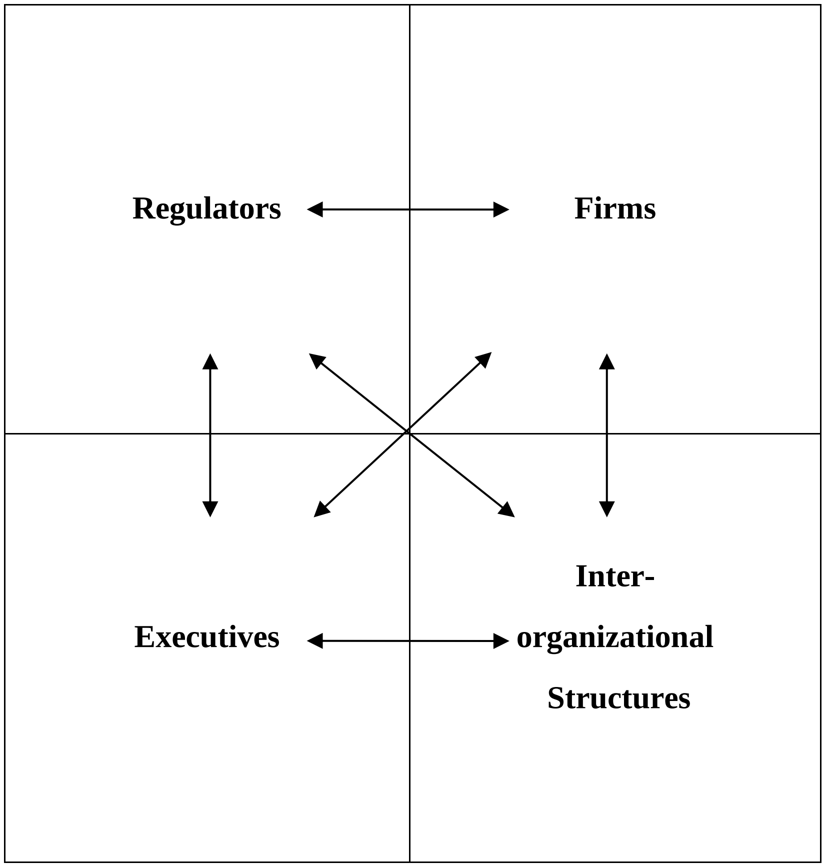
coverage of a salient social issue and obtain increased donations and membership and therefore heightened status and legitimacy. Regulators such as agencies, prosecutors, or elected lawmakers may also leverage information feedback loops to efficiently target violators and raise their own profile through successful fines, prosecutions, or settlement agreements. Inter-organizational structures may likewise employ information feedback loops for private gain such as when an insurance company tips off regulators if insurance fraud is suspected.

V. INFORMATION FEEDBACK LOOPS

Information feedback loops are conduits that allow information to flow within the compliance system among regulators, firms, executives, and inter-organizational structures. As elements of a fire-alarm theory of oversight they encourage a positive response aimed to promote compliance-related objectives. Figure 2 captures the four components of the compliance system and the various feedback loops that may exist within the elements of the system.

FTC, Facebook Settles FTC Charges That It Deceived Customers by Failing to Keep Privacy Promises (Nov. 29, 2011), https://www.ftc.gov/news-events/press-releases/2011/11/facebook-settles-ftc-charges-it-deceived-consumers-failing-keep [https://perma.cc/F86W-7Z8C].

Figure 2.



The system generates ten separate information feedback loop relationships that include:

- Regulators – Firms
- Regulators – Inter-organizational Structures
- Regulators – Executives
- Regulators – Regulators
- Firms – Inter-organizational Structures
- Firms – Executives
- Firms – Firms
- Inter-organizational Structures – Executives
- Inter-organizational Structures – Inter-organizational Structures
- Executives – Executives

Each relationship will be discussed below with examples of information feedback loops derived from practice.

A. Regulators-Firms

The regulator-firm dyadic relationship is the most extensively discussed in the literature and gives rise to five different information feedback loops comprised of: informal notice-and-comment rulemaking, board oversight duties, independent monitors, public disclosure requirements, and the use of data analytics.

1. Informal Notice-and-Comment Rulemaking

Agencies spend a considerable amount of effort soliciting, collecting, and responding to public comments during the regulatory process because they are legally required to do so under the Administrative Procedures Act.[190] Agencies must issue a notice of proposed rulemaking and then "give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments."[191] The information elicited through this process can yield greater insight and a broader perspective and allows the regulator to view information from the perspective of various regulated entities and important stakeholders such as consumer groups, watchdogs, and non-governmental organizations who might report failures within the existing system.

This process can trigger an alarm in cases when an interested party alerts the regulator of a risk or compliance deficiency. A contributing factor in Boeing's MAX 737 compliance failure was that the company exploited an exemption to this public input process and bypassed the public scrutiny process of their proposed regulatory exemption.[192]

2. Board Oversight Duties

State courts have the power to craft legal standards that impose personal liability for the breach of a fiduciary duty related to a compliance failure. Yet, the *Caremark* duties crafted by the Delaware Supreme Court for duty of oversight liability due to compliance failures have been difficult to enforce against directors. As regularly stated by the courts these "are among the most difficult of corporate claims"[193] to pursue successfully since the required element for a claim of this type is the breach of duty of loyalty. This requires proof of bad faith or intentional wrongdoing by directors.[194]

More recently, however, the Delaware Supreme Court in *Marchand v. Barnhill* addressed *Caremark* duties, holding that a complaint may survive dismissal if the board does not address one of the major areas of regulatory risk affecting a company, or have protocols in place for acquiring information related to this major source of risk. In this case, the company that makes Blue Bell ice cream faced liability since the ice cream it produced injured consumers. As the court stated: "As a monoline company that makes a single product—ice cream—Blue Bell can only thrive if its consumers enjoyed its products and were confident that its products were safe to eat. That is, one of Blue Bell's central compliance issues is food safety."[195] Also, executives' interactions with product safety

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190. *See* Michael A. Livermore et al., *Computationally Assisted Regulatory Participation*, 93 NOTRE DAME L. REV 977, 983 (2018) (stating that "[t]his procedural notice-and-comment requirement has been given teeth (and arguably claws) through the hard look review that courts undertake under the APA's 'arbitrary' or 'capricious' standard.").

