Regulatory Enforcement in a Social Media Economy

There seems to be a periodic flow of business news reports where a government agency announces an out-of-court settlement and the accused corporation pays a large sum without admitting or denying guilt. News pundits offer a subtle nod and wink to infer that there was some kind of hanky panky going on, and cynics lament that there must have been a steamy back room deal. But is the incentive to quickly come to settlement economically rational? And does it really serve the goals of public policy? This article suggests that, with a certain level of regulatory burden, the high costs to comply create a perverse incentive. In addition, this author will assign the blame on the rule-makers, arguing that the rule-breakers are acting in accordance with standard economic patterns. Finally, this article will propose a refined enforcement model aimed at achieving better compliance and improved quality in public regulation.

Let's take a recent case in point. In October 2011, Citibank and the Securities and Exchange Commission (SEC) announced a settlement of several hundred million dollars pertaining to the alleged mis-marketing of some Collateralized Debt Obligations (CDOs). Judge Rakoff in the Federal Courts rejected the settlement, saying

"… the Court concludes, regretfully, that the proposed Consent Judgment is neither fair, nor reasonable, nor adequate, nor in the public interest."

Judge Rakoff rightly acknowledged that it was impossible to know if the settlement was just and fair, especially since the defendant (in this case a large bank) did not deny any wrong-doing. The case will make its way through the appeals process, and oddly enough the regulators are pushing to get the settlement re-approved. The public statements by the SEC make claim to the agency not having sufficient personnel and resources to prosecute the case in the courts. For more, see http://online.wsj.com/article/BT-CO-20111215-718347.html There are a variety of public policy problems with a regulatory environment where an oversight agency calls "foul" and then reaches an out-of-court settlement with the defendant. Cynics claim that the rule-breakers will write off the amount as a "cost of doing business". Regulators claim "efficiency" and insist that, while it is unfortunate, the out-of-court enforcement action serves to expeditiously make amends for torts that would otherwise clog up the legal system and burden the regulatory agencies with undue expense.

On its face, the regulatory efficiency argument should be challenged. In terms of cost, the legal fees could be outsourced across a variety of legal firms via public auction. Demand would be fierce, and the regulators would sponsor competition for the right to prosecute on behalf of the government, driving down costs to highly competitive levels and avoiding the bureaucracy associated with building a law firm inside the government. On a more fundamental note, it is bad public policy to avoid the scrutiny of legal due process – our society deserves to know better. If one believes in the soundness of our judiciary, then we should welcome the chance to debate and determine objectively whether laws have indeed been broken. One could argue that racing towards out-of-court settlements with regulators has the perverse effect of encouraging regulators to become more aggressive. Since the regulators can easily and legally extort funds from the industry they regulate, they can lodge more complaints even if the evidence of non-compliance is lacking. Regulators that follow this approach would not be acting nefariously, rather they would be maximizing their economic outcome. Their enforcement success is oftentimes judged based on the size and frequency of extracting settlements, not on improvement in industry integrity. Taken to a logical extreme, the regulators run the risk of becoming "thug-like" in their need to extract increasing amounts of settlements to demonstrate their effectiveness. The industry participants would also be acting rationally by hiring lobbyists and supporting politicians who claim to be more lenient to their cause. The result is corrupt politics, crony capitalism and general malaise. One should think about the Occupy Wall Street movement of 2011 and wonder how much of the frustration stemmed from a "rigged system" versus a hatred for those achieving the economic status of the "1%".

Ideally, rather than finding lobbyists to coddle their cause, industry participants should seek to improve their own governance and be vigilant on their compliance efforts. However, if one assumes that a company is a purely economic being, then the decision to engage in politics makes complete sense. Let's dig into the economic theory to evaluate this argument. In business, the expected profits are a function of revenues less variable and fixed costs.

Profit = Revenue minus Expenses (Fixed and Variable)

As profits build up, the company creates a capital base. Capital is used for paying the unexpected costs for events which can otherwise threaten the existence of the company. In addition to retained profits, other capital sources are equity raised from the investors. Simplistically, one can think of capital as the wealth of a company. In a capitalist society, a company is charged with earning the maximum profits and gaining the highest return on capital. The Board of Directors is legally bound to act as such.

