
COMPLIANCE PROGRAMS, PENALTY MITIGATION AND THE FERC

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Synopsis: Corporate exposure to criminal and civil penalties has grown in recent years. Many corporations have responded by strengthening their compliance programs to reduce the potential for violations, but these programs also present risks because they detect and reveal violations that would not otherwise be uncovered by the government. Many federal regulators have recognized this dilemma and adopted policies that reduce (or, in some cases, eliminate) penalties for corporations that adopt effective compliance programs. The Federal Energy Regulatory Commission (FERC) recently moved in this direction by articulating certain general factors on penalty mitigation for effective compliance programs. This article urges the FERC to go one step further and adopt a more formalized policy on penalty mitigation. Specifically, it suggests a policy under which the FERC would decline to impose a penalty for a nonserious violation if the corporation: (i) adopted reasonable preventive measures to deter misconduct, (ii) detected and reported the violation promptly, and (iii) took appropriate remedial action in response to the violation. As this article was being printed, the Commission adopted a formal policy on compliance programs that is, in many important respects, consistent with this recommendation.

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INTRODUCTION

*The problem of corporate wrongdoing has long been a matter of serious social concern. Both large bureaucratic organizations and smaller firms have the capacity to inflict serious harm, and often a strong competitive motive to cut corners in terms of legal compliance.*¹

*[P]rosecutors have exploited their virtually unchecked power to extract and coerce ever greater concessions [from corporations], jeopardizing the very nature of our adversary system.... It [is] a state-sponsored shakedown scheme in which corporations are extorted to pay penalties grossly out of proportion to any actual misconduct.*²

Corporate exposure to civil or criminal wrongdoing by employees has grown sharply in recent years.³ Congress has increased the penalties for corporate crime⁴ and high-profile prosecutions are now commonplace.⁵ Civil enforcement is stronger as well, with federal agencies receiving enhanced penalty authority and upgrading their enforcement programs.⁶

The FERC recently joined this trend. In 2005, in the wake of the California electricity crisis and market manipulation by Enron, Congress gave the FERC significant new civil penalty authority⁷ and the FERC quickly adopted a modern enforcement regime, including a formal policy statement on enforcement and a

1. Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 77 (2002) (emphasis added) [hereinafter *Behavioral Economics of Corporate Compliance*].

2. Richard Janis, *Deputizing Company Counsel as Agents of the Federal Government: How Our Adversary System of Justice Is Being Destroyed*, WASHINGTON LAW, March 2005, http://www.dcbar.org/for_lawyers/resources/publications/washington_lawyer/march_2005/stand.cfm (discussing corporate criminal prosecutions by the Department of Justice) (emphasis added).

3. Gerard E. Lynch, *The Role of Criminal Law in Policing Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 23 (Summer, 1997).

4. The Sentencing Reform Act of 1984 significantly increased the fines for corporate misconduct and the 1991 Federal Sentencing Guidelines implemented these reforms by adopting "enormous" corporate fines. Richard S. Gruner, *Towards and Organizational Jurisprudence: Transforming Corporate Criminal Law through Federal Sentencing Reform*, 36 ARIZ. L. REV. 407 (1994) [hereinafter *Transforming Corporate Criminal Law*].

5. Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853 (2007) ("In the past few years, federal prosecutions of organizations have sharply accelerated"); Christopher A. Wray & Robert K. Hur, *Corporate Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice*, 43 AMER. CRIM. L. REV. 1095 (2006) [hereinafter *Corporate Prosecution in a Post-Enron World*].

6. Press Release, Statement of the Securities and Exchange Commission Concerning Financial Penalties, Release No. 2006-4 (Jan. 4, 2006) (SEC's "authority to impose [civil] penalties is relatively recent in the Commission's history, and the use of very large corporate penalties is more recent still"); Stephen Calkins, *Corporate Compliance and the Antitrust Agencies' Bimodal Penalties*, 60 LAW & CONTEMP. PROBS. 127 (Summer, 1997) ("Antitrust has seen a remarkable increase in authorized penalties").

7. Energy Policy Act of 2005, Pub. L. No. 109-58 § 1284, 119 Stat. 980. Chairman Kelliher recommended that Congress grant the Commission civil penalty authority in: Joseph T. Kelliher, *Market Manipulation, Market Power and the Authority of the Federal Energy Regulatory Commission*, 26 ENERGY L.J. 1 (2005).

no-action letter process.⁸ Not surprisingly, it also started imposing significant civil penalties.⁹

This transition has not been without controversy. There have been criticisms of the fairness of the process, as well as suggestions that the penalties are too high. This latter criticism has included allegations that cooperation and self-reporting are not sufficiently valued in calculating civil penalties and are sometimes used more as “sticks” than “carrots.”¹⁰ The FERC recently responded to some of these criticisms by adopting a package of enforcement reforms in May 2008, including strengthening due process for the subjects of an investigation, increasing opportunities for compliance guidance, and, relevant here, increasing the prominence of corporate compliance programs in the determination of civil penalties.¹¹

This latter policy shift began in 2007, when Chairman Kelliher released his first lengthy statement on enforcement, in which he emphasized that “[i]t is a personal priority for me as Chairman to strengthen compliance programs in the regulated community”¹² and stated that “[i]t is the combination of a strong compliance program and self-reporting that provides a regulated company the best opportunity for avoiding a significant civil penalty, or perhaps avoiding a penalty altogether.”¹³ The FERC’s reforms in May 2008, embraced Chairman Kelliher’s increased focus on compliance programs, “mak[ing] it clear that the commitment of a company to compliance will be one of the two most important

8. *Enforcement of Statutes, Orders, Rules and Regulations*, 113 F.E.R.C ¶ 61,068 (2005); *Interpretive Order Regarding No-Action Letter Process*, 113 F.E.R.C ¶ 61,174 (2005).

9. *In re PacifiCorp*, 118 F.E.R.C ¶ 61,026 (2007); *In re SCANA Corporation*, 118 F.E.R.C ¶ 61,028 (2005).

10. These are similar to the criticisms leveled at other federal enforcement agencies. A former U.S. Attorney has argued that cooperation is “being used by some prosecutors . . . to force companies to behave and reform themselves as the prosecutors, fashioning themselves as the new corporate governance experts, think they should.” Mary Jo White, *Corporate Criminal Liability: What Has Gone Wrong?*, PLI CORP. LAW & PRACTICE, COURSE HANDBOOK SERIES NO. 6063, 37TH ANNUAL INSTITUTE ON SECURITIES REGULATION 815, 818 (2005). Similarly, one commentator has argued that the SEC’s “carrot of offering leniency for cooperation has been transformed through subsequent cases into a powerful stick wielded against companies that do not fully cooperate with an SEC investigation and take other corporate action demonstrating contrition and penance.” Russell G. Ryan, *Cooperation in SEC Enforcement: The Carrot Becomes The Stick*, 19 WASH. LEGAL FOUND LEGAL BACKGROUNDER, Oct. 1, 2004, at 1. A general counsel of a major corporation has lamented that “[c]ompanies today that take aggressive ethics and compliance steps run high risks of being beaten with their own acts, beaten with the carrots that were supposed to lure them to do good things.” John S. Baker, Jr., *Reforming Corporations through Threats of Federal Prosecution*, 89 CORNELL L. REV. 310, 317 (2004).

11. As a corollary to these reforms, the Chairman emphasized that “[i]f we are going to require compliance, and noncompliance is subject to significant civil penalties, we must be clear in our regulatory requirements.” Joseph T. Kelliher, Statement on Enforcement Package, Docket No. PL08-3-000 (May 15, 2008) [hereinafter *Statement on Enforcement Package*]. This is consistent with JOHN RAWLS, *A THEORY OF JUSTICE* 212 (Harvard Univ. Press 1971) (“Unless citizens are able to know what the law is and are given a fair opportunity to take its directives into account, penal sanctions should not apply to them. This principle is simply the consequence of regarding a legal system as an order of public rules addressed to rational persons in order to regulate their cooperation, and of giving the appropriate weight to liberty”).

12. Joseph T. Kelliher, Statement for Conference on Enforcement Policy, Docket No. AD07-13-000 (Nov. 14, 2007) [hereinafter *Conference on Enforcement Policy*].

13. *Id.*

factors in our determination of civil penalty amounts, along with seriousness of the offense.”¹⁴

The FERC’s increased focus on corporate compliance programs is, as I will discuss below, consistent with the academic literature in this area and the practice of other federal agencies. It is therefore the correct path to take, but it is not a particularly easy path to take. There is significant concern in the literature that agencies cannot readily distinguish between “cosmetic” compliance programs and effective ones in deciding whether to mitigate penalties.¹⁵ This has encouraged many federal agencies to proceed cautiously, declining to adopt formal rules and proceeding instead on a case-by-case basis.¹⁶

The FERC has so far followed this cautious approach by articulating certain general “factors” to be considered, but not providing more formal policy guidance.¹⁷ This article urges the FERC to take the next step and adopt a more formal policy. The FERC does not, like some agencies, have a long track record of individual cases that reveal how compliance programs will affect penalty calculations. The absence of such precedent makes it harder for FERC-regulated companies to tell how much credit will be given for their compliance programs. This is no doubt a source of angst for them, but, more importantly, it is a public policy concern as well. Incentives matter in this area and, without clearer guidance, the incentives for corporations to maintain effective compliance programs will not be as strong as they should be.

To provide greater guidance, this article urges the FERC to adopt a formal policy framework for when a compliance program can mitigate a civil penalty altogether. Specifically, it proposes that the FERC decline to impose a civil penalty for *nonserious* violations if: (i) the company adopted reasonable preventive measures (*e.g.*, hiring, training, and supervision), (ii) the company detected and reported the violation promptly, and (iii) the company took appropriate remedial actions (*e.g.*, disciplinary action and/or prospective reforms). For more serious offenses, these three factors would be given significant weight in reducing a penalty, but would not necessarily avoid a penalty altogether.

14. *Statement on Enforcement Package*, *supra* note 11.