191. 5 U.S.C. § 553(c) (2012).

192. Gates et al., *supra* note 4.

193. Stone v. Ritter, 911 A.2d 362, 372 (Del. 2006).

194. Gail Weinstein et al., *Delaware Supreme Court Reverses Dismissal of Fiduciary 'Caremark' Suit After Finding Lack of Board-Level Oversight*, 30 WESTLAW J. MERGERS & ACQUISITIONS 01 (Sept. 19, 2019).

195. Marchand v. Barnhill, 212 A.3d 805, 809 (Del. 2019).

regulators in that case were insufficient. The board needed to be apprised of these issues and take an active role managing important regulatory risks such as health and food safety.[196]

Thus, the Delaware Supreme Court fashioned what one prominent scholar views as a heightened duty of the board to avoid willful ignorance or knowledge of ineffective compliance;[197] for example, the failure to have the requisite expertise to address major sources of regulatory risk (food safety for a food company) and to have procedures and systems in place that allow information related to this type of regulatory risk to reach the board for deliberation and action. The *Marchand v. Barnhill* case thus creates a duty to implement alarm-styled information feedback loops within companies that connect regulators and the board with respect to regulatory risk-related matters that are of material concern to the business.

3. Independent Monitors

A controversial structural oversight technique that allows compliance-related information to flow directly between the firm and regulators is the use of independent monitors.[198] This fire-alarm technique is reserved for cases where a firm has been investigated for compliance lapses and it is usually an aspect of a settlement agreement between a prosecutor and the firm.[199] The use of monitors has been critiqued as an overly intrusive and costly structural governance tool.[200] However, external monitors may be necessary for firms that require extensive oversight due to prior misbehavior that evidences a clear disregard for the law and that reaches the highest levels of the organization.

4. Public Disclosure Duties

There is no general regulation that requires companies to disclose compliance-related issues to the public or a regulatory body.[201] A publicly-traded company, however, will have disclosure duties with respect to anything deemed material to investors.[202] Some companies go beyond what is legally required and discuss compliance activities and risks as part of a corporate social responsibility program.[203]

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196. *Id.*

197. *See* Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 VAND. L. REV. 2013, 2045 (2014) (concluding that "[r]egarding the second prong, this Article's analysis suggests that the *Caremark* standard need not be applied so stringently as to require disobedience bordering on outright complicity or knowing misconduct. The stated standard of conscious disregard is amply capacious to also capture fiduciaries acting with willful ignorance or an awareness that their efforts at compliance are insufficient.").

198. *See generally* Cristie Ford & David Hess, *Can Corporate Monitorships Improve Corporate Compliance?*, 34 J. CORP. L. 679 (2008) (describing the evolution of corporate monitorships as a result of settlement agreements).

199. *Id.*

200. *See* Baer, *supra* note 23, at 1060–70 (describing why monitors are overly intrusive and costly).

201. Griffith, *supra* note 3, at 2100.

202. *See generally* Steven E. Bochner & Samir Bukhari, *The Duty to Update and Disclosure Reform: The Impact of Regulation FD and Current Disclosure Initiatives*, 7 STAN. J.L. BUS. & FIN. 225 (2002) (describing the duties to disclose at a publicly traded company).

203. *See* Phillips & Barboza, *supra* note 86 (stating that some companies are opting to meet higher standards than the current laws in place); David A. Dana & Janice Nadler, *Regulation, Public Attitudes, and Private Governance*, 16 J. EMP. L. STUD. 69, 85 (2019) (finding empirical support for corporate social responsibility efforts that generate a favorable public reaction that translates into regulation); Ann M. Lipton, *Mixed Company:*

In some narrow instances, statutes or regulations require an affirmative disclosure of a compliance-related issue. For example, in the banking sector, financial institutions have an affirmative duty to file suspicious activity reports to the Treasury Department.[204] Several states have imposed affirmative duties in cases where data breaches have compromised consumer data and require consumers to be notified in the event their data has been breached.[205]

5. *Data Analytics*

Regulators increasingly mine public data to detect red flags or patterns of non-compliance.[206] Since a considerable amount of information is now stored electronically in databases, regulators are reviewing this information to detect violations. For example, agencies such as the SEC mine trading data to detect patterns of possible insider trading[207] and make use of proprietary algorithms to detect abnormal investment returns that merit additional scrutiny.[208] To reduce Medicare insurance fraud, the U.S. Centers for Medicare and Medicaid Services released datasets to increase transparency in healthcare and identify fraud within Medicare.[209]

Recently, the DoJ stated that during investigations and settlement discussions with violators it would ask companies about their own internal uses of data analytics to detect and prevent wrongdoing and that this will be a factor that lessens the severity of sentencing recommendations.[210] Regulators and SROs are also strengthening their own internal data management practices to improve fraud detection and investigation capabilities.[211] When coupled with artificial intelligence and other sophisticated algorithms, the use of big data is a practice at the frontier of alarm-styled compliance oversight.

The Audience for Sustainability Disclosures, 107 GEO. L.J. ONLINE 81, 87 (2018) (discussing how "[w]e may need to create a new disclosure framework attuned not just to the informational needs of investors, but also to the informational needs of the general public").

204. 12 C.F.R. § 21.11 (2011).

205. *See, e.g.*, FLA. STAT. § 501.171 (2019) (stating that certain security breaches require notice of the breach).

206. Matthew S. Miner, Deputy Assistant Att'y Gen., Remarks at the 6th Annual Government Enforcement Institute (Sept. 12, 2019).

207. *See* Todd Ehret, *SEC's Advanced Data Analytics Helps Detect Even the Smallest Illicit Market Activity*, REUTERS (June 30, 2017), https://www.reuters.com/article/bc-finreg-data-analytics/secs-advanced-data-analytics-helps-detect-even-the-smallest-illicit-market-activity-idUSKBN19L28C (explaining that enhanced data analytics can quickly detect insider trading).