Capitalism → Companies seek to maximize profits

One can criticize the simplicity of the above maxim, but capitalism has proven to be the best economic model for empowering the wealth and well-being of average citizens. The purpose of this paper is not to re-invent capitalism, so we will accept the foregoing as a basic axiom, and will explore the implications in a rational economic decision framework related to regulatory compliance.

History of Regulation

Unconstrained capitalist behavior can tend towards ever increasing monopolies. As a measure of promoting fairness, we enact laws and regulations to stem the tendency of industry actors to run roughshod over the “little people”. One can criticize the effectiveness of our rule-making bodies, but the historical purpose for their existence was to protect and improve society. In most cases, industry regulations can be traced back in history to some bad event. For example, we passed the Securities and Exchange Laws in 1933 and 1934 to address perceived abuses contributing to the Great Depression. Similarly, many of our environmental laws can be traced back to pollution or some other event which may have harmed, killed or maimed innocent people. The result of our cumulatively reactive enforcement regime is that compliance gets more complicated as our society evolves. Over time, layers of regulations are added onto existing regulatory burdens; and inevitably, conflicting and overlapping rules come into existence. These policy “warts” are abdicated to lawyers and lobbyists for eventual remediation via legislation, Presidential executive order, or via the courts – all of which are fertile ground for corruption. Recent history is filled with stories of 2,000 page laws which are passed in haste, or in the dead of night, leaving the interpretation and enforcement implications to be worked out over years – think of Obamacare, Dodd-Frank, and even the Income Tax code as examples of laws which are so complex that teams of analysts and lawyers are required to understand and take positions on the interpretation of the laws. When lobbyists and legislators can insert earmarks and other sweeteners in these exceedingly complex laws, it reinforces the perception that the game is rigged in favor of those who can buy and sell influence.

Capitalism Interpreted

Now, let’s return to the economic actor of our analysis – the simple “company”. Whether the company is large or small, there is an economic cost to compliance. Entrepreneurs and professional managers alike are constantly evaluating the costs of compliance to determine whether the increase in costs will leave them with insufficient or negative profits. Let’s dig into this decision framework from the viewpoint of the company. In a highly regulated industry, populated by large and small competitors, the complexity of staying in compliance can reach a point where the incentive for compliance becomes opposite of its intention. Consider the case of a large financial service provider who is competing against an entrepreneurial upstart for home mortgages – a highly regulated environment. The larger competitor, or the defender, would love for the smaller competitor to disappear, either through bankruptcy or a merger so that the competitiveness would decrease. Meanwhile, the challenger is actively seeking growth in market share to break into the top spot. All challengers dream of one day becoming defenders.

Business Competition → Beat or Eliminate the Competitors

Defender → Gain more power

Challenger → Gain more growth

Now, let's add to the mix an overwhelming cost of regulatory compliance. Imagine that a series of rules are passed which put the very definition of staying in compliance at risk. Facetiously, one could imagine a state where it is impossible to be in compliance with every rule, since some rules conflict with each other. In this overly-regulated environment, the intended behavior from the regulators' view would be to have industry participants try to be as compliant *as possible*. Yet, from an entrepreneur's view, the effect of over-regulation is to struggle to grow and it requires the entrepreneur to maintain increased financial capital to cover any unexpected enforcement actions which may be thrown at the firm from a regulator. Economically, the risk of loss from an overzealous regulator is not much different from a fire or an earthquake – except it is not (usually) insurable. **<u>When industry participants make the leap from basic compliance to probabilistic compliance, it is a game changer.</u>** Economic game theory would suggest that such a leap will result in a trend towards minimizing the expected cost of compliance. To understand this logic, let's think of a competitive industry and its participants.

Defender - The large firm is defined as having achieved a sufficient capital base to cover unexpected losses from regulatory enforcement actions. The defender has a goal to save as much money on compliance as possible, since outright compliance is not possible. The defender will search for the lowest cost approach for staying out of trouble, and will use the excess profits (from the cost savings) to compensate for the capital withheld against future regulatory enforcement.