15. Kimberly D. Krawiec, *Corporate Decisionmaking: Organizational Misconduct: Beyond the Principal-Agent Model*, 32 FLA. ST. L. REV. 571, 572 (2005) [hereinafter *Beyond the Principal-Agent Model*]:

[A]ny duty-based liability system that conditions the organization's duty on the presence of internal compliance structures is likely to fail because courts lack sufficient information about the effectiveness of such structures. As a result, an internal compliance-based liability system encourages the implementation of largely cosmetic internal compliance structures that reduce legal liability without reducing the incidence of organizational misconduct.

John C. Coffee, “*Carrot and Stick*” *Sentencing: Structuring Incentives for Organizational Defendants*, 3 FED. SENT. R. 126, 127 (1990):

[A] perverse incentive may arise to invest in cosmetic monitoring -- that is, monitoring that has no real impact on employee behavior, but that looks good at sentencing if the corporation is ever convicted. Such monitoring expenditures could be rationally made much as an insurance premium is paid, not to prevent the occurrence of the threatened event, but to reduce the loss if it does occur.

Garrett, *supra* note 5, at 890 (“Enron had a compliance program entitled ‘Respect, Integrity, Communication and Excellence,’ which despite the lofty title existed only on paper”).

16. *Corporate Prosecution in a Post-Enron World*, *supra* note 5.

17. *Revised Policy Statement on Enforcement*, 123 F.E.R.C. ¶ 61,156 P 55-72 (2008).

As this article was being printed, the FERC adopted a *Policy Statement on Compliance*¹⁸ that is, in many important respects, consistent with my proposal. The FERC is to be commended for taking this important step, which makes FERC one of the most progressive federal agencies on this issue. With this action, the primary value of this article is no longer to encourage prospective reforms by FERC, but rather (i) to provide the context for these reforms, particularly the related practices of other federal agencies and the significant body of academic work in this area, and (ii) to identify certain implementation issues that FERC will face in applying its new policy.

Part I of the Article provides an overview of enforcement theory and practice as it relates to compliance programs. Part II of the Article provides an overview of the FERC's enforcement policies in this area. Part III offers the foregoing recommendation, offers support for it, and addresses certain implementation issues and potential objections to it.

I. CORPORATE COMPLIANCE PROGRAMS: ENFORCEMENT THEORY AND AGENCY PRACTICE

A. *Theories of Corporate Liability*

There are three forms of corporate liability that are relevant to the issue of penalty mitigation for compliance programs. Each form has a somewhat different effect on the incentives to invest in compliance programs.

The first is *respondeat superior* (strict vicarious liability) under which the corporation is vicariously liable for the acts of its employees, regardless of whether it has exercised due care in supervising their conduct (such as, by maintaining an effective compliance program).¹⁹ The rationale for this rule is that the corporation is in the best position to deter the unlawful conduct of its employees (through hiring decisions, training, monitoring, etc.) and it is the only entity with sufficient financial means to pay most civil or criminal penalties.²⁰

18. Policy Statement on Compliance, 125 F.E.R.C. ¶ 61,058 (2008).

19. Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUDIES 833, 838 (1994) [hereinafter *Perverse Effects of Corporate Liability*]

Under [*respondeat superior*], a corporation is criminally liable for criminal acts of its agents committed within the scope of their authority. The scope of this liability is remarkably broad. . . . [C]orporations . . . may be held criminally liable even though the criminal acts were against corporate policy or express instructions.

Memorandum from Larry D. Thompson, *Principles of Federal Prosecution of Business Organizations* at 6 (Jan. 20 2003) [hereinafter *Thompson Memo*] ("A corporate compliance program, even one specifically prohibiting the very conduct in question, does not absolve the corporation from criminal liability under the doctrine of *respondeat superior*.").

20. V.S. Khanna, *Corporate Liability Standards: When should Corporations be Held Criminally Liable?*, 37 AMER. CRIM. L. REV. 1239, 1244-45 (2000) (strict vicarious liability causes a corporation to internalize the costs of enforcement and is otherwise appropriate because agents are often judgment proof); *Perverse Effects of Corporate Liability*, *supra* note 19, at 834

Crime is deterred efficiently, this view holds, if the corporation is held strictly liable for all its crimes, subject to a fine equal to the social cost of crime divided by the probability of detection (H/p), because this forces the corporation to internalize the social cost of its criminal activity.

Beyond the Principal-Agent Model, *supra* note 15, at 576

The second is a duty-based liability under which a corporation is liable for the acts of its employees only when it has failed to adhere to a duty of care.²¹ For example, if a corporation adopts a rigorous compliance program, including internal controls to deter unlawful conduct by its employees, it would not be held liable if an employee ignores these controls and commits a wrongful act.²²

The third is a “composite” of the first two under which the corporation is held vicariously liable for the acts of its employees, but its duty of care (or lack thereof) is relevant to the issue of *remedies (penalties)*.²³ A corporation’s adherence to a duty of care is therefore not an affirmative defense, but can be an important mitigating factor in calculating penalties.²⁴ This theory is in widespread use today by most federal agencies, including the Department of Justice (DOJ) and Securities Exchange Commission (SEC).²⁵ It is also the approach reflected in the FERC’s Revised Enforcement Policy Statement.²⁶

The application of these theories creates different incentives for corporate compliance programs. *Respondeat superior* provides strong incentives to adopt *preventive* measures (e.g., hiring, training, and supervision) because those measures reduce the likelihood that a violation will occur and, hence, that a penalty will be imposed.²⁷ However, strict vicarious liability does not provide strong incentives for *policing* measures that *detect* and *report* unlawful conduct that preventive measures fail to impede.²⁸ This is because the corporation not

[S]trict vicarious liability systems may force the adoption of the socially optimal level of internal organizational enforcement and deterrence mechanisms (internal compliance structures). This is because when an organization bears all of the costs of any harm it causes, it has an incentive to reduce the incidence of such harm up to the point where the costs of such reduction equal the benefits.

Richard Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193, 1227 (1985)

The basic justification for the doctrine [of *respondeat superior*] is that employees rarely can pay substantial money judgments, and therefore tort liability will have little effect on their incentives. If the employer is liable, his incentives will be productively affected -- he will take greater care in hiring, supervising, and where necessary, firing employees.

For an exception to this general rule, see Jennifer H. Arlen and William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 UNIV. ILL. L. REV. 691 (1992) (finding that strict vicarious liability not appropriate for “fraud on the market” securities law violations because of the unique nature of these actions).

21. *Beyond the Principal-Agent Model*, *supra* note 15, at 579.

22. Charles J. Walsh and Alissa Pyrich, *Corporate Compliance Programs as a Defense to Criminal Liability: Can a Corporation Save its Soul?*, 47 RUTGERS L. REV. 605 (1995) [hereinafter *Can a Corporation Save its Soul?*]; Andrew Weismann, *Why Punish? A New Approach to Corporate Criminal Liability*, 44 AMER. CRIM. L. REV. 1319 (2007) [hereinafter *Why Punish?*].

23. *Beyond the Principal-Agent Model*, *supra* note 15, at 581 (“composite liability regimes assign liability based on a strict liability standard but apportion sanctions based on a negligence standard.”); Jennifer Arlen and Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U.L. REV. 687, 694 (1997) [hereinafter *Controlling Corporate Misconduct*]

24. *Controlling Corporate Misconduct*, *supra* note 23.

25. *Corporate Prosecution in a Post-Enron World*, *supra* note 5.

26. *Revised Policy Statement on Enforcement*, *supra* note 17, at P 57.

27. *Controlling Corporate Misconduct*, *supra* note 23, at 693 (“[strict vicarious] liability can lead companies to institute ‘preventive measures’ that deter by making misconduct more difficult or expensive for wrongdoers, or by reducing the illicit benefits of unpunished (or successful) misconduct, without affecting the probability that it is detected by enforcement officials.”)

28. *Perverse Effects of Corporate Liability*, *supra* note 19, at 836

only incurs costs to implement the policing program, but then incurs more costs because it has disclosed conduct that (in the absence of penalty mitigation) will be penalized by the government.²⁹

A duty-based regime inverts these incentives. A “duty-based liability is generally better able to induce firms to undertake optimal policing measures such as monitoring, investigating, and reporting.”³⁰ However, it presents weaker incentives to adopt preventive measures because of the difficulty of determining *ex post* whether the “duty” has been met.³¹

It is for these reasons that most federal agencies reject either extreme and apply a composite approach that makes corporations vicarious liable, yet reduces penalties for companies with strong compliance programs. I will discuss further the manner in which this is accomplished in section I.C.

B. Academic Proposals to Address the Problems Posed by Strict-Liability or Duty-Based Liability Regimes

There is general consensus in the literature on two fundamental points. The first is that strict liability regimes will not induce optimal corporate compliance because they discourage policing measures that detect and report violations. The second is that duty-based regimes will not induce optimal preventive measures because of the inability of courts and agencies to evaluate that duty with any precision.

This regime of strict vicarious liability presents corporations contemplating enforcement expenditures with conflicting, potentially perverse, incentives. On the one hand, increased enforcement expenditures reduce the number of agents who commit crimes by increasing the probability of detection and thus each agent's expected cost of crime. On the other hand, these expenditures also increase the probability that the government will detect those crimes that are committed, thereby increasing the corporation's expected criminal liability for those crimes.

Amitai Avireem, *Corporate Decisionmaking: In Defense of Imperfect Compliance Programs*, 32 FLA. ST. U.L. REV. 763, 772 (2005) (“A well-known weakness of the strict liability regime is that it creates an incentive for the organization not to police misconduct that it believes can be hidden from the public and prosecutors.”); *Transforming Corporate Criminal Law*, *supra* note 4, at 457 (“the systematic steps necessary for firms to qualify for reduced sentences are ones that may also make the external detection of corporate offenses more likely.”).

29. The relationship between the cost of policing measures and the cost of penalties means that “increased corporate liability [penalty levels] does not necessarily reduce corporate crime and, indeed, may result in increased crime.” *Perverse Effects of Corporate Liability*, *supra* note 19, at 836.

30. *Controlling Corporate Misconduct*, *supra* note 23, at 694.

31. *Id.* at 705

Duty-based liability could hardly eliminate all incentives to commit misconduct arising from diffuse pressures to increase corporate profit. In addition, a duty-based regime would face serious problems of judicial error. Reviewing compensation and discharge policies is a difficult task: legitimate compensation plans designed to reward employee performance also are likely to reward profit-enhancing misconduct. By comparison, strict liability does not require courts to distinguish legitimate from illegitimate firm behavior.