208. *Early Fraud Detection: How the SEC Uses Data Mining*, CLARK SCHAEFER HACKETT (June 21, 2012), https://www.cshco.com/articles/early-fraud-detection-how-the-sec-uses-data-mining/ [https://perma.cc/4TNN-W3Q9].

209. *New Medicare Data Available to Increase Transparency on Physician Utilization,* U.S. CTRS. FOR MEDICARE & MEDICAID SERVS. (June 1, 2015), https://www.cms.gov/newsroom/fact-sheets/new-medicare-data-available-increase-transparency-physician-utilization [https://perma.cc/G86T-QGPH].

210. Miner, *supra* note 206.

211. *See* FIN. INDUS. REGUL. AUTH. SPECIAL REV. COMM., REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA'S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND MADOFF SCHEMES 4–75 (2009), https://www.madcowprod.com/wp-content/uploads/2012/03/FINRA.pdf [https://perma.cc/8BZM-2EZ9] ("Technological improvements should be made to the principal information technology systems utilized by the examination staff. The goal should be to make more member firm data readily available to the examination staff, including all significant changes in member firms, regulatory actions, and significant documents.").

B. Regulators-Inter-organizational Structures

1. Oversight

A principal information feedback loop in this relationship involves agency oversight of SROs or third-party monitors. For example, the SEC has delegated authority to, and exercises oversight over, FINRA.[212] FINRA is a self-regulatory organization that supervises broker-dealers under the Securities and Exchange Act of 1934.[213] FINRA implements rules developed by the SEC and as a matter of course, FINRA offers technical assistance and coordinates with the SEC and other regulators to help improve its oversight functions.[214] SROs are important sources of industry practices and developments and they can help regulators detect new types of activity that can generate systemic risk and red flags.[215]

2. Complaints

Regulators may also receive complaints or tips from third parties. In the securities and insurance industry, for example, a competitor or insurance provider that suspects fraud has a financial incentive to report suspected abuse to regulators. Consumers and former employees can also be an important source of information that alerts regulators to potential non-compliance.[216] In many cases, the process is simple, and the transaction costs are low for reporting a suspected violation.

Agency costs within the regulatory system, however, might frustrate these important sources of information in two ways. First, regulators and law enforcement may be overwhelmed with information and may not appropriately respond to the alarm. Second, capture or influence exerted by industry may silence the alarm through the political or lobbying process. A solution to the first problem is to create more efficient data management techniques such as procedures for assessing data and enhancing databases to lower information costs.[217]

An effective approach to limit the second problem is transparency. One approach may be for regulators to engage in a precommitment strategy and publicly post complaints and tips. This will increase transparency and serve as a redundancy fail-safe since these important alarms may be acted on by other interested stakeholders who may triage and triangulate efforts and act on private incentives to pursue legal action or a non-market

212. FINRA regulates all broker-dealers that interact with the public and derives its authority to do so under the Securities and Exchange Act of 1934. *See* Macey & Novogrod, *supra* note 148, at 964 (stating that "FINRA was created pursuant to the Securities Exchange Act of 1934 . . . which contemplated a system wherein member-owned securities exchanges and broker-dealer associations would regulate the activities of its member securities firms, subject to the oversight of the Securities and Exchange Commission . . . ."). *See also* Van Loo, *supra* note 152, at 399–400 (stating that "[a]gencies also enlist a growing number of private third-party monitors to assess compliance.").

213. Macey & Novogrod, *supra* note 148, at 964.

214. *See* FINRA, *supra* note 211, at 71 (concluding that "[w]hile a number of these recommendations can be effected by FINRA alone, others will require the concurrence of the SEC and a critical recommendation as to the expansion of FINRA's jurisdiction will require Congressional action").

215. *Id.* at 74–76.

216. *Id.* at 13–18.

217. *Id.* at 74–75.

strategy such as public shaming or boycotts.[218]

C. Regulators-Executives

Whistleblowers are an important information feedback loop within the compliance system that connect regulators and executives and act as a powerful fire-alarm. Some high-level compliance investigations were initiated by the efforts of a whistleblower who brought corporate malfeasance to light. Federal statutes such as Sarbanes-Oxley codify anti-retaliation protections for whistleblowers and Dodd-Frank provides bounties to whistleblowers who provide the SEC with information that leads to a successful enforcement action.[219] These protections maintain an important line of communication between corporate agents and regulators, particularly when agency costs lead to shirking or self-dealing and suppress this information to the detriment of the principal firm.

D. Regulators-Regulators

Regulators routinely interact with other regulators housed in separate agencies. Our regulatory system is characterized by shared regulatory spaces.[220] In this space, agencies have fragmented or overlapping authority. This has benefits and drawbacks since it might create turf wars, allow firms to play regulators off each other through a strategy of regulatory arbitrage, and raises the principal-agency costs of coordination among agencies and regulated entities. Collaboration, resource sharing, and trust are critical to ensure adequate regulatory oversight under this system.[221] Since information will be distributed across several regulators, this feedback loop requires intensive collaborations and a culture of teamwork and openness. The incentive among some regulated firms is to strategically parcel information to different regulators and pit them against each other.[222]

E. Firms-Inter-organizational Structures

1. Certifications

Some organizations offer certifications related to compliance. For example, the International Organization for Standardization has recently promulgated ISO 37001, the first international standard designed to help an organization implement an anti-bribery management system and enhance existing internal controls.[223] The audit to achieve this certification is performed periodically by a third-party external auditor.[224] This type of

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218. *See generally* David P. Baron & Daniel Diermeier, *Strategic Activism and Nonmarket Strategy*, 16 J. ECON. & MGMT. STRAT. 599 (2007) (describing how activist NGOs may seize the opportunity to act on private incentives).

219. 17 C.F.R. § 240.21F-2 (2011); *see also* Jennifer M. Pacella, *Silencing Whistleblowers by Contract*, 55 AM. BUS. L.J. 261, 266–79 (2018) (detailing the Dodd-Frank Rule protecting whistleblowers).