Challenger - For an undercapitalized firm that is fighting to grow, the situation is worse. Why? Because a poorly capitalized firm is unable to withstand an enforcement action. The entrepreneurs running challenger firms know that if they get into regulatory trouble, they will be sold or driven bankrupt. As a result, there are two sub-optimal responses. The <u>conservative entrepreneur</u> will choose to be solidly compliance minded – defensively attempting to ensure that they do not break any rules and carefully growing their capital base. The <u>reckless entrepreneur</u> will decide there is "nothing to lose" and therefore seek minimal compliance and maximum profits, betting that they can grow fast enough and be lucky enough to escape any enforcement losses. The challenger's decision to avoid compliance becomes economically more rational when the cost of lobbying is less than the cost of compliance. Thus, as the cost of compliance increases relative to the cost of lobbying, the system gets corrupted – more and more firms will choose the path of minimal compliance and maximum lobbying. And one cannot assign blame to these morally reckless firms. The firms that choose the "reckless path" will appear more profitable than the morally conservative firms. The reality becomes such that rule breakers will be rewarded and rule followers will be punished by the capital markets. In other words, if regulation gets too complex, the system becomes fully backward and broken.

If Cost of Compliance > Cost of Lobbying → then minimize the ***<u>Cost</u>*** of Compliance

Contemporary Regulatory Enforcement

The root of the above problem lies in excess complexity combined with a legal and enforcement regime which provides a disincentive for jurisprudence and an incentive for quick settlements. Furthermore, by using money as the consequence for rule-breaking, we make it easier for economically rational managers to decide to become less compliant. One alternative solution is to increase the bar for enforcement actions – in other words, take away the out-of-court settlement option. The ability to enter into settlements without accepting or denying wrongdoing can be curbed through legislation or the courts, or both. However, most observers would agree that, while this sounds good, it would only make the cost of breaking the law greater. The dilemma faced by the challengers would persist – small challengers would still be rewarded for minimizing compliance and the reckless players will still be favored. While increased fines and stricter enforcement standards may have appealing sound bites, it is unlikely to change behaviors. Another alternative is to increase licensing and professional standards in regulated industries. Rule breakers could be banished from the industry should they fail to uphold the standards of honest behavior, including compliance with laws and regulations. While such an ethically oriented response is admirable, the reality is that many professions are already subject to this peer-based enforcement regime, and the track record is not encouraging. It has been demonstrated over time that increasing the professional cost of non-compliance will not solve the institutional problem.

The basic premise for an effective solution is that the cost of non-compliance needs to be fairly balanced with the cost of compliance. After all, the purpose of regulations is to encourage good behavior, not to encourage bad behavior. Bad behavior is only pursued when it is economically rational to do so.

If Cost of Compliance < Cost of Non-Compliance and/or Lobbying → Seek to Maximize Compliance

As we have seen above, the cost of non-compliance cannot be solely reduced to financial terms, as there will always be an incentive to try to game the system – especially with challengers. Solutions to the broken compliance regime necessitate a model where a politician's hand cannot be greased or a lobbyist cannot be retained to smooth over the conflicts arising from noncompliance. In other words, the impact of noncompliance has to be much more severe than financial loss - enter the Internet, and more specifically, enter social media.

Social media platforms have the ability to engage the general public in a more intimate role with rule breakers. One can use the power of the Internet to create not only a bully-pulpit, but also to generate a widespread mechanism for debating the motivations and merits of the rule breakers. Taken to its extreme, rule breakers would fear public reprisal and customer disdain from being labeled as a persistent rule-breaker - it could damage their image and their brand reputations. Firms that fall on the wrong side of public opinion due to malfeasance could suffer a dangerous drop in business – this is the basis of capitalism – survival of the fittest and laissez-faire.

