



Reflections on Corporate Governance, Managerial Incentives, and Regulatory/Antitrust Compliance

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***To Enforce and Comply: Incentives inside
Corporations and Agencies***

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Keynote Speech

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How to get Corporate Compliance?

- Antitrust 'out of fashion' with the crisis, when states compete on how to increase corporations' margins...
- But issues of firm governance and compliance relevant for financial regulation (bank risk taking behavior...) and many other laws

Main underlying policy questions:

- Should the fact that a firm is a complex organized composition of individuals and assets affect the way we should design and enforce the law?
- If yes, how?
- Partly based on Buccrossi-Spagnolo 2008 (ABA Book)
- I'll try to raise some interesting issues for the Panel ²

Firm Objectives...

- ...do not usually include 'compliance', with financial regulation or antitrust laws...
- Shareholders vs stakeholders debate
 - Shareholders: maximization of discounted expected flow of profits, vs.
 - Stakeholder: welfare of employees, creditors, local community, suppliers... *but not consumers*
- *Legal environment*, e.g. financial regulation or antitrust laws and their *enforcement*, can be seen as an *incentive scheme* between the 'collective principal' and their 'agents' (citizens and firms)
- Main difference with standard Pr.-Ag.: political involvement of agents to choose principals' intermediaries and affect their incentive schemes...
political sustainability constraints

Employees/Managers' Objectives

- Firms owned by shareholders but acting through managers and other employees with own preferences
- Other classic Pr.-Ag. problem, in which shareholders try to discipline managers' behavior through
 - Direct monetary compensation
 - Internal career concerns
- Interacting with many other important drivers of managers/employees' behavior, including
 - External career concerns (future monetary compensation)
 - Status in society, social relations and approval...
 - Legal risk (incapacitation)
 - Moral, cultural and religious values (e.g. 'do not betray colleagues')

Corporate or Individual Crime?

- ❑ Corporate crime committed by individual managers or employees representing shareholders
- ❑ Case 1: no serious Governance problems;
 - management/employees act in accordance with shareholders (and no strong externalities between groups of shareholders), so that we can consider the firm as one entity
- ❑ Not so interesting: then no big difference from law enforcement against individuals, apart from available sanctions (limited liability, no imprisonment), almost standard 'optimal deterrence' story
- ❑ More interesting Case 2: Governance problems;
 - shareholders unable to fully control management, employees
 - then question relevant: can we modify laws and their enforcement to help them?

Case 1: no Governance Problems

Assuming away internal agency problems, the main concerns are those typical of standard optimal deterrence (expected fines, self reporting schemes...), as any individual fine will be indemnified

What remains somewhat special about Corporate compliance in my view are mainly:

- Political influence linked to the ability of corporations to affect law enforcers... not the focus of this talk
- Constraints on sanctions linked to limited liability

We will discuss it briefly here, as sufficiently high sanctions for firms-shareholders are a necessary, though not always sufficient condition for compliance

Limited Liability and Corporate Crime

- Limited liability crucial to encourage **risk taking**...
- As we know from the crisis and theory of bank regulation, some times it leads instead to **excessive risk taking** and **risk shifting**...
- There is no obvious principle suggesting that the same degree of limited liability is optimal for **legal** and for **illegal** risk taking...
- For the Panel:
Shouldn't we at least consider limiting liability protection for corporate crimes that benefit shareholders, or other forms of extended liability (e.g. to creditors, as suggested by Hiriart and Martimort (2006) for environmental damage)?

Limited Liability and Antitrust Fines

In Antitrust there is a tendency to take for granted that we should never risk to drive bankrupt a competitor, as this may increase industry concentration...

- Fines have been ridiculously small in the past, are still very small in many jurisdictions, and are still bounded above by strange ad hoc criteria, like 10% of global yearly **turnover or sales**...
 - So that industries at the end of the chain have higher fines?
 - So that smart managers choose an optimal cartel price above monopoly price to reduce turnover and expected fines?

“FINE TUNING”

- US Courts have been ‘fine tuning’, i.e. adapting fines to financial status of companies (Crayfish et al. 1997)
- Some legal scholars has even been writing that this is the right thing to do when setting fines...

Strategic judgement proofing...

- Literature on Judgment Proofness (from Shavell 1986 to Che and Spier 2008): Reducing fines for companies that are more indebted...
 - Distorts firms' capital structure inducing them to increase leverage in order to be safe for high fines
 - Reducing/eliminating the deterrence effect of fines
- Read Che and Spier (2008) on what happened to liability for personal injury once NY Taxi companies understood they could avoid damages by increasing leverage...
- In Antitrust it did not happen, but fines and damages have been nuts and berries; if they go on growing up to a point in which top managers will note them...
- Host of issues here for the Panel: optimal seniority of fines, extended liability, etc., no obvious solution...

Case 2: Governance Problems Matter

Inside Firms and Cartels, Main Issues Discussed:

1. Shareholders may more or less consciously rely on *managerial incentives* that foster collusion or other *profitable* corporate crime
2. Conversely, managers/employees may undertake more crime than desired by shareholders because it is *impossible to align their incentives* better
3. Law enforcers may exploit firm's internal agency problems encouraging *individual whistleblowing*
4. Companies may *react* creating internal *compliance policies*, including '*internal whistleblowing channels*'

1. Managerial Incentives and Collusion

My earlier research (Spagnolo 2000, 2005):

- *empirically observed* top manager incentives, like staggered stock options and standard bonus schemes, tend to facilitate collusive behavior
- Likely chosen for completely different reasons:
 - Increase 'long term' perspective (avoid short-termism)
 - Avoid enough-but-not-excessive risk taking
- Other stakeholders, like lenders, may further encourage collusive behavior (Spagnolo 2004)
- Consistent with EU Cartels decided at the Top (Harrington 2006)
- Recent related research suggest that incorporating non-contractibility issues (Chen 2008) and effort dimensions (Aubert 2008) may exacerbate problem¹¹

Dealing with Managerial Incentives

- How come observed incentives so pro-collusive?