220. *See generally* Freeman & Rossi, *supra* note 56 (explaining why regulators act in a way requiring agencies to "share regulatory space").

221. *Id.*

222. *See generally* Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010) (describing the conditions under which firms may pit agencies against one another).

223. INT'L STANDARDS ORG., ISO 37001 ANTI-BRIBERY MANAGEMENT SYSTEMS, https://www.iso.org/iso-37001-anti-bribery-management.html [https://perma.cc/S6VB-9Y5C] (last visited Sept. 1, 2020).

224. *Id.*

information feedback loop allows deficiencies within a compliance system to be reported back to the firm's board, top management, and external constituencies such as regulators, customers, and investors.

Other companies offer external audits of supply chains and sub-contractors to ensure legal compliance with regulations. For example, a company called ISN audits sub-contractors to ensure they comply with job-site health and safety regulations.[225] Any deficiencies will alert the contracting firm and trigger a corrective response that ensures compliance.

2. *Private Information Disclosures*

A feedback loop that may play a greater role in the future is the request to inspect corporate books and records brought under Section 220 of the Delaware General Corporation Law. Section 220 gives stockholders of Delaware corporations the ability to inspect certain corporate books and records provided the requester demonstrates a "proper purpose" for seeking such materials.[226] To demonstrate that an investigative purpose is proper, the stockholder must prove by a preponderance of evidence "a credible basis from which the court can infer that mismanagement, waste or wrongdoing may have occurred."[227]

This duty of information disclosure allows important compliance-related information to flow between the firm and external parties such as stockholders. Investors who are injured due to the failure of oversight related to compliance matters may seek to hold fiduciaries personally responsible and use these types of information requests to initiate a civil case concerning a board's failure to exercise its *Caremark* oversight duties with respect to positive law such as a consent decree, statute, or regulation.

A recent case involving Facebook illustrates the use of this information feedback loop.[228] In 2011, Facebook entered into a consent decree with the Federal Trade Commission and agreed to implement more stringent measures to protect the privacy and security of its users' data.[229] This process was to be monitored by an external data security expert and the reports and oversight of this activity were to be led by a specialized audit committee of Facebook's board of directors.[230] In 2018, stockholders sued Facebook to obtain internal company records under a Section 220 request to assist them in their litigation against Facebook for failing to protect the data of 87 million users during the Cambridge Analytica data breach scandal.[231] The Delaware Chancery Court granted the motion to compel information and stated:

> In light of the low Section 220 evidentiary threshold, I am satisfied Plaintiffs have proven "legitimate issues of wrongdoing." Stated differently, Plaintiffs have presented some evidence that Facebook's directors and officers may have

225. *See generally Platform Overview,* ISN, https://www.isnetworld.com/en/contractor-management-solution [https://perma.cc/N3ZP-W44P] (last visited Sept. 1, 2020) (describing ISN's purpose).

226. DEL. CODE ANN. tit. 8, § 220 (2016).

227. Seinfeld v. Verizon Commc'ns, Inc., 909 A.2d 117, 118 (Del. 2006); DEL. CODE ANN. tit. 8 § 220(b) (2020).

228. *In re* Facebook, Inc. Section 220 Litig., Consol. C.A. No. 2018-0661-JRS (Del. Ch. May 31, 2019).

229. *Id.* slip op. at 2.

230. *Id.* slip op. at 10

231. *Id.* slip op. at 2

> breached their Caremark duties, particularly in light of the [FTC] Consent Decree in place at the time of most of the data privacy breaches alleged in this action.[232]

F. Firms-Executives

The firm-executive relationship is a critical information pathway since executives play an integral role as gatekeepers of information. This section discusses four information feedback loops comprised of specialized board committees, agency lines of reporting and authority, data management and analytics, and anonymous hotlines.

1. Specialized Board Committees

An important information conduit within the compliance system is the ability of the firm's board to exercise appropriate compliance-related oversight. As discussed earlier, the *Marchand v. Barnhill* case creates a heightened duty on a Delaware corporation's board to be apprised of important sources of regulatory risk.[233] This has a direct relation to compliance since non-compliance can cripple a company. As recognized by the court and legal commentators, one way the board can insulate itself from personal liability in these cases is to designate a specialized sub-committee within the board to address the regulatory risk associated with positive law.[234] This requires the members of these specialized board subcommittees to have the required level of knowledge related to regulations and their frequent monitoring of the regulatory risks related to important business issues. Interactions between the firm's senior executives and regulators are no longer sufficient to avoid the *Caremark* duty of oversight liability.[235] These interactions are now supposed to be reported to, and acted upon, by the board.[236]

2. Agency Lines of Reporting and Authority

Firms are expected to devise the agency structures, reporting lines and levels of authority related to compliance.[237] For example, some firms delegate compliance authority to the CEO.[238] The consensus is that large organizations, and particularly those in regulated industries, should create a separate function specifically related to compliance and appoint a Chief Compliance Officer (CCO).[239] It is also the consensus that a compliance department and its employees should report to the board and the CEO. The potential for information to be suppressed due to higher agency costs increases when compliance officers are not provided with the appropriate authority or when they are made to report to another executive such as the Chief Financial Officer or the Chief Legal Officer.

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232. *Id.* slip op. at 6.

233. Marchand v. Barnhill, 212 A.3d 805, 822–23 (Del. 2019).

234. *See* Weinstein et al., *supra* note 194, at 5.

235. *Marchand*, 212 A.3d at 822 ("At best, Blue Bell's compliance with these requirements shows only that management was following, in a nominal way, certain standard requirements of state and federal law. It does not rationally suggest that the board implemented a reporting system to monitor food safety or Blue Bell's operational performance.").

236. *Id.* at 824.

