

Behavioral Ethics, Behavioral Compliance

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1. Introduction

The design of an effective legal compliance system for an organization fearing prosecution for white-collar crime or regulatory violations requires skill at predicting human behavior. The surveillance portion of compliance involves estimates about who is most likely to misbehave, and when. The communicative aspect—training and guidance—requires thinking about what kinds of messages and incentives are most effective. Forensics and resolution are about, at least in part, learning from the experience and applying the lessons to future activity.

It's entirely plausible to use the economist's assumption of rational choice—opportunism with guile—in making these predictions. But the realism of that assumption has been under attack for decades now, even though it still offers appealing methodological traction. Psychologists assure us that people cheat less than they could, even when assured of a gain. But they cheat more than they should, for reasons that are a complex mix of dispositions, cognitive frames and situational influences. Sociologists, in turn, urge that we look outside the individual mind for what drives compliance or noncompliance with law, to a variety of cultural forces. All of this makes compliance-related predictions much more contingent and messy, especially since there is no simple model to invoke and the research very much a work in progress.¹ The hope, however, is that it can make the predictions be more accurate.

¹ In a forthcoming book, I extend this analysis to the task of securities regulation generally. Langevoort, forthcoming.

The label “behavioral compliance” can be attached to the design and management of compliance that draws from this wider range of behavioral predictions about individual and organizational behavior.² Like conventional economics, it understands that incentives matter. Indeed, a core portion