Probably because antitrust fines were nuts and berries and were the last of the issues when boards were designing compensation packages...

- Regulation of delicate governance variables, like managerial incentives difficult and risky, obviously not a reasonable remedy (think about the lively and unsettled academic debate on CEO pay, and current policy debate started by Obama in relation to TARP...)
- **Higher fines and liability will solve the problem when interests aligned**; growing corporate fines and more effective enforcement will push shareholders not to reward for illegal gains...

2. Real Governance Problems

Shareholders unable to control management...

Can we adapt law enforcement to help increase managers' alignment with shareholders' objective to comply with regulations of various type?

Law enforcers can use tougher methods than corporation, including

- ❑ disqualification and imprisonment
- ❑ leniency programs and whistleblower reward schemes

For the Panel:

But if the corporation is then heavily fined, is it really in the interest of shareholders that law enforcers catch a fraudulent or colluding employee/manager? Should then corporate liability be reduced?

(e.g. Arlen and Kraakman 1997 vs. Kraviec 2005)

3. Exploiting Insiders to Enforce

Whether or not shareholders and managers are aligned, the fact that organizations are composed of multiple individuals can be exploited to enforce compliance

For Cartels, there has been a lively academic debate on **rewarding 'innocent' whistleblowers to elicit information**, as in the False Claim Act, and **'guilty' whistleblowers to undermine trust**

(Aubert et al. 2006; Kovacic 2001; Rey 2003; Spagnolo 2000, 2004, 2008)

For Financial Fraud, after the fall of Enron, whistleblower protection became a concern, already taken into account in the first regulatory reactions like the SOX

A debate on the need for **rewarding besides protecting 'innocent' whistleblowers** followed (see e.g. Zingales 2004, Zingales et al. 2008)

Rewarding 'Innocent' Whistleblowers

- Very large literature on the enormous individual costs of blowing the whistle (some ref. in Spagnolo 2008 and Zingales et al. 2008, but lots more...)
- The False Claim Act experience showed that frivolous claims can be handled and filtered out at low cost
- Zingales et al. (2008) shows that the percentage of fraud detected by whistleblowers jumps from 14 to 41% when moving from financial to healthcare fraud, where the False Claim Act applies...
- Issue for the Panel:
Why are 'innocent' whistleblowers still not rewarded, while in most countries even 'guilty' whistleblowers are rewarded with leniency? Are all lawmakers drunk?

Individual vs Corporate Amnesty

Interaction between Corporate and Individual Leniency studied in Aubert et al. (2006), Festerling (2005)...

Many questions unanswered (Schinkel/Spagnolo 2008):

- ❑ Where individual and corporate leniency programs are present, the corporate one typically covers all individuals with a blanket provision. This may prevent an 'internal race' between the board and individual employees.
- ❑ Individual applications are strictly individual, all others are incriminated, including colleagues and friends of applicant, who may therefore refrain from applying.
- ❑ Issue for the Panel:
Is this always optimal? What about 'partial coverage' solutions, and 'joint' non-corporate applications by a reporting 'team' of colleagues?

4. 'Compliance Programs Trend' 1/4

Internal vs. External Whistleblowing

Compliance Policies with 'Internal Whistleblowing' should facilitate internal control of corporate crime...

However, such 'internal reporting channels' may be very hard to distinguish from 'Internal Policies for Catching and Dissuading Whistleblowers'...

They may disrupt hiring policies (Friebel and Raith 2004)

Issue for the Panel:

Should we encourage firms to arrange 'Compliance Policies' that create internal reporting systems? Couldn't these undermine external whistleblower schemes, reducing deterrence and compliance?

4. 'Compliance Programs Trend' 2/4

- ❑ Organizations may have an informational advantage in the monitoring of their managers, though they have more limited sanctioning power...
- ❑ From this and increasing fines, the recent 'business' of 'Compliance Program'
- ❑ Here emerges the **political** aspect of Corporate Crime, with a lot of lobbying by corporations and their lawyers to ensure a fine discount for the mere presence of an 'appropriate' Compliance Program...
- ❑ But what is an 'appropriate' or 'effective' Compliance Program, and what would be the effect of reducing fines for corporations that implement it?

4. 'Compliance Programs Trend' 3/4

- ❑ Coming from a country that has a lot of laws and a lot of policemen, I know that these numbers may have very little to say about effective law enforcement...
- ❑ We also know well the problem of 'non-tariff barriers to trade', through twisting apparently good regulation
- ❑ Courts could certainly ascertain whether an organization did set up some necessary elements of such a program, hiring and training people, writing declarations etc...
- ❑ ...but they will never be able to distinguish between a firm that implemented it effectively and one that only pretended to do it just to face lower fines...

4. 'Compliance Programs Trend' 4/4

- Only useful indicator of whether companies 'pretend' or 'do' implement a program is the outcome, i.e. whether they manage to deter employee crime...
- ...hence, to maximize their effectiveness, incentives must be linked to the outcome/success of the compliance program, not to its mere presence

Issue for the Panel

- This happens automatically without changing liability rules, through lower damages for employee crime, and is reduced by discounts based on the mere 'presence' of a compliance program... or?