237. Griffith, *supra* note 3, at 2101–02.

238. PRINCIPLES OF THE L. COMPLIANCE, RISK MGMT., AND ENF'T § 3.14 (AM. LAW INST., Tentative Draft No. 1, 2019).

239. Griffith, *supra* note 3, at 2101–02.

Compliance and risk management officers are often privy to critical compliance-related information that can be acted upon by the board. A red flag arises when the CEO alters reporting structures so that compliance-related information is kept from the board. This occurs when the CEO alters the top compliance officers' reporting line to another executive or prevents this officer from communicating with the board. Several cases of compliance failures highlight the heightened agency costs and significant risks of decentralizing compliance and placing compliance under the direction of executives further below the corporate hierarchy.[240]

3. Data Management and Analytics

Firms and regulators increasingly view compliance as an information management activity.[241] Compliance departments can use information as a feedback loop to monitor behavior that can trigger warnings or red flags. Along these lines, compliance departments can use information repositories and data analytics techniques to predict compliance failures. The use of big data, algorithms, and artificial intelligence may be the next frontier for the compliance industry.

Simple but creative techniques that use data can yield positive results. For example, athletics in higher education is regulated by federal statutes and NCAA regulations.[242] Several high-profile scandals at universities have involved student-athletes engaged in academic fraud.[243] A key practice involves academic advisors who funnel student-athletes into fake "paper courses" to ensure student-athletes receive high marks and remain academically eligible to compete. To control for this risk, some universities now monitor registrar data to detect patterns that might indicate whether certain advisors are funneling student-athletes into particular courses. These examples suggest data can play a key role to prevent, detect, and investigate compliance failures.[244] These examples also indicate a certain level of sophistication and cooperation necessary to work with other departments that maintain critical data, for example, IT departments. Since effective compliance oversight that incorporates the use of fire-alarms is cross-disciplinary, this calls to attention the critical need for a compliance officer to have the appropriate level of senior management support to have access to the data that is necessary to allow a fire-alarm to be utilized.

To appropriately manage risk and follow industry practices large organizations deploy

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240. *See* Orozco, *supra* note 9, at 262 (discussing how the CEO of MF Global reassigned the Chief Risk Officer's reporting line to avoid hearing risk-related concerns).

241. *See generally* Root, *supra* note 16, at 1029–32 (describing the transition to viewing compliance as an information management activity); Miner, *supra* note 206.

242. *See, e.g.*, NAT'L COLLEGIATE ATHLETIC ASS'N, 2020-21 NCAA DIVISION I MANUAL § 12.3.1 71 (2020), https://web3.ncaa.org/lsdbi/reports/getReport/90008 [https://perma.cc/6MVY-S44L] (forbidding student athletes from being represented by agents).

243. *See* Sara Ganim & Devon Sayers, *UNC Report Finds 18 Years of Academic Fraud to Keep Athletes Playing*, CNN (Oct. 23, 2014), https://www.cnn.com/2014/10/22/us/unc-report-academic-fraud/index.html [https://perma.cc/PQ23-RGXT] (describing student-athlete scandal at University of North Carolina).

244. Martinez, *Complex Compliance Investigations*, *supra* note 22, at 286 (focusing "on the detection and investigative stages [of compliance] and the continuum between them. [Also, demonstrating that] many recent compliance failures within organizations might have been avoided if more robust processes—meaning the actions, practices, and routines that firms can employ to communicate and analyze information—had been in place to ensure investigations were conducted in a manner that allowed the firm to analyze information from diverse areas within the firm.").

sophisticated and resource-intensive data management techniques. These techniques nonetheless require appropriate oversight. For example, Wells Fargo employed a fairly sophisticated employee termination database that documented the reasons for termination due to an internal investigation.[245] The number of terminations due to fraudulent account-related practices was increasing at an alarming rate and was recorded in this database.[246] These terminations raised an alarm, yet, the decentralized compliance head within the business group where the fraud occurred challenged the data and prevented the information from reaching senior risk and audit officers who monitored company-wide risks.[247]

4. Anonymous Hotlines

An anonymous hotline can encourage tipsters to submit information that can alert compliance departments and other firm executives of regulatory violations. Yet, to be effective, these information feedback loops must be administered with appropriate oversight and integrity. First, the hotlines should allow users to report anonymously and protect the identity of the tipster. The fear of reprisal is considerable since whistleblowers often experience retaliation.[248] Second, the hotline should maintain a line of communication with the whistleblower to ensure that follow-up information can be gathered by those in charge of compliance. Third, the company should take action to correct the issues.

G. Firms-Firms

Firm-to-firm information feedback loops require board-level interactions within both entities. One way firms can achieve these high-level feedback loops is to form an alliance to share information, best practices, and regulatory risk management techniques. Some companies decide to do this after a major compliance and regulatory failure in the efforts to improve their reputation and demonstrate a credible commitment to reforms. For example, some firms in the manufacturing industry have formed compacts with other firms to promote human rights and ethical supply chain practices.[249]

One example of this is the Accord on Fire Building and Safety in Bangladesh.[250] This accord was created after the Rana Plaza garment factory building collapsed and killed 1,133 people.[251] Signatories include global garment companies and labor unions. The accord has several fire-alarm components such as procedures to file safety and health complaints, disclosures of inspection reports, and corrective action plans that are designed

245. INDEP. DIRS. OF THE BD. OF WELLS FARGO & CO., *supra* note 14, at 50.

246. *Id.*

247. *Id.*

248. *See* Matt Egan, *I Called the Wells Fargo Ethics Line and Was Fired*, CNN (Sept. 21, 2016), https://money.cnn.com/2016/09/21/investing/wells-fargo-fired-workers-retaliation-fake-accounts/index.html [https://perma.cc/3BM8-HNHN] (detailing an employee's termination after calling an ethics hotline and sending an email to human resources).

249. *About*, ACCORD ON FIRE & BLDG. SAFETY IN BANGLADESH (2018), (last visited Mar. 6, 2020), https://bangladeshaccord.org/about [https://perma.cc/MJ5Q-LUVX]. The full accord is available at https://bangladesh.wpengine.com/wp-content/uploads/2018/08/2018-Accord.pdf [https://perma.cc/5LLF-QBQA].

