How the Prospect of Fault Influences Managers’ Compliance

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**Market regulators should focus more on fault than fines to enhance compliance**

When it comes to heading off bad behaviour, securities regulators may do better to focus on fault rather than fines.

## That’s because fault matters, according to a recent study by Matthew Sooy, an assistant professor in managerial accounting and control at the Ivey Business School at Western University in London, Ont.

In fact, Sooy found that higher fines sometimes led to lower compliance – that managers increasingly ‘price’ their choice – by weighing the costs and benefits of compliance – rather than focusing on just doing the right thing. His study — which examined the “complicated relationship” between fault and compliance — found that fault paired with weak financial penalties actually *increases* managers’ compliance with regulations and policies relative to when managers face strong financial penalties without fault.

That actually flies in the face of traditional thinking of regulators and investors that penalties trump fault and higher fines should lead to better compliance. However, it doesn’t, his study found.

## The experiment

In his study, Sooy reviewed research on sanctions and compliance. He noted that regulators such as the SEC “rely heavily” on no-fault settlements. For example, between 2012 and 2014, the SEC averaged 722 enforcement actions per year resulting in US$3.53 billion in annual financial sanctions. About 90 per cent of settlements involved no-fault clauses, where the target being investigated agreed to pay a penalty without admitting or denying wrongdoing.

The upside to no-fault settlements is that they avoid costly and protracted litigation, which enables the SEC to pursue roughly twice as many cases. The downside, critics say, is that it by removing fault from enforcement, it reduces financial violations to a “cost of business” and enables offenders to essentially “buy their way out of a violation” — effectively reducing sanctions to a “price.”

Sooy sought to examine the effect that assigning fault had on compliance. After reviewing previous studies, he predicted that managers faced with fault would “be more willing to comply with costly regulations and be more willing to exceed minimum compliance thresholds.” Absent fault, he expected that compliance managers would treat fines as a “price” and compare the financial gains of non-compliance to the costs of financial sanctions.

He tested his theories by using a “modified dictator game” involving 230 students posing as “underwriters” and “investors,” controlling variables such as fault or no-fault settlements, and the levels of financial sanctions. He also measured compliance frequency and quality, and tested investors’ expectations of compliance under various levels — full disclosure, minimal disclosure and no disclosure.

## Results

When it came to the “underwriters,” Sooy writes that “I observe greater compliance frequency and compliance quality when sanctions include fault. However, I also observe the effects of fault on compliance depend on the magnitude of sanctions.”

“Participants in my study react negatively to the combination of fault assignment and strong sanctions. Pairing fault assignment with strong sanctions appears to provoke more violations and reduced compliance quality, leading compliance frequency to be no greater and compliance quality to be lower than in other conditions.”

Interestingly, when he tested the investors, which he called a proxy for public expectations, he found they expected the opposite of what actually happened. When fault is assigned with strong sanctions, investors expect greater, rather than lower compliance, and when compliance is combined with weaker sanctions, they expect lower rather than greater compliance — views that were contrary to the actual findings of his experiment.

## Implications

Sooy says that his study makes several important contributions that would benefit regulators and researchers.

He says stronger penalties only weakly increase compliance frequency but do not increase compliance level because the penalties lower full compliance rates overall.

On the other hand, fault assignment interacts with sanction strength leading to increased compliance when paired with weak sanctions, but *decreased* compliance when paired with strong sanctions.

“Thus, regulators should be careful when treating the compliance compelled through fines as equivalent to the compliance compelled through non-financial sanctions, such as fault.”

As well, “regulators should also be careful when balancing public demand for sanctions with the actual efficacy of various sanctioning dimensions.”

He adds that his study contributes to experimental research and suggests the notion of sanctions should be broadened to include the social dimension of sanctions.

The study also “makes a methodological contribution by allowing for differences in *compliance quality,* a distinction of importance to regulators, researchers, and the public. Compliance quality reflects participants’ willingness to incur greater individual costs to effect greater social benefits, consistent with arguments for ‘spirit of the law’ versus ‘letter of the law’ compliance. In this study, I find that many participants select individually costly high-quality compliance when given the option; fault impacts participants’ willingness to do so.”

He argues that “regulators must balance the efficacy of their policies with public demand for policies. My study suggests that one potential benefit of no-fault policies is that there appears to be greater alignment between the actual and expected efficacy of no-fault sanctions relative to no-fault sanctions.”

Sooy calls for future research to “investigate intersections of social dimensions of sanctions and perceptions of regulatory justice.” Researchers could add to this area, he says, by “further investigating exactly how, and for whom, fault is shaping perceptions and compliance.”

He adds to the extent that fault assignment is influencing managers’ perceptions of their own compliance, it is likely to also influence how others — such as jurors, coworkers, and the general public — perceive the culpability of those who are assigned fault (or not), and the justice achieved from sanctions assigned to them. “Future research could investigate how fault assignment influences decision-makers’ perceptions of achieved justice, which may interact with their subsequent willingness to transact with, trust, cooperate with, and/or punish those labeled with fault.”

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