Beyond the Principal-Agent Model, *supra* note 15, at 580

[S]trict vicarious liability standards are considered superior to negligence-based organizational liability standards in terms of inducing the optimal level of internal compliance structures. Although negligence-based liability could in theory induce the optimal level of internal deterrence measures, it is unlikely to achieve this goal in practice due to the difficulty of accurately determining whether the standard of care has been met.

This has led to an examination of “adjusted” or “composite” regimes that retain the beneficial elements of one model, but make adjustments to account for its shortcomings. Although practitioners tend to advocate a duty-based model (whereby firms are punished only if prosecutors can establish a duty was violated),³² the academic work has focused on making adjustments to the strict vicarious liability model to eliminate the disincentive to detect and report violations.³³ I will briefly discuss the most detailed work in this area below, with other articles of interest noted in the margin.

Of this academic body of work, Arlen and Kraakman offer perhaps the most thorough analysis. They consider a variety of modifications to the strict vicarious liability model and conclude that each has certain limitations.³⁴ They first consider various “adjusted” strict liability approaches that attempt to hold a corporation harmless for the impact of its policing measures.³⁵ There are two primary forms of adjusted strict liability: (i) the first gives the corporation immunity for detecting and reporting an offense (*i.e.* the government must either pursue only the culpable employee, or use other information to pursue the corporation), and (ii) the second reduces the penalty to account for the increase in probability of detection produced by the corporation’s policing measures.³⁶ They conclude, however, that these sanction-adjusted regimes suffer from certain “credibility” problems, such as the notion that the government will actually ignore a self-report when considering whether to pursue action against the corporation (as opposed to action against culpable employees).³⁷

They therefore turn to various “composite” models that combine strict- and duty-based liability – *i.e.*, they hold the corporation strictly liable for the offense but adjust the penalty to account for whether it discharged its policing duties.³⁸ There are two principal variations of composite models that are worth noting here. The first is the difference between a “two-tier” model that gives a firm credit only if it satisfies *all* policing duties³⁹ and a “multi-tier” model that varies the credit if the firm satisfied some, but not all, its policing duties.⁴⁰ They conclude that two-tier regimes can produce optimal enforcement in theory, but

32. *Can a Corporation Save its Soul?*, *supra* note 22; *Why Punish?*, *supra* note 22.

33. In addition to examining strict vicarious liability, duty-based, and composite regimes, Khanna also discusses two forms of “mens rea” liability. Khanna, *supra* note 20, at 1248-1284.

34. *Controlling Corporate Misconduct*, *supra* note 23.

35. *Id.*

Adjusted strict liability regimes hold firms strictly liable for their agents’ wrongdoing but attempt to overcome the perverse effects of strict liability by insulating a firm’s expected sanction from the effects of policing measures. An insulating adjustment can be made in two ways: (1) by leaving the firm’s sanction unchanged by using rules of privilege or use immunity to ensure that the probability that the firm is sanctioned remains fixed despite the firm’s monitoring efforts (“probability-fixed strict liability”); or (2) by reducing the sanction to precisely offset the increase in the probability of detection associated with policing measures undertaken by the firm (“sanction-adjusted strict liability”).

Id. at 719.

36. *Id.*

37. *Id.* at 722-23.

38. *Id.*

39. *Id.*

40. *Id.*

may suffer from credibility problems in practice.⁴¹ They therefore support a multi-tier model that avoids those problems:

Where this [credibility] concern arises, we favor a multi-tiered regime that unbundles and separately motivates ex ante policing measures such as monitoring and ex post measures such as investigating and reporting. For example, such a regime could subject the firm to a very high sanction if it neither monitors optimally nor reports, but partially mitigate this sanction if it either monitors or reports. Thus, the firm will have an incentive to take one efficient policing measure even if it lacks an incentive to take another - although it can only earn full mitigation by performing all of its policing duties.⁴²

The second important distinction in models is the difference between “duty-based” and “result-based” approaches. A duty-based model gives full credit even if a firm fails to detect a violation, provided that its monitoring program was optimal (recognizing that even an optimal program will miss some violations).⁴³ By contrast, a result-based model provides full credit only when the violation is actually detected and reported.⁴⁴ Arlen and Kraakman conclude that neither model is perfect. For example, the results-based regime can be inferior because “it will lead to excessive monitoring in some cases, and it is more difficult to administer than the [duty-based] regime.”⁴⁵ It may cause wasteful spending on monitoring because firms receive no credit at all in the absence of actual detection.⁴⁶ On the other hand, a duty-based model is problematic if courts or agencies cannot readily determine whether a firm actually uncovered its wrongdoing.⁴⁷ If this is the case, a result-based regime will be superior because it will ensure that “firms cannot get full mitigation by monitoring optimally but pretending not to detect anything.”⁴⁸

Arlen and Kraakman then evaluate the Federal Sentencing Guidelines (Guidelines) against this backdrop. They find that, although the Guidelines use a composite model, they “suffer[] from the problems associated with each of [the] composite regimes [studied] with few of the benefits of any of them.”⁴⁹ They therefore recommend several modifications, such as, providing credit for monitoring programs that cover wrongdoing by senior management, and providing credit for an optimal monitoring program that nonetheless fails to detect a particular violation.⁵⁰

Krawiec offers a detailed critique of composite models and reaches very different conclusions than Arlen and Kraakman.⁵¹ Krawiec agrees with Arlen and Kraakman (and others) that strict vicarious liability, standing alone, will not

41. *Id.* at 735 (“the two-tiered regime fails if managers perceive a significant risk that a firm will not be eligible for sanction mitigation as the result of either judicial error or an agency problem affecting one of its several policing duties (for example, employees who refuse to report misconduct)”).

42. *Id.* at 736.

43. *Id.*

44. *Id.*

45. *Id.* at 739.

46. *Id.* at 739.

47. *Id.*

48. *Id.* at 741.

49. *Id.* at 748.

50. *Id.* at 751-52.

51. *Beyond the Principal-Agent Model*, *supra* note 15.

produce optimal compliance, particularly because it punishes the adoption of many policing measures.⁵² However, Krawiec criticizes the most common solution, namely the adoption of composite regimes with a duty-based element to reward effective policing.⁵³ According to Krawiec, courts and agencies have too little information to make reasonable duty-based determinations:

[C]ourts and agencies are unlikely to possess the ability to differentiate effective internal compliance structures from cosmetic ones—that is, those structures designed to create the illusion of compliance for purposes of avoiding legal liability, rather than for the purpose of deterring misconduct. This is because differentiating real internal compliance structures from purely symbolic ones is a difficult task for legal decisionmakers, particularly ex post when, by definition, the structures in question have failed to deter misconduct. Additionally, the indicators of an effective internal compliance structure are easily mimicked, and the true level of effectiveness is difficult for any decisionmaker lacking perfect information to determine.⁵⁴

Krawiec supports her point with certain empirical studies, concluding that they show little evidence that compliance programs reduce organizational misconduct.⁵⁵

As an alternative to traditional composite regimes, Krawiec recommends two adjustments to strict liability rules.⁵⁶ The first adjustment is the adoption of an evidentiary privilege that provides immunity for information revealed to the government through internal policing measures⁵⁷ (similar to Arlen and Kraakman's first "sanction-adjusted" regime). The second is to offer credit for self-reporting and cooperation.⁵⁸ In Krawiec's view, neither adjustment requires courts or agencies to make duty-based findings, but both provide strong incentives for policing measures:

Firms can still be encouraged to engage in internal policing and cooperation with government authorities through some combination of evidentiary privilege rules and reduced sanctions for cooperation with government investigations. In other

52. *Id.* at 576.

53. *Id.* at 572 (composite regimes result in "an underdeterrence of organizational misconduct and, second, a proliferation of costly but ineffective internal compliance structures.") *Id.*

54. *Id.* at 580. Calkins also shares Krawiec's skepticism, contending that "[Arlen and Kraakman] underestimate the difficulty of designing and then shoe-horning companies into approved compliance models, and of distinguishing genuinely effective (although unsuccessful) programs from ones that merely appear to be effective." Calkins, *supra* note 6 at 149; *See also* Coffee, *supra* note 15 at 128 ("Any policy evaluation of the wisdom of placing substantial sentencing weight on compliance plans or other monitoring systems must recognize that courts are inevitably making decisions about the adequacy and good faith of such efforts based on imperfect information."). *But see* Khanna, *supra* note 20, at 1272

[T]here are reasons to be a little more optimistic about the judicial ability to assess the effectiveness of compliance programs. First, courts have made similar assessments tolerably well in the past. Second, as courts and prosecutors become more experienced in assessing compliance programs one would expect greater accuracy in that assessment.

55. *Beyond the Principal-Agent Model*, *supra* note 15, at 591 ("the evidence that does exist is decidedly mixed, with many of the most recent and methodologically sound studies finding no significant correlation between the most widely used internal compliance structures and reduced organizational misconduct.") Krawiec acknowledges that certain studies show a positive correlation, but she criticizes these studies as methodologically flawed or inconclusive. *Id.* at 591-93.

56. *Id.*

57. *Id.*

58. *Id.*

words, firms can be rewarded not for the mere existence of internal compliance structures, but for ex post demonstrations that such structures revealed useful information that was then used to penalize those responsible for misconduct, thus presumably deterring future misconduct.⁵⁹

Krawiec does not, however, support either recommendation in detail; rather, the primary purpose of her article is to demonstrate the shortcomings of existing composite regimes.⁶⁰ Therefore, she does not respond to Arlen and Kraakman's critique of these alternatives – *i.e.*, (i) the credibility problems with immunity, and (ii) the over-monitoring problems with purely “results-based” crediting.⁶¹

Langevoort approaches the problem from a somewhat different perspective, using a behavioral analysis to assess the policies governing credit for compliance programs.⁶² Three of his main conclusions are relevant to this article.