250. *Id.*

251. *Id.*

to save lives.[252]

H. Inter-organizational Structures-Executives

Individual executives provide information feedback to their organizations through their participation in professional societies. For example, a growing compliance association is the Society for Corporate Compliance and Ethics (SCCE). These societies may facilitate information sharing through seminars, guides, reports, best practices, and case studies. The information gained from these societies may be transferred back to the organization to identify gaps or weaknesses and help strengthen compliance practices.

I. Inter-organizational Structures-Inter-organizational Structures

Agencies and third-party organizations collaborate to share information related to regulatory violations or risky business practices. Agencies with fragmented authority must collaborate and share information to effectively regulate industry. For example, in the financial sector SROs such as FINRA and regulatory agencies such as the SEC and CFTC often share information to effectively regulate industry. This is particularly necessary when a firm parcels out information to distinct agencies and attempts to engage in regulatory arbitrage.[253]

J. Executives-Executives

Executives who interact with other executives may share stories, experiences, and knowledge to strengthen the compliance infrastructure within their organizations and alert each other of violations and potential risks. Executives often trigger an alarm to their supervisor when they sense a violation has occurred. It is the role of the supervisor to act on that information and inform those higher up the chain about the violation. To achieve an effective reporting system, executives must cultivate an environment of openness, trust, and accountability.

VI. THEORETICAL AND POLICY IMPLICATIONS

Several theoretical and normative policy implications arise from the analysis of information feedback loops under a fire-alarm styled approach to regulation and compliance. This section will discuss the various implications that arise in relation to corporate governance theory, public policy, laws, regulations, and compliance-related practices within firms.

A. Theoretical Implications

The introduction of fire alarm-styled compliance contributes to a growing body of theoretical literature in this field. The approach has both descriptive and normative value since it seeks to promote the aims of regulation. Yet, fire-alarm-styled compliance has broader implications with respect to corporate governance.

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252. *Id.*

253. *See* Fleischer, *supra* note 222, at 230 (describing regulatory arbitrage as the legal technique used to avoid the implications of regulatory schemes).

First, the fire-alarm approach to compliance positively addresses what scholar Kim Krawiec labels an "incomplete contracts governance theory" under negotiated forms of governance.[254] The policing compliance approach is particularly problematic from this perspective since vague laws and regulations are likely to lead to opportunistic behavior by parties such as attorneys and consultants who will advocate for structural compliance reforms that generate inefficient and ineffective cosmetic compliance reforms.[255] Yet, the fire-alarm approach, as an aspect of negotiated governance,[256] mitigates the risk of a cosmetic compliance program since it addresses the principal problem of agency costs and distributes governance to actors who have an interest to promote regulation, resulting in real compliance versus cosmetic compliance.

Second, a fire-alarm approach fits nicely within the board supremacy perspective of corporate governance.[257] From the perspective of fire alarms, boards are the appropriate and ultimate locus of managerial oversight and fiduciary responsibility to both the firm and its owners. This rejects the managerialist perspective of the firm where boards are relegated to a secondary status and are in effect subservient to managers.[258]

The fire-alarm approach to compliance extends theory in that it also promotes the goals of stockholders and stakeholders under the director primacy theory of corporate governance. Often, these interests are viewed as contradictory. Yet, from the perspective of agency and information costs, fire alarms help reduce informational asymmetries and allow a variety of stakeholders such as customers, suppliers, stockholders, and policymakers to trigger warnings that will help the firm, acting through its board, to satisfy its regulatory obligations.

Scholars have decried the increasingly public nature of corporate governance due to the increasing regulatory burdens imposed on companies, structural oversight reforms imposed by zealous prosecutors, and the increased criminalization of compliance. In many ways, corporate compliance challenges existing notions of corporate governance and highlights the tension between the public aims of regulation and the desire among corporate actors to regulate their activities through private law.[259] In his classic article on board supremacy, Professor Stephen Bainbridge stated:

> Proponents of shareholder wealth maximization typically treat corporate governance as a species of private law, such that the separation of ownership and control does not in and of itself justify state intervention in corporate governance. In contrast, stakeholderists commonly treat corporate governance as a species of public law, such that the separation of ownership and control becomes principally a justification for regulating corporate governance so as to achieve

254. *See* Krawiec, *supra* note 156, at 516 (stating that "negotiated governance models vary in their particulars, they share two common themes. First, all assert that regulation should be more co-operative and collaborative, and less authoritative. Second, each rests on an assumption that greater involvement in the governance process by a variety of interested groups—including the regulated group—will produce a more effective regulatory regime.").

255. *Id.* at 522–32.

256. *See generally* Freeman, *supra* note 55 (arguing for a collaborative governance system).

257. Bainbridge, *supra* note 91.

258. *Id.*

259. *See* Griffith, *supra* note 3, at 2079 (discussing how compliance subverts traditional notions of corporate governance and theories of the firm since regulators and compliance officers have supplanted the traditional role of shareholders, boards, and executives in the execution of corporate governance within firms).

social goals unrelated to corporate profitability.[260]

The fire-alarm approach to compliance helps reconcile these two seemingly divergent aspects of governance. An effective fire-alarm approach to compliance will reduce agency and information costs within the firm and among external parties. These information flows will then channel back to the board as the ultimate and proper locus of authority and oversight.[261] Yet, in doing so the fire-alarm approach also supports the public aims of regulation by empowering various stakeholders within the compliance system to sound an alarm so appropriate action may be taken by the board. In this way, the interests of stockholders, the firm, and stakeholders are all aligned through this third method of compliance oversight.

If proven effective, greater use of fire alarm-styled governance and compliance will also reduce the temptation among regulators, prosecutors, and lawmakers to enact overly-aggressive or punitive measures against firms that result in inefficient or quack corporate governance.[262] For example, scholars foresee greater federalization of corporate governance due to public pushback since state law has, to an extent, failed to hold corporate leaders accountable for their oversights.[263] Much like the good faith fiduciary obligations and duties of oversight serve the expressive purpose of reinforcing the legitimacy of corporate governance, information feedback loops can also serve a similar expressive goal that restores faith in state corporate governance law and avoids drastic federalization of this area of law.[264]

From a systems theory perspective, information feedback loops help promote the normative goal of compliance; however, they also help maintain stability and continuity within the entire regulatory system. As professors Belinfanti and Stout stated in their work on systems theory and corporate governance, "[a] second sustainability mechanism found in many systems is homeostasis—that is, information and control feedback loops that allow the system to adjust to disturbances in its external environment and stay within the parameters necessary for continued functioning."[265] Information feedback loops thus allow firms to maintain their existence; however, they also reduce the chances that failures due to the actions of a few bad actors will lead to wholesale reforms across the system.