Regulatory Threat → Cost of Doing Business

Social Media Threat → Viability of Staying in Business

The threat of public disdain looms much larger in the board room than a several hundred million dollar fine, or even the loss of a professional designation. The firm's very existence may come into question if they are exposed and castigated in the public realm – think of facebook and twitter inspired boycotts and "name-and-shame" tactics on social media pages. Such is the power of the wired generation that they can collectively become a regulatory conscience. Granted, this sounds somewhat akin to the "rise of the masses" or even "mob rule", but the reality of our current media environment is that those actions which reach the public consciousness can quickly turn viral. If companies face the risk of a negatively viral PR campaign, it may be sufficient marginal disincentive to break the rules.

Expected Loss = Regulatory Penalty + Social Media Embarrassment

In the above scenario, even a relatively small probability of becoming a social media pariah may skew the expected value such that the loss becomes unbearable. And, unlike politicians and lobbyists, social media sites should be more difficult to corrupt because of their diffused nature.

The reliability of reported enforcement violations can be further enhanced via ratings. Time and again it has been proven that ratings matter - think of the impact that rating buyers and sellers had on the level of trust in commerce sites like eBay. Granted, eBay is a closed market, and it is possible to ensure that each participant is catalogued as part of the marketplace. One could argue that such exclusivity is not present in other markets. Nonetheless, the potential for social sites, news sites and business directories to rate and catalogue the compliance patterns of participants is straightforward. If a company's compliance rating was to decline, the probability of social media embarrassment increases, reinforcing the perceived cost of non-compliance and improving the odds that the company will increase their compliance efforts. Writers could also be assigned ratings to aid readers in evaluating the reliability of their reviews. Regulatory agencies could evolve to play the role of moderator - collecting and reviewing accusations, providing feedback on the validity of accusers, and prosecuting wrongdoing when circumstances suggest that a violation is valid.

Companies commonly respond to criticism with threats of litigation serving as a battering ram to opponents. Those who chastise corporations frequently receive legal letters and lawsuit threats as a means of squelching the criticism. In many cases, the bad guys win because the little guys do not have the financial resources to defend themselves. Given the disparity in resources, some ground rules would have to be put in place to ensure that the accused firms could not cover up negative opinion through legal threats. And, to be fair, corporations require protection from ill-informed criticism and smear campaigns. An opportunity exists for regulators to play the role of a fair arbiter. Regulatory agencies could launch and/or sponsor social media-based sites which would provide legal indemnification for valid whistle blowers and could discipline the false accusers. Such a model would encourage stricter journalistic standards for the social medial critic, and could take away a convenient tool available to the heavy-handed corporation that wishes to silence its valid critics.

Role of Regulator → Protect Corporations from False Accusations + Indemnify valid whistle blowers.

Conclusion

The past five years have been witness to the rise of social media, with prominent examples of sites like Twitter and Facebook influencing elections as well as governments' stability. This paper argues that Internet-based social media tools could be utilized to re-engineer the compliance regime for heavily regulated industries.

Granted, the Internet and social media cannot solve all of the problems related to regulatory compliance, but perhaps the tools could be harnessed more effectively to improve the decision framework related to regulatory compliance. If implemented properly, a social-media based compliance regime might shift the decision framework back towards compliance instead of its current model of rewarding non-compliance. The concept could even be broadened to include avenues for the industry to engage constructively with regulators, identifying and criticizing areas where rules don't make sense and proposing alternatives. The end result could be less apathy and more engagement in our public discourse. Perhaps the Facebook generation can even reclaim their role in an active and small government, ridding our society of the need for an increasingly large class of government elites who seem to be appointed to manage every aspect of our ordinary lives.

This writer acknowledges that the above proposal requires more research and development, and hopes that this serves as a call for additional minds to be applied towards crafting regulatory and compliance regimes which truly serve the public good instead of corrupting the very industries that they were designed to protect. The author's personal opinion is that we require less regulation, and more efficient enforcement. I believe that modern media tools can play a valuable role in this evolution.

About the author – Ed Hoofnagle is a technology entrepreneur and a writer. He is a founding member of ebusinessware inc., an outsourcing and technology firm. Ed is interested in the application of technology to improve our lives and to foster better citizenship – opinions are the author's only.
edhoofnagle@gmail.com