First, Langevoort urges courts and agencies, when designing standards for effective compliance programs, to set the bar “at medium height.”⁶³ By this he means not setting the bar at either the low end using “standard” industry practices, or at the high end using agency-created “optimal” practices. On the low end, he states that “we would not expect that firms, on average, will have optimal compliance systems”⁶⁴ and, therefore, “it would obviously be foolish for the law to test the reasonableness of a system simply by reference to what are common practices in the industry.”⁶⁵ On the high end, he finds that agency-created optimal practices not desirable because:

it is unlikely that the legal system will be particularly adept at determining optimality. Once an example of serious illegality is uncovered, there is a bias (driven by hindsight, among other things) to see the problem as preventable at the time. That environment will not easily tolerate the perception that low-level monitoring was reasonable, biasing outcomes in the direction of over-penalization.⁶⁶

He, therefore, urges courts and agencies to “limit[] our insistence on compliance to that which is already a best practice within the relevant industry

59. *Id.* at 577. Professor Coffee shares the skepticism that courts and agencies are able to reasonably assess compliance programs. As an alternative, he would change the timing of when penalties are mitigated.

[T]here is a better way to evaluate the corporation's efforts at crime prevention than to judge them at the moment of sentencing. Specifically, mitigation credits should be awarded on a provisional basis, through the vehicle of a suspended sentence, so that they thus remain subject to forfeiture if the organization is involved in related civil or criminal offenses during a reasonable period of unsupervised probation.

Coffee, *supra* note 15, at 126.

60. *Beyond the Principal-Agent Model*, *supra* note 15, at 577.

61. *Controlling Corporate Misconduct*, *supra* note 23, at 722-23, 739. In a subsequent article, Avirem responds directly to Krawiec and criticizes her conclusions. Avirem, *supra* note 28. Interestingly, however, Avirem does not contest her central thesis – that courts are incapable of applying a composite regime that uses a duty-based penalty mitigation scheme – choosing instead to raise two somewhat ancillary points, namely that, even if Krawiec is correct, (i) corporations have an incentive to comply with the law to maintain their reputations, and (ii) strong compliance programs have a “placebo” effect because they make the public believe that corporations are not violating the law. *Id.* at 765.

62. *Behavioral Economics of Corporate Compliance*, *supra* note 1.

63. *Id.*

64. *Id.* at 111.

65. *Id.*

66. *Id.* at 113.

(as opposed to trying to force steps to significantly improve on these standards, *de novo*).⁶⁷ To implement this approach, he recommends that agencies “search for what firms at the high end of voluntary compliance practices have accepted.”⁶⁸

Second, Langevoort cautions that certain common elements of compliance programs should be viewed more skeptically than is ordinarily the case.⁶⁹ For example, aggressive monitoring can have unintended negative consequences by making employees “who see themselves as basically honest and responsible” feel distrusted by the firm.⁷⁰ He therefore concludes that certain “soft” measures, such as fostering an atmosphere of ethics and trust, can have positive effects on compliance without harming employee morale and performance.⁷¹ He also cautions that, although a values-based compliance program can produce such benefits, “the objective indicators of a values-based program are also easy to mimic, making it difficult to separate out the sincere programs from the fakes.”⁷²

Another example is the role of compliance department professionals. He suggests that such professionals may unintentionally bias their conclusions, rather than interpreting legal requirements objectively.⁷³ “Sociologists have observed that legal compliance officials, for example, sometimes *overstate* the law’s demands compared to how an external observer might interpret the legal rules. They do this not in bad faith, but rather honestly believing in their construal.”⁷⁴

Third, Langevoort compares the value of different types of monitoring programs and concludes that courts and agencies may: (i) tend to overestimate the value of direct employee monitoring by line supervisors, and (ii) tend to underestimate the costs (and hence overestimate the value) of external monitoring by third parties:

Firms must be sanctioned for having poor systems or be given some sort of bonus for having good ones. But that necessarily means that a fact-finder has to make a reasonableness determination with respect to any given system, which in turn implies some cost-benefit analysis. My main claim here... is that these evaluations are prone to unexpected error in two somewhat off-setting directions. First, evaluators are likely to overestimate the extent to which a firm can rely on line supervisor monitoring to detect possible illegality. While such supervision will catch some misconduct, a host of forces thwart its effectiveness overall. Here, the

67. *Id.* at 75.

68. *Id.* at 115.

69. *Id.*

70. *Id.* at 97.

71. Ethics or integrity-based compliance systems

are premised on the assumption that most agents become psychologically invested in the firm, and bring a level of intrinsic motivation to their jobs. If the firm’s commitment to certain behaviors can be communicated successfully, this should be a strong pull. And if other agents publicly signal their adherence to the policy, conformity pressures will go to work as well. A positive compliance culture will evolve.

Id. at 104.

72. *Id.* at 106.

73. *Id.*

74. *Id.* at 100.

bias is toward tolerating sub-optimal monitoring. Secondly, there is also a likelihood of underestimating the costs associated with the most obvious cure for line supervisor bias: third-party compliance audits. This likely error biases the legal response towards insisting on too much auditing, forcing unnecessarily costly compliance initiatives.⁷⁵

This latter conclusion regarding third-party monitoring has significant implications for federal agency practice. As Garrett explains, sixty percent of DOJ settlements in recent years have required the hiring of independent monitors with “sweeping powers to gather information, promulgate policies, and oversee compliance.”⁷⁶ If Langevoort is correct, this approach should be pursued with care.⁷⁷ Indeed, there have been Congressional proposals to reform the practice⁷⁸ and the DOJ has issued new guidelines to govern the use of such monitors.⁷⁹ The FERC has not yet adopted third party monitoring, but Chairman Kelliher has signaled that external compliance audits will be considered on the right set of facts.⁸⁰

In sum, the academic literature supports two propositions that are in direct tension, namely that: (i) some credit must be given for corporate compliance programs, particularly their policing elements (detection and reporting) to encourage the use of these programs; but (ii) calculating that credit is problematic because of imperfect information in distinguishing between cosmetic and effective compliance programs. I will address this tension – and, in particular, the distinctions between preventive and policing measures, as well as ex ante and ex post considerations⁸¹ – in my proposal in Section III.

C. Practice at other Federal Agencies

This section provides a brief overview of certain federal agency practices on penalty mitigation for effective compliance programs. This is not an exhaustive survey, as others have ably performed that task.⁸²

I focus on three practice areas that are relevant here. The first is criminal prosecutions under the Guidelines and the related policies of the DOJ. I discuss

75. *Id.* at 74.

76. Garrett, *supra* note 5, at 897.

77. A cautious note was also struck by Frank Bowman, *Somebody Has to Cry Foul*, *The American Lawyer*, Aug. 18, 2008 (“Federal prosecutors are good at investigating crimes and proving them in court. . . . But there is little evidence that prosecutors . . . have any particular competence in corporate governance.”).

78. *Id.*

79. Memorandum from Craig S. Morford, Acting Deputy Attorney General, on Selection and Use of Monitors in Deferred Prosecution Agreements and Non-Prosecution Agreements with Corporations (March 7, 2008).

80. Kelliher, *supra* note 4, at 4.

81. Although preventive measures tend to implicate subjective matters of ex ante program design and policing measures tend to implicate ex post observable conduct (*e.g.*, whether a program in fact detected, reported and remedied a violation), there are elements of compliance programs that span both. For example, compensation policies can be a hybrid – *i.e.*, they represent ex ante preventive measures by threatening a loss of compensation for misconduct but they also represent policing measures by punishing that misconduct ex post. Similarly, a monitoring program that is visible to employees can be a hybrid – *i.e.*, it acts as a preventive measure by reducing the incidence of violations by letting employees know that their misconduct may be detected and punished, but it also acts as a policing measure by detecting that misconduct if and when it occurs.

82. *Corporate Prosecution in a Post-Enron World*, *supra* note 5; Garrett, *supra* note 5.

this area because of its influence on development of civil enforcement policy throughout the federal government.⁸³ The second is a brief discussion of SEC precedent because the SEC, as a leading civil enforcement agency, also influences the actions of other federal civil enforcement agencies. The third is the Environmental Protection Agency (EPA) because its policy is among the most detailed in the federal government. The EPA's policy is also generally consistent with the approach I recommend in the final section of the article.

1. Criminal Prosecutions: The Guidelines and DOJ Policies

Criminal prosecutions of corporations are governed by the Guidelines and related DOJ policies. Chapter eight of the Guidelines addresses penalties for corporate misconduct, including the role of compliance programs.⁸⁴ As to such programs, the Guidelines "offer[s] incentives to organizations to reduce and ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-police its own conduct through an effective compliance and ethics program."⁸⁵

These incentives are implemented by "scoring" factors that compute a fine by reference to both aggravating and mitigating factors. For example, the corporation receives an adverse "culpability score" if the violation was committed by "high level personnel" or "tolerance" of the offense was "pervasive" throughout the organization.⁸⁶ Similarly, the corporation receives a significant scoring "credit" if the violation was committed despite the presence of an effective compliance program *and* the violation was self-reported.⁸⁷ In the best case – *i.e.*, if high level personnel were not involved, the activity was not tolerated, there was an effective compliance program, and the violation was self-reported – the fine could be reduced substantially.⁸⁸

The Guidelines does not, however, provide significant detail on what an "effective" compliance program is, opting instead to outline general principles. The Guidelines states that: (i) the overall purpose of a compliance program should be to "prevent and detect" violations, (ii) the program should be staffed with employees who have "day-to-day operational responsibility" for monitoring the program and reporting on it to senior management, (iii) the hiring practices of the company should be designed to screen out individuals with a prior history of violations, (iv) there should be effective training programs for employees on

83. *Beyond the Principal-Agent Model*, *supra* note 15, at 585.

Because the [Organizational Sentencing Guidelines (OSG)] was one of the first major legal regimes to make the transition from strict vicarious liability to an internal compliance-based standard, it is an extraordinarily important segment of the internal compliance-based legal regime. However, the OSG internal compliance-based approach to organizational misconduct was quickly emulated in other legal fields. As a result, today a wide variety of civil, criminal, and regulatory provisions encourage the adoption of internal compliance structures through duty-based vicarious liability regimes.

84. United States Sentencing Commission, *Guidelines Manual* (Nov. 2007) [hereinafter *FSG*].

85. *Id.* at ch. 8, 487 (2007).

86. *Id.* at ch. 8, pt. C § 2.5

87. *Id.* ch. 8, pt. C § 2.5(f)-(g).