In the past, system-wide regulatory reform has been brought about by the actions of a few bad actors in highly publicized cases. One example of this was the passage of Sarbanes-Oxley in response to the bad behavior and non-compliance within companies like Enron, Worldcom, and Tyco.

Scholars have criticized such wholesale and reactionary reform as inefficient and unduly punitive to the majority of firms who do not misbehave.[266] Greater reliance on information feedback loops within these scenarios may have prevented or lessened the negative impact of these failures by bringing to light the illegal activity in a manner that would eliminate the need for wholesale reforms.

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260. Bainbridge, *supra* note 91, at 549.

261. *Id.* at 552.

262. *See generally* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005) (describing a "quack corporate governance").

263. Pollman, *supra* note 197, at 2030.

264. *Id.*

265. Belinfanti & Stout, *supra* note 41, at 603–04.

266. *See* Romano, *supra* note 262, at 1587–90 (noting that Sarbanes-Oxley created differing burdens on smaller firms compared with larger firms).

Another important theoretical insight is that information feedback loops are not intended to supplant the policing or architectural compliance approaches. Each of these approaches has strengths and weaknesses and may complement one another to create a more robust, effective, and efficient compliance system. Information feedback loops, however, address a weakness in the other two approaches since they distribute oversight to parties outside the firm and help reduce information asymmetries and agency costs across the system. For example, a regulator's policing approach consisting of a site inspection may trigger a fire-alarm style approach that involves a Section 220 information request under Delaware law. Combined, these two compliance approaches may trigger the necessary internal reforms that strengthen overall compliance within a firm or raise the alarm with respect to other compliance failures that need to be remediated.

In some cases, a hybrid approach will yield the best results. For example, an external compliance certification process may reveal deficiencies or red flags as a fire-alarm and effectively integrate elements of a board-level pre-commitment strategy under the architectural approach. Also, a Section 220 demand for corporate information that is used in shareholder litigation might be used by a regulator or compliance department to facilitate an internal investigation under a policing approach. These examples demonstrate how a triangulated compliance approach that involves public and private actors may yield the most efficacious results.

B. Public Policy Implications

In today's era of reduced oversight and deregulation, information feedback loops serve a vital public interest to promote greater compliance that may not be achieved through the policing or architectural approaches. Corporate lobbyists influence legislatures to promote deregulation and regulatory agencies may fall prey to industry capture since the heads of agencies are often political appointees and increasingly former industry executives.[267] In this laissez-faire regulatory environment, checks and balances are critical to ensure accountability, transparency, and the public aims of regulation and legislation. Information feedback loops can help promote these important public policy aims. In light of this, lawmakers, courts, agencies, and firms should strive to strengthen the effectiveness of information feedback loops through legislation, regulation, case law, and corporate governance practices. Since several of the information feedback loops also generate incentives for actors within the compliance system, this approach has the virtue of efficiency compared to the policing and architectural approaches.

As the systems theory of compliance demonstrates, there is no universal architect or designer who can oversee the entire compliance system. In this scenario, where agency costs persist across system components, stakeholders should be empowered to report and act on information triggered as a fire alarm. Information feedback loops provide this safety valve and provide society the benefit of greater redundancy within the system. This may

267. *See* Benjamin P. Edwards, *The Dark Side of Self-Regulation*, 85 U. CIN. L. REV. 573, 607 (2017) (stating that "[e]ven with independent, effective, and competent frontline personnel, financial regulators may perform poorly if the 'message from the top skews their effectiveness.' For example, an organization's board may reduce enforcement budgets or issue directives to expedite oversight examinations." (quoting Steven Davidoff Solomon, *The Government's Elite and Regulatory Capture*, N.Y. TIMES (June 11, 2010), http://dealbook.nytimes.com/2010/06/11/the-governments-elite-and-regulatory-capture [https://perma.cc/LR65-YA8E])).

lead to some short-term inefficiencies; however, over the long-term, they increase the probabilities of detection.

The effectiveness of fire alarms that use data analytics as a detection or preventive measure should compel regulators and law enforcement to require companies to make greater internal use of data analytics as a fire-alarm technique. Companies may be incentivized to use this type of fire alarm in compliance if prosecutors make greater use of it as a factor to induce favorable settlements and sentencing recommendations.[268] Regulators may also strengthen their efforts to divulge public data that interested stakeholders may use to trigger an alarm. For example, state attorney general consumer protection divisions receive complaints directly from consumers. Releasing complaint data to the public might raise a fire alarm and be used by internal and external company stakeholders to investigate company practices. Data that can be used in this triangulated manner is released by the SEC to find patterns of insider trading or securities fraud and the Department of Health and Human Services to investigate cases of Medicare and Medicaid fraud.[269] State courts can strengthen the compliance system by following the example of the Delaware Supreme Court in the *Marchand* and *Facebook* cases. In *Marchand*, the Delaware Supreme Court heightened the duty on boards to monitor positive law and regulatory risks. In the *Facebook* case, the Delaware Chancery court affirmed a low evidentiary threshold for stockholders to obtain internal records related to regulatory oversight duties. Directors' fear of personal liability due to inadequate regulatory oversight and the requirement to produce internal documents related to these issues are two important fire-alarm processes that can greatly improve regulatory compliance. State courts should thus expand the oversight duties for directors to include an affirmative duty to oversee critical regulatory risks and establish low evidentiary thresholds for internal document requests.