88. *Beyond the Principal-Agent Model*, *supra* note 15, at 584 ("Assuming the absence of any aggravating factors, such as involvement in the violation by high-level personnel, the presence of "effective" internal compliance structures will result in a reduction of the organization's fine by up to sixty percent").

compliance, (v) the program should be constantly monitored for success or improvement, (vi) there should be procedures to enable “whistleblowers” to identify violations and communicate them confidentially, (vii) there should be employee policies that provide incentives for compliance and disciplinary action for noncompliance, and (viii) the program should be supported by senior management.⁸⁹

The charging policies of the DOJ are also relevant here. In the wake of numerous corporate scandals (including Enron and the dot.com meltdowns),⁹⁰ the DOJ released the “Thompson memo” to provide guidance to its United States Attorneys on charging practices for corporate violations.⁹¹ Given the timing of the memo, it is not surprising that it strikes a fairly aggressive tone on corporate prosecutions (*e.g.*, stating that indictments can provide “deterrence on a massive scale”⁹²) and strikes a fairly cautious tone on compliance programs. It states that, although “[t]he Department encourages... corporate self-policing,” “the existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation for criminal conduct.”⁹³ It also states that “the commission of such crimes in the face of a compliance program may suggest that the corporate management is not adequately enforcing its program.”⁹⁴

With respect to the design of compliance programs, the Thompson memo does not provide specific guidance. Rather, it emphasizes that “the Department has no formal guidelines for corporate compliance programs”⁹⁵ and notes that the “fundamental questions” are whether the program is “well designed” and “work[s].”⁹⁶ It also directs prosecutors “to determine whether a corporation’s compliance program is merely a ‘paper program’ or whether it was designed and implemented in an effective manner.”⁹⁷ The Thompson Memo has been revised several times since its issuance, but its portions relating to compliance programs have not changed materially.⁹⁸

It is also important to note that the DOJ has begun to pursue structural compliance reform through agreements not to prosecute corporations. As Garrett and others have documented, these “structural reform” prosecutions have

89. *FSG*, *supra* note 84, at ch. 8 pt. B § 2.1.

90. *Corporate Prosecution in a Post-Enron World*, *supra* note 5 (describing genesis of Thompson Memo).

91. *Thompson Memo*, *supra* note 19, at 6.

92. *Id.* at 2.

93. *Id.* at 6.

94. *Id.* The Thompson Memo emphasizes that, of the factors relevant to whether to charge a corporation with criminal conduct, “the most important is the role of management.” *Id.* at 4. This is consistent with the policies of other agencies, such as the FERC, that emphasize the role of management in judging the severity of the offense. However, Khanna has questioned whether this practice is appropriate. Vikramaditya S. Khanna, *Should the Behavior of Top Management Matter?*, 91 GEO. L.J. 1215, 1219 (2003) (“The overall results of my analysis show that although top management’s behavior matters a great deal in influencing the behavior of other corporate agents and the corporation itself, there are only some instances in which the involvement of top management in corporate wrongdoing should result in greater corporate sanctions.”).

95. *Corporate Prosecution in a Post-Enron World*, *supra* note 5, at 7.

96. *Id.*

97. *Id.*

98. UNITED STATES DEP’T OF JUSTICE, MANUAL FOR US ATTORNEYS, PRINCIPLES OF FEDERAL PROSECUTION OF BUSINESS ORGANIZATIONS, Title 9, Ch.9-28.800.

increased sharply in recent years.⁹⁹ With “[o]rganizations fear[ing] the catastrophic punitive fines and severe reputational consequences of a conviction,” the DOJ has pursued “a novel strategy by prosecuting large organizations far more often, but leveraging the prosecutions to secure adoption of sweeping internal reforms.”¹⁰⁰ This has raised some questions about overreaching, with some commentators suggesting that prosecutors use “something close to absolute power”¹⁰¹ to secure “agreements [that] often read like the confessions of a Stalinist purge trial.”¹⁰² Whether or not these prosecutions were appropriate, the important point for purposes of this article is the widespread imposition of structural reforms. As Garrett shows, following the issuance of the Thompson Memo, sixty percent of the corporate settlements required the hiring of an independent monitor and sixty-nine percent required the implementation of a compliance program.¹⁰³

2. The SEC

The SEC’s most detailed statement on cooperation and compliance programs is set forth in a 2001 order approving an enforcement settlement.¹⁰⁴ The order sets forth certain general questions regarding compliance programs and self-reporting that the SEC will consider, the most pertinent here being:

2. What compliance procedures were in place to prevent the misconduct now uncovered? Why did those procedures fail to stop or inhibit the wrongful conduct?
6. How was the misconduct detected and who uncovered it?
7. How long after discovery of the misconduct did it take to implement an effective response?
8. What steps did the company take upon learning of the misconduct? Did the company immediately stop the misconduct? Are persons responsible for any misconduct still with the company? If so, are they still in the same positions? Did the company promptly, completely and effectively disclose the existence of the misconduct to the public, to regulators and to self-regulators?
10. Did the company commit to learn the truth, fully and expeditiously? Did it do a thorough review of the nature, extent, origins and consequences of the conduct and related behavior?
12. What assurances are there that the conduct is unlikely to recur? Did the company adopt and ensure enforcement of new and more effective internal controls and procedures designed to prevent a recurrence of the misconduct?¹⁰⁵

Applying these factors in the case at bar, the SEC decided to forego the imposition of any penalties because the company had quickly identified the violations, promptly report them, remedied them internally through disciplinary

99. Garrett, *supra* note 5, at 854. See also *Corporate Prosecution in a Post-Enron World*, *supra* note 5; Lawrence Finder & Ryan McConnell, *Devolution of Authority: The Department of Justice’s Corporate Charging Policies*, 51 ST. LOUIS L.J. 1 (2006) (discussing DOJ corporate charging policies before and after the Thompson Memo); Griffin, *Compelled Cooperation and the New Corporate Criminal Procedure*, 82 N.Y.U.L. REV. 311 (2007).

100. Garrett, *supra* note 5, at 855.

101. John C. Coffee, Jr., *Deferred Prosecution: Has it gone too far?*, NAT’L L.J., July 25, 2005 at 13.

102. Richard A. Epstein, Op-Ed., *The Deferred Prosecution Racket*, WALL. ST. J., Nov. 28, 2006 at A14.

103. Garrett, *supra* note, 5 at 895.

104. Securities and Exchange Commission, Accounting and Auditing Enforcement Release No. 1470, 2-4 (Oct. 23, 2001).

105. *Id.* at 5-9.

actions, and taken prospective corrective action to avoid future violations. Its discussion of these facts provided additional guidance as to how its generic policy would be implemented:

We are not taking action against the parent company, given the nature of the conduct and the company's responses. Within a week of learning about the apparent misconduct, the company's internal auditors had conducted a preliminary review and had advised company management who, in turn, advised the Board's audit committee, that Meredith had caused the company's books and records to be inaccurate and its financial reports to be misstated. The full Board was advised and authorized the company to hire an outside law firm to conduct a thorough inquiry. Four days later, Meredith was dismissed, as were two other employees who, in the company's view, had inadequately supervised Meredith; a day later, the company disclosed publicly and to us that its financial statements would be restated. The price of the company's shares did not decline after the announcement or after the restatement was published. The company pledged and gave complete cooperation to our staff. It provided the staff with all information relevant to the underlying violations. Among other things, the company produced the details of its internal investigation, including notes and transcripts of interviews of Meredith and others; and it did not invoke the attorney-client privilege, work product protection or other privileges or protections with respect to any facts uncovered in the investigation.

The company also strengthened its financial reporting processes to address Meredith's conduct - - developing a detailed closing process for the subsidiary's accounting personnel, consolidating subsidiary accounting functions under a parent company CPA, hiring three new CPAs for the accounting department responsible for preparing the subsidiary's financial statements, redesigning the subsidiary's minimum annual audit requirements, and requiring the parent company's controller to interview and approve all senior accounting personnel in its subsidiaries' reporting processes.

Our willingness to credit such behavior in deciding whether and how to take enforcement action benefits investors as well as our enforcement program. When businesses seek out, self-report and rectify illegal conduct, and otherwise cooperate with Commission staff, large expenditures of government and shareholder resources can be avoided and investors can benefit more promptly.¹⁰⁶

In 2006, the SEC issued another statement of general policy regarding the imposition of civil penalties.¹⁰⁷ The SEC noted that its "authority to impose [civil] penalties is relatively recent in the Commission's history, and the use of very large corporate penalties is more recent still."¹⁰⁸ The SEC noted that, against this backdrop, providing generic guidance was important because "[r]ecent cases have not produced a clear public view of when and how the Commission will use corporate penalties, and with the Commission itself a variety of views have heretofore been expressed, but not reconciled."¹⁰⁹ The statement of policy did not, however, provide significant new detail on the role

106. *Id.* at 1-3.

107. Statement of the Securities and Exchange Commission Concerning Financial Penalties, Release No. 2006-4 (Jan. 4, 2006).

108. *Id.* at 1.

109. *Id.*

of compliance programs or cooperation generally.¹¹⁰ Rather, the primary purpose of the release was to address the relevance of shareholder harm to civil penalty imposition, finding that “the strongest case for the imposition of a corporate penalty is one in which the shareholders of the corporation have received an improper benefit as a result of the violation; the weakest case is one in which the current shareholders of the corporation are the principal victims of the securities law violation.”¹¹¹

3. The EPA

The EPA adopted a formal policy in 1995 (and amended it in 2000) to encourage detection, self-reporting, and correction of environmental violations.¹¹² The purpose of the policy “is to enhance protection of human health and the environment by encouraging regulated entities to voluntarily discover, promptly disclose and expeditiously correct violations of Federal environmental requirements.”¹¹³ In developing this policy, the EPA relied on the framework of the Guidelines and emphasized that its conditions are “flexible enough to accommodate different types and sizes of businesses and other regulated entities” regulated by the EPA.¹¹⁴ When the EPA reaffirmed the policy in 2000, it studied its effectiveness over the first five years and found that the number of self reports had increased every year under the policy.¹¹⁵

The EPA’s program waives 100 percent of a civil penalty for a violation that was detected, reported and remedied through a “systematic” compliance monitoring system and seventy-five percent of penalties for violations that were detected, reported, and remedied without such a systematic program.¹¹⁶ As the EPA explained, the purpose of this policy is to encourage better self-policing by corporations, given limited government enforcement resources:

The revised Policy being announced today is designed to encourage greater compliance with Federal laws and regulations that protect human health and the environment. It promotes a higher standard of self-policing by waiving gravity-based penalties for violations that are promptly disclosed and corrected, and which were discovered systematically—that is, through voluntary audits or compliance management systems. To provide an incentive for entities to disclose and correct violations regardless of how they were detected, the Policy reduces gravity-based penalties by 75% for violations that are voluntarily discovered and promptly disclosed and corrected, even if not discovered systematically.