Regulators should also encourage and protect whistleblowers. The repercussions of blowing the whistle can be significant and detrimental and include adverse employment actions, shunning, or even litigation. Regulators and policymakers can protect whistleblowers by granting them statutory immunity or common law protections such as the public policy exception to an at-will employment termination. For example, employment law doctrines such as the public policy exception protect whistleblowers who report a violation to a public authority.[270] Specific statutes also protect this source of

268. *See JPMorgan Chase & Co. Agrees to Pay $920 Million in Connection with Schemes to Defraud Precious Metals and U.S. Treasuries Markets*, U.S. DEP'T OF JUST. (Sept. 29, 2020), https://www.justice.gov/opa/pr/jpmorgan-chase-co-agrees-pay-920-million-connection-schemes-defraud-precious-metals-and-us [https://perma.cc/57R5-RA27] (discussing how the deferred prosecution agreement was based on JPMorgan Chase & Co. "revising their trade and electronic communications surveillance programs, implementing tools and processes to facilitate closer supervision of traders, taking into account employees' commitment to compliance in promotion and compensation decisions, and implementing independent quality assurance testing of non-escalated and escalated surveillance alerts").

269. *New Medicare Data Available to Increase Transparency on Hospital and Physician Utilization*, *supra* note 209.

270. *See, e.g.*, Keveney v. Mo. Mil. Acad., 304 S.W.3d 98, 101 (Mo. 2010) (holding, in part on grounds of public policy, that an employee's termination is wrongful if it results from his refusal to perform an illegal act); Skillsky v. Lucky Stores, Inc., 893 F.2d 1088, 1094 (9th Cir. 1990) (holding that terminating an employee for his having a poor reputation is an actionable claim); Dicomes v. Washington, 782 P.2d 1002, 1006–07 (Wash. 1989) (holding that the firing of an employee for her disclosure of potentially damaging information to an overseeing agency contravenes public policy and constitutes a wrongful termination).

feedback through mandated anti-retaliation protections that are designed to encourage whistleblowing.[271] They may also incentivize whistleblowers by providing financial rewards such as bounties. Lastly, legal doctrines should protect whistleblowers against liability. For example, in some cases, firms may seek to muzzle whistleblowers using confidentiality agreements. These contractual agreements should be invalidated from a public policy matter to encourage whistleblowing and avoid chilling this important compliance-related fire alarm.[272]

An agency's or prosecutor's enforcement discretion is generally not reviewable by the courts.[273] An agency's determination to grant a regulatory exemption, however, is an increasingly common tactic used by companies to avoid regulatory compliance. The U.S. Supreme Court said that "an agency's authority to proceed in a complex area [of] regulation by means of rules of general application entails a concomitant authority to provide exemption procedures in order to allow for special circumstances."[274] Yet, there is uncertainty whether the practice of granting regulatory exemptions is reviewable by the courts under the Administrative Procedures Act since an exemption under that statute may be classified by an agency as an adjudication (not reviewable) or final rulemaking result (reviewable).[275]

One commentator noted that the use of exemptions can be problematic for several reasons. First, if there are enough exemptions this casts doubt regarding the validity of the regulation's statutory scheme. It may also call into question whether an agency has abdicated its oversight responsibility. Lastly, many exemptions are not reviewable for arbitrariness or abuse of discretion and do not involve the traditional public notice-and-comment rulemaking process. One of the hallmarks of administrative law is that it solicits input from interested parties. Removing this fire-alarm approach to rulemaking can grant too much leniency to companies and generate negative social externalities.[276]

The case of *Delta Airlines v. United States* is illustrative of this problem and how the courts have tried to limit the negative aspects of agencies that excessively grant exemptions in a way that fundamentally changes a rule without undergoing the public notice-and-comment rulemaking process.[277] In that case, Delta Airlines challenged the FAA's practice of granting nearly 35% of 900 or so yearly applications for an exemption related to a pilot's health examination.[278] The court stated:

> The record in the case . . . provides clear evidence that the defendants have effectively amended the Regulations by issuing pro forma exemptions and placing functional limitations on medical certificates, allegedly based upon this perception of the advance in medical technology. Whether these changes can be

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

272. *See generally* Pacella, *supra* note 219 (proposing regulatory amendments to allow whistleblowers to turn over documentary support for their claims while balancing employer's concerns to restrict internal, confidential documents from exposure).

273. *See* Heckler v. Chaney, 470 U.S. 821, 831–33 (1985) (stating an agency's decision to not pursue an enforcement action is not reviewable by the judiciary).

274. United States v. Allegheny-Ludlum Steel Corp., 406 U.S. 742, 755 (1972).

275. 5 U.S.C. §§ 551(11), 551(13), 701–06.

276. Gates et al., *supra* note 4.

277. Delta Air Lines, Inc. v. United States, 490 F. Supp. 907 (N.D. Ga. 1980).

278. *Id.* at 912–13.

> made and the goal of the [Administrative Procedures] Act and Regulations to promote air safety to the highest degree possible still be served is not an appropriate inquiry for the court at this time. The response to that question will undoubtedly come from members of the public, who will have the opportunity to comment if the FAA desires to legitimate its "change in policy" by complying with the Administrative Procedure Act.[279]

The use of exemptions should thus be used sparingly by agencies so as not to override the public goals of regulation and avoid the fire-alarm aspects of public notice-and-comment rulemaking. It may even be the case that excessive reliance on exemptions of this sort will trigger one of the various fire alarms discussed above.

VII. CONCLUSION

This article has contributed to the growing body of compliance law theory and scholarship. It does so by introducing a new and third approach to compliance called the fire-alarm approach. This approach is grounded in the theoretical perspectives of negotiated governance and director primacy. It also contrasts but complements two other well-known compliance approaches; the policing and architectural approaches. The fire-alarm approach is executed throughout the compliance system that includes regulators, firms, executives, and third-party relationships. A virtue of the fire-alarm approach is that it helps reduce agency costs by increasing transparency and information flows across the various compliance system elements. This is achieved through what are called information feedback loops. These information flows, or feedback loops, reduce agency costs that lead to opportunism, shirking of duties, and conflicts of interest. This, in turn, promotes the goals of regulation that are designed to ensure trust in the marketplace and the protection and integrity of public welfare, health, and safety.

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279. *Id.* at 919.