* * *

110. *Id.* at 4. (The policy statement cites factors such as whether the violation represented “isolated conduct by only a few individuals” and whether the corporation took prompt steps to report the conduct and correct it internally).

111. *Id.* at 3.

112. Incentives for Self-Policing, Discovery, Disclosure, Correction and Prevention of Violations, 65 Fed. Reg. 19,618 (2000) [hereinafter *EPA Audit Policy*]. For a good discussion of competing theories of environmental enforcement generally, see also Clifford Rechtschaffen, *Deterrence versus Cooperation and the Evolving Theory of Environmental Enforcement*, 71 S. CAL. L. REV. 1181 (1998).

113. 65 Fed. Reg. at 19,618.

114. *Id.* at 19,621

115. *Id.* at 19,619.

116. This waiver of civil penalties does not apply to the disgorgement of “economic benefits” of the violation. This is similar to FERC’s policy that considers civil penalties separate from the disgorgement of unjust profits.

[B]ecause government resources are limited, universal compliance cannot be achieved without active efforts by the regulated community to police themselves. More than half of the respondents to the... 1995 Price Waterhouse survey said that they would expand environmental auditing in exchange for reduced penalties for violations discovered and corrected. While many companies already audit or have compliance management programs in place, EPA believes that the incentives offered in this Policy will improve the frequency and quality of these self-policing efforts.¹¹⁷

The Policy adopts the following nine conditions (all of which must be satisfied for a full waiver and eight of which must be satisfied for a seventy-five percent waiver): (i) the violation must have been discovered “systematically” through either an environmental audit, or a compliance management system that reflects due diligence in preventing, detecting and correcting violations;¹¹⁸ (ii) “the violation must have been identified voluntarily, and not through a monitoring, sampling, or auditing procedure that is required by statute, regulation, permit, judicial or administrative order, or consent agreement”;¹¹⁹ (iii) the violation must be reported to the EPA within twenty-one days of its detection;¹²⁰ (iv) the violation must be detected “before EPA or another government agency likely would have identified the problem either through its own investigative work or from information received through a third party”;¹²¹ (v) “the entity must remedy any harm caused by the violation and expeditiously certify in writing to appropriate Federal, State, and local authorities that it has corrected the violation”;¹²² (vi) “the regulated entity must agree to take steps to prevent a recurrence of the violation after it has been disclosed... [such as] improvements to the entity’s environmental auditing efforts or compliance management system”;¹²³ (vii) the violation must not have been a repeat violation at the same facility within the past three years;¹²⁴ (viii) the mitigation policy does *not* apply to “violations that result in serious actual harm to the environment or which may have presented an imminent and substantial endangerment to public health or the environment”¹²⁵; and (ix) the entity must cooperate with the EPA.¹²⁶

II. FERC ENFORCEMENT POLICY AND CORPORATE COMPLIANCE PROGRAMS

The FERC’s first Enforcement Policy Statement was adopted in October 2005¹²⁷ and “encourage[s] regulated entities to have comprehensive compliance programs, to develop a culture of compliance within their organizations, and to

117. *EPA Audit Policy*, *supra* note 112, at 19,619.

118. *Id.* at 19,621.

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. *Enforcement of Statutes, Orders, Rules, and Regulations*, 113 F.E.R.C. ¶ 61,068 (2005). The Statement adopted factors that were consistent with the Commission’s earlier regulations addressing penalties for violations of Part 1 of the Federal Power Act (concerning hydropower licensing). *Id.* at P 11 (*citing* 18 C.F.R. § 385.1505).

self-report and cooperate with the [FERC] in the event violations occur.”¹²⁸ The Policy Statement therefore identified compliance programs as a “mitigating” factor in assessing penalties and posed questions to be considered in determining how much mitigation is due, including: (i) whether the company’s compliance plan is formal and well-documented; (ii) whether it is actively supported by senior management; (iii) whether it includes formal training of employees; (iv) whether there are audits of compliance; and (v) how the company responds to violations, such as with disciplinary action.¹²⁹

The FERC began implementing the Policy Statement through a series of settlement orders adopted in 2007. These early settlement orders do not, however, contain much discussion of whether the company’s compliance program (or lack thereof) was relevant to the size of the penalty imposed.¹³⁰ However, a few of the orders require the company to expend funds to create a stronger compliance program going forward.¹³¹

Despite the lack of discussion of compliance programs in these early orders – or perhaps because of it – many in the regulated community criticized the FERC for not giving adequate credit for self-reports and other components of a strong compliance program. Responding to these concerns at the November 2007 technical conference, Chairman Kelliher stated:

The object of FERC enforcement policy is to achieve maximum compliance with regulatory requirements. We can achieve greater compliance by taking steps to strengthen the compliance programs of regulated companies, by using our penalty authority to encourage compliance, and by being clear in our regulatory requirements. Our goal is compliance, not the collection of civil penalties. However, it is sometimes necessary to impose civil penalties in order to encourage maximum compliance.

It is a personal priority for me as a Chairman to strengthen compliance programs in the regulated community. Actions we can take now to strengthen compliance will pay great dividends over time.

* * *

It is therefore important that companies put in place strong compliance programs that have internal controls that reduce or eliminate the incidence of violations. Once such a program is in place, if a violation nonetheless occurs and is detected as part of the compliance program (such as through internal audits), the violation should be self-reported. *It is the combination of a strong compliance program and self-reporting that provides a regulated company the best opportunity for avoiding a significant civil penalty, or perhaps avoiding a penalty altogether.*¹³²

128. *Id.* P 2.

129. *Id.* P 22.

130. See generally, *Revised Policy Statement on Enforcement*, 123 F.E.R.C. ¶ 61,156 at P 61 (2008). (“While we do not articulate here the precise amount of mitigation credit that was earned for self-reporting in our recent enforcement actions, we reiterate that the penalties would have been greater absent self-reporting”).

131. Accounting and Auditing Enforcement Release, *supra* note 104.

132. *Conference on Enforcement Policy*, *supra* note 12. The belief that an increased focus on compliance can induce positive change in corporations is consistent with the views of sister agencies. The SEC’s former director of enforcement has stated: “Throughout corporate America there are signs of fundamental change -- a profound shift to a corporate culture of cooperation and compliance. . . . Boards of directors are becoming stronger and more independent. They are starting to take decisive action in response to ethics and compliance failures.” Stephen M. Cutler, Director of Enforcement, U.S. Sec. and Exch. Comm’n, Remarks Before the Directors’ Education Institute at Duke University (Mar. 18, 2005), available at

Six months later in May 2008, the FERC revised its enforcement policies in a series of orders (including a Revised Policy Statement) and, pertinent here, codified the Chairman's increased focus on compliance programs.¹³³ As explained by the Chairman, the Revised Policy Statement "make[s] it clear that the commitment of a company to compliance will be one of the two most important factors in our determination of civil penalty amounts, along with the seriousness of the offense."¹³⁴

The Revised Policy Statement emphasizes a number of factors that will be considered in determining the strength of a compliance program, including "(i) systems and protocols for monitoring, identifying and correcting possible violations, (ii) a management culture that encourages compliance among company personnel, and (iii) tools and training sufficient to enable employees to comply with [FERC] requirements."¹³⁵ The Policy Statement also emphasizes the relevance of "the actions taken by the company to correct the activity that produced the violation."¹³⁶ The Revised Policy Statement also provides guidance on self-reporting, including whether the violation was detected through an internal audit, promptly reported to the FERC, and promptly corrected. Finally, the FERC announced that it would "hold periodic workshops in which we will discuss the elements we expect to see in vigorous compliance programs."¹³⁷

III. RECOMMENDATIONS

This section recommends that the FERC adopt a formal policy for when an effective compliance program can mitigate civil penalties. Although there are several reasonable approaches to this issue, my proposal is as follows: the FERC should decline to impose a civil penalty for *nonserious* violations if (i) the company had reasonable preventive measures in effect (*e.g.*, hiring, training, and supervision), (ii) its compliance program detected and reported that violation promptly, and (iii) the company took appropriate remedial action (*e.g.*, to discipline the offensive behavior and/or implement prospective reforms). For more serious offenses, these three factors would be given significant weight, but would not necessarily avoid imposition of a penalty. I will describe each element of the proposal below and compare it to the academic work and federal agency practice in this area. I will then discuss how the prongs relate to each other in determining penalty mitigation.

A. *Serious vs. Nonserious Violations and The Calculation of Penalty Amounts*

The first element of the proposal that merits discussion is the distinction between serious and nonserious violations. If a corporation satisfies the three prongs of the test – reasonable preventive measures, detection and reporting, and

<http://www.sec.gov/news/speech/spch031805smc.htm>. – Check which statement these come from through the whole article.

133. *Revised Policy Statement on Enforcement*, 123 F.E.R.C. ¶ 61,156.

134. *Statement on Enforcement Package*, *supra* note 11.

135. 123 F.E.R.C. ¶ 61,156 at P 57.

136. *Id.*

137. *Id.*

remediation – it can avoid a penalty for nonserious violations, but not necessarily for serious violations. I define “nonserious” as offenses that produce little or no social harm.

At first blush, the distinction between serious and nonserious offenses may appear unwise. The seriousness of an offense does not necessarily correlate to the culpability of the corporation. A rogue employee can ignore a company’s compliance program and engage in a serious offense, just as he or she can ignore the program and engage in a nonserious offense. I therefore acknowledge there are some problems with this distinction, but nonetheless believe it appropriate for the following reasons.

First, it is consistent with the “composite” approach followed by most federal agencies.¹³⁸ Without this distinction, the test would essentially convert the theory of liability into a duty-based one, *i.e.*, the corporation would not be liable – regardless of the harm to third parties or the seriousness of the offense – if it had adhered to a standard of care in prevention, detection/reporting, and remediation. There is some support in the literature for such an approach, but it is a distinct minority (primarily by practitioners)¹³⁹ and it would represent a sharp departure from the practice of most federal agencies. Even the EPA, which has one of the most progressive penalty mitigation policies, retains an exception for serious offenses.¹⁴⁰

To be sure, a foolish consistency is not desirable and so the question remains whether the distinction should be retained for reasons other than consistency with federal agency practice. I think the answer is still yes. The difficulty of parsing cosmetic programs from effective ones is real and, although this difficulty applies to both serious and nonserious offenses, the consequences of error are obviously greater the more serious the offense. When the question becomes whether to absolve a corporation of all liability for a very serious offense (*e.g.*, where customers were significantly harmed by market manipulation or electricity blackouts), the softness of the analysis on compliance program design is a matter of real concern.

My proposal is also generally consistent with much of the economic literature. Economists generally contend that, to achieve optimal deterrence, a penalty should equal the social harm of a violation, divided by the probability of detection.¹⁴¹ The economic literature therefore does not generally favor *elimination* of penalties for effective compliance programs, but rather only a

138. *Corporate Prosecution in a Post-Enron World*, *supra* note 5.

139. *Can a Corporation Save its Soul?; supra* note 22; *Why Punish?; supra* note 22.

140. 65 Fed. Reg. at 19,621.

141. Arlen, *supra* note 19, at 834 (“Crime is deterred efficiently . . . if the corporation is held strictly liable for all its crimes, subject to a fine equal to the social cost of crime divided by the probability of detection (H/p), because this forces the corporation to internalize the social cost of its criminal activity.”); Garrett, *supra* note 5, at 875-76 (“Following deterrence theory, which provides an economic justification for corporate criminal liability, prosecutors should seek to impose an optimal punishment based on the harm and the probability of detection of the malfeasance.”). *See also* John T. Byam, *The Economic Inefficiency of Corporate Criminal Liability*, 73 J. CRIM. L. & CRIMINOLOGY 582, 598 (1982); *See generally* Garry S. Becker, *Crime and Punishment: An Economic Approach*, JOURNAL OF POLITICAL ECONOMY, Vol. 76, No. 2, p. 193 (1968) (punishment for crime should be through fines determined by the social cost of the crime).

reduction to a residual level, such as to account for the increase in probability of detection through the firm's policing efforts.¹⁴²

My proposal is generally consistent with this approach because it defines nonserious as offenses that produce little or no social harm. This class of offenses is not, as might appear at first blush, *de minimis*. Many FERC regulations prohibit conduct that *may* harm the public in many cases, but not necessarily in all cases. Examples include mergers that occur without prior authorization or violations of tariffs intended to prevent undue discrimination. These acts *may* harm the public, but, as cases such as *Bangor*¹⁴³ and *Gexa*¹⁴⁴ illustrate, this will not always be the case.¹⁴⁵

For these and other similar cases, my proposal would eliminate civil penalties if the firm satisfied each prong of the test. Admittedly, this is an imperfect solution to a difficult problem. On the one hand, an economist could argue that no penalty is appropriate in these cases *irrespective* of compliance efforts because there is no social harm. By contrast, a political scientist could argue that social cost should not play such a pivotal role, particularly when the FERC has made generic findings regarding the public harm necessitating its regulations and, in addition, because social cost is difficult to calculate in any event. I concede there are arguments on both sides that would push my proposal in one direction or the other, but I nonetheless believe it strikes the appropriate balance by using social cost as the standard, but not eliminating a penalty unless a firm also satisfies all three prongs.¹⁴⁶

For more serious offenses, my proposal would offer mitigation for firms that could satisfy prongs one through three, but the civil penalty would not be eliminated entirely. As Arlen, Kraakman, and Langevoort argue, where there is significant social harm, compliance programs should reduce the penalty, but not eliminate it.¹⁴⁷ I agree and believe the reduction should be significant if all three prongs are satisfied. The more serious the potential harm to the public, the more we should care about providing strong incentives for corporations to adopt rigorous internal controls to prevent and/or report such behavior. Mitigation credit should therefore be significant for serious violations if all three prongs of the test are satisfied, even if the penalty is not eliminated altogether.

142. *Controlling Corporate Misconduct*, *supra* note 23, at 719, 726-27; *Behavioral Economics of Corporate Compliance*, *supra* note 1, at 115.

143. *In re Bangor Gas Co., LLC*, 118 F.E.R.C. ¶ 61,186, at P 12 (2007) ("no identifiable financial harm to third parties").

144. *In re Gexa Energy LLC*, 120 F.E.R.C. ¶ 61,175 at P 15 (2007) ("there was no harm to the market or to market participants from Gexa's violations discussed here");

145. Reliability violation are another good example. The standards adopted under FPA Section 215 do not punish only that conduct which results in outages, but rather sets standards that are designed to prevent outages.

146. *Conference on Enforcement Policy*, *supra* note 12. I am not suggesting that a penalty is appropriate for *every* violation of FERC regulations if the firm does not satisfy all three prongs. The FERC routinely exercises its enforcement discretion not to impose civil penalties in a variety of circumstances having nothing to do with compliance programs. This is a standard enforcement practice that should continue. Rather, my proposal is intended to address violations for which FERC would typically impose a penalty *but for* the existence of mitigation for compliance programs.

147. 123 F.E.R.C. ¶ 61,156.

Before concluding this section, two additional points merit discussion. First, in proposing a distinction between serious and nonserious offenses that is based on social cost, I recognize that the FERC uses a long list of factors to determine penalties, only one of which is social harm. Importantly, the FERC may consider certain violations to be serious, even if they pose no actual social harm.¹⁴⁸ I do not disagree that there may be exceptions where significant penalties may be appropriate if the *risk* of serious social harm is high, but no actual harm occurred (just as there are significant penalties for attempted murder, not just actual murder), but I believe these to be the exceptions, not the rule.

The second point is the issue of whether penalties or penalty mitigation should be fixed in advance or vary with the facts of each case. The Guidelines provides a model for the former, adopting fixed base penalty amounts that are increased or decreased to account for aggravating and mitigating factors.¹⁴⁹ Although this approach is helpful in providing consistency where multiple judges are setting penalties,¹⁵⁰ I do not propose it here for several reasons.

First, consistency is not the central concern here because, with the exception of reliability violations, the FERC is the only arbiter of penalties (and, even for reliability violations, it is the final arbiter).¹⁵¹ Second, as Arlen, Kraakman, Khanna, and others argue, fixed penalty schedules are almost certain to ensure that penalties do not track the social cost of the crime and thus will be either too high or too low to provide the right incentives.¹⁵² I agree. Although violations can be ranked roughly in terms of severity, this does not mean that penalties for them should be determined *ex ante*. For example, most would agree that market manipulation and reliability violations that cause blackouts can be “severe” violations, but this does not help us in calculating penalties *ex ante*. A reliability violation that results in an outage to a small town should not receive the same penalty as one that blacks out the entire East Coast. Market manipulation that skews trading on an illiquid hub should not receive the same penalty as manipulation that contributes to something akin to the California electricity crisis. That is why case-by-case determinations are appropriate in this area.

148. *Statement on Enforcement Package*, *supra* note 11, at 5 (significant penalties may be appropriate for violations that pose a risk of serious harm, but not actual harm).

149. *FSG*, *supra* note 84, at ch. 8 pt. C § 2.5.

150. As it relates to the Sentencing Guidelines, this consideration was of particular importance given the large number of federal district courts that must apply penalties. For somewhat similar reasons, the electric industry adopted a “penalty matrix” for reliability violations under FPA Section 215 to help ensure consistency in penalty determinations by the different NERC regions.

151. The exception is, of course, judicial review in each case.

152. *Controlling Corporate Misconduct*, *supra* note 23, at 747 (“the [Sentencing] Commission must abandon its goal of standardizing fines for all similar crimes, and attempt to take into account the impact of policing measures on the probability of detection”); *Corporate Liability Standards*, *supra* note 20, at 1,268 (“If the corporation does take optimal enforcement measures then this high fine would be reduced down to a minimum fine that the corporation would still have to pay. This minimum fine should still impose the full expected social costs of the activity on the corporation (i.e., this minimum fine is the strict liability fine”). *Behavioral Economics of Corporate Compliance*, *supra* note 1, at 115; Chris William Sanchirico, *Detection Avoidance*, 81 N.Y.U.L. REV. 1331, 1373 (2006) (fixed fines may perversely increase corporate expenditures on detection avoidance).

B. Prong One: Reasonable Preventive Measures

Prong one requires that a company had reasonable preventive measures (e.g., hiring, training and supervision, including monitoring) in effect when the violation occurred. This prong is, in some respects, the most difficult to apply. The literature makes a fairly compelling case that it is difficult to parse cosmetic compliance programs from effective ones, particularly as it relates to preventive measures. Prong one nevertheless serves an important function, even if it is one that must be approached with care. As Chairman Kelliher has explained, ex post self-reports are not sufficient, standing alone, to mitigate a penalty:

[S]elf-reports are better understood as an essential component of a sound compliance program, not a factor that stands alone. For example, consider a hypothetical company that violates the law every day and is rigorous in reporting those violations every day. In my view, such a company should not be rewarded for those self-reports, but rather should be viewed as suspect for not having a sound compliance program dedicated to reducing or eliminating the incidence of violations.¹⁵³

As Kelliher's point suggests, preventive measures should be considered in penalty mitigation to avoid rewarding the "habitual self-reporter" who does not have effective preventive measures in place. This does not mean, however, that "repeat" self-reports should, standing alone, constitute evidence of a weak compliance program. Rather, given the complexity and number of the FERC regulations, even a company with a strong compliance program will incur violations from time to time and, particularly if those violations are nonserious, the fact that they occurred and were self-reported should not, standing alone, suggest a weak compliance program and hence significant penalties.

Prong one is also consistent with much of the literature in this area. Arlen, Kraakman, and Langevoort support providing credit for preventive measures, particularly for the elements of monitoring and supervision that are preventive in nature.¹⁵⁴ (A duty-based approach would go even further, providing full credit for reasonable preventive measures even if the firm did not actually detect and report the violation.)¹⁵⁵ By contrast, Krawiec and others argue against providing credit for preventive measures because of the difficulty of making duty-based evaluations.¹⁵⁶ I agree with this concern to some degree because courts and agencies have imperfect information in making distinctions in this area. However, this does not mean that *no* credit should be given for preventive measures. After all, the purpose of policy in this area is to *prevent* violations and therefore some credit should be given for reasonable preventive measures. My proposal does so and addresses Krawiec's concern by withholding *full* credit for those cases where a firm actually detects and reports the violation as well.

On the implementation issue of what constitutes "reasonable" preventive measures, I agree with Langevoort that neither "common" industry practice nor

153. *Conference on Enforcement Policy*, *supra* note 12, at 3.

154. *Controlling Corporate Misconduct*, *supra* note 23, at 736-41; *Behavior Economics of Corporate Compliance*, *supra* note 1, at 111-115.

155. *Controlling Corporate Misconduct*, *supra* note 23, at 736; *Can a Corporation Save its Soul?*, *supra* note 22; *Why Punish?*, *supra* note 22.

156. *Beyond the Principal-Agent Model*, *supra* note 15.

agency-dictated “optimal” practices should be the standard.¹⁵⁷ The industry’s “common” practice is likely to set the bar too low, particularly at this early stage of the FERC’s modern enforcement regime. Many companies are only now developing comprehensive FERC compliance programs, and the FERC has only recently articulated a philosophy that would encourage such programs by providing penalty mitigation. It is therefore too early to defer to common practices, even if that was ever a wise choice (which Langevoort suggests is not the case).

On the other hand, I agree that agency-dictated “optimal” practices should not be the standard either. As Langevoort contends, courts and agencies have an inherent bias to favor overly aggressive compliance programs that produce wasteful spending.¹⁵⁸ Moreover, as Krawiec and others argue, courts and agencies have limited information in assessing compliance program design and therefore should be reluctant to create such designs from scratch.¹⁵⁹ There are too many difficult corporate law issues relating to governance, supervision, compensation, and hiring that are implicated in this area for a government agency to be expected to create an optimal program on its own.

This is why I believe industry “best practices” should be the goal in this area, as Langevoort argues. The FERC has moved in the right direction in this area by holding a recent technical conference on industry compliance practices. To further this effort, the regulated community would benefit from coalescing around a model compliance program or, at a minimum, gathering information on the best practices that exist today. Until this occurs, it may not be possible to determine whether the subject of an investigation has used “best practices,” but it should be possible to determine whether it made reasonable efforts to prevent violations through corporate culture, training, monitoring, etc. During a transition period, this should be sufficient, even if not ideal.

C. *Prong Two: Detection and Reporting*

The second prong requires that a corporation actually detect and report the violation. In this respect, the proposal is “result-based” because, to receive full mitigation, a firm must not only use reasonable supervision and monitoring to detect violations, it must actually detect and report them to receive full credit. Although my proposal has this result-based element, it is not solely result-based. I agree with Arlen and Kraakman that a pure result-based model can produce over-monitoring and hence social waste. My proposal, therefore, does not give credit *only* when a violation is actually detected and reported. Rather, it limits *full* mitigation to those cases. In this respect, it is a “multi-tiered” regime that offers varying levels of credit for varying levels of performance, a regime that Arlen and Kraakman favor under many circumstances.

Before turning to prong three, there is one obvious implementation question that should be addressed – *i.e.*, how quickly a violation must be reported. The EPA’s audit policy requires that a violation be reported within twenty-one days

157. *Behavior Economics of Corporate Compliance*, *supra* note 1, at 111-115.

158. *Id.* at 113.

159. *Beyond the Principle Agency Model*, *supra* note 15.

of its detection to qualify for full mitigation credit.¹⁶⁰ This approach has the benefit of encouraging prompt reporting, but such a bright line may not be appropriate for the FERC's enforcement. Not every FERC regulation is clear and, therefore, in some cases it may take time to determine whether a particular act violated the law.¹⁶¹ Equally important, it may also take time to determine whether a particular act was an isolated event or part of a recurring pattern of conduct. I would, therefore, suggest a more flexible approach of requiring "prompt" reporting and address whether that occurred on a case-by-case basis. The essential inquiry should be whether the corporation acted diligently and without delay to investigate and report the violation, not whether a particular fixed time period was met.

D. Prong Three: Remediation

The third prong of the test requires that the firm take reasonable steps to remedy the misconduct (*e.g.*, taking disciplinary action). The issue of remediation has received less attention in the literature than detection and reporting, but it is nonetheless important for several reasons. First, the FERC's statutory penalty authority generally requires it to consider "the efforts of [the violator] to remedy the violation in a timely manner."¹⁶² Second, although remediation is a policing measure, it also serves an important preventive role as well. If employees fear they will be sanctioned for misconduct, they are less likely to commit violations. However, for a firm to be credible in this area, it must not only have *ex ante* policies that communicate that message, it must follow through with disciplinary action once that misconduct occurs.

Second, requiring remediation has efficiency benefits as well. A corporation can more quickly and effectively remedy unlawful conduct than the government. For example, a corporation can stop unlawful conduct immediately and adopt stronger controls to make it less likely to reoccur in the future – all without the lengthy delays typically associated with government action (some of them for good reason, *e.g.*, providing due process).

It is for these reasons that I propose a third prong that requires some reasonable level of remediation. Admittedly, however, this prong is not simple to administer because it implicates certain subjective judgments. For example, there are a range of potential disciplinary actions that may be appropriate on a given set of facts (*e.g.*, a reprimand, cut in pay or, in the worst case, termination) and these judgments are somewhat subjective or, at a minimum, difficult for agencies to evaluate *ex post*. The issue of *which* prospective changes, if any, are necessary to prevent the conduct from reoccurring also implicates a somewhat subjective area.

Because of this, I would counsel against a bright-line test or setting the bar too high in this area. Rather, the FERC should focus on whether the corporation acted reasonably to discipline the conduct and adopt any necessary controls to

160. *EPA Audit Policy*, *supra* note 112 at 19,621.

161. For similar reasons, Arlen and Kraakman critique the Sentencing Guidelines as "forc[ing] firms to report - and even plead guilty to - suspected wrongdoing before they can determine whether their agents committed wrongs." *Controlling Corporate Misconduct*, *supra* note 23, at 748.

162. 16 U.S.C. § 825(o)(1)(b).

prevent its reoccurrence. This is obviously a fact-specific inquiry, as well as a somewhat subjective one, but it is probably the best that can be done in this area.

E. The Relationship Between Each Prong of the Test

This section addresses how the three prongs relate to each other in calculating penalty mitigation. I do not propose a “fixed weighting” of each prong for reasons similar to the reasons for not favoring *ex ante* penalty schedules. Instead, I favor an approach whereby the FERC articulates *why* each factor is important, but not necessarily *how* they will be weighted in each individual case. If handled carefully, this approach can give industry sufficient guidance to structure strong compliance programs, but without tying the FERC’s hands in reaching the right result in individual cases.

A few examples hopefully will illustrate this point. Consider a case where a firm has adopted a compliance program that clearly exhibits the best practices in the industry, but it fails to detect a particular violation through no fault of its own (*e.g.*, because an employee concealed it) and that violation instead is uncovered through a FERC audit. In this situation, adopting a rigid approach that assigns a fixed “weight” to each of the three factors, such as by weighting them equally (thirty-three percent each), would only ensure that the FERC gets the answer wrong. As explained in the foregoing sections, the reason for the “result-based” prongs of my proposal is the recognition that evaluating compliance program design is very difficult. However, in a case where it is quite clear that a firm has adopted industry best practices, and its failure to detect the violation is not because of a defect in its monitoring and supervision program, it would send the wrong signal to provide only minimal penalty mitigation. Rather, in this case, the mitigation should be very high (albeit not complete), despite the fact that prongs two and three were not met.

Conversely, consider a case where it is quite clear that a firm has a very poor compliance program (*e.g.*, poor corporate culture, little or no training and porous monitoring and supervision), but it nonetheless detects, reports and remedies a particular violation. Here again, a rigid policy that fixes the weight of each factor in advance would do more harm than good. In this situation, the firm has satisfied two of the three prongs, but its weak compliance program would suggest only modest penalty mitigation. To be sure, the FERC must consider whether it would have uncovered the violation on its own,¹⁶³ but the case remains a good example of where failure to satisfy prong one can weigh heavily against significant penalty mitigation even where prongs two and three are satisfied.

These examples hopefully illustrate how a policy that clearly articulates *why* each factor is important can provide sufficient guidance to industry without

163. As the economic literature indicates, the probability of detection should play a significant role in penalty calculations and, therefore, the less likely the government would have uncovered the violation on its own the more mitigation credit should be provided for self-reports. *Controlling Corporate Misconduct*, *supra* note 23, at 721 (discussing models that “induce optimal policing measures within a strict liability framework by continuously reducing sanctions to offset an increased probability of detection”). For two articles focusing on differing issues related to detection. *Detection Avoidance*, *supra* note 152, at 1,373 (“In practice, the problem of law enforcement is half a matter of what the government does to catch violators and half a matter of what violators do to avoid getting caught.”) and Byam *supra* note 141, at 598.

unduly tying the FERC's hands in determining *how* each factor is applied in individual cases. I am not suggesting this approach is perfect and, if more detailed guidance can be given without sacrificing accuracy, it should be. But I do believe that my proposal is superior to either extreme – either: (i) articulating a long list of factors without any real explanation as to why each is important or how they relate to each other, or (ii) fixing in advance the weight that each prong or fact will receive.

CONCLUSION

The FERC's modern enforcement regime remains relatively young and evolving. Its recent focus on compliance programs in the calculation of civil penalties constitutes an important part of this evolution. FERC should be commended for continuing this evolution by adopting the recent *Policy Statement on Compliance*. As the literature indicates, incentives matter very much in this area and therefore adopting such a formal policy framework should help to encourage the adoption of strong compliance programs by regulated companies and therefore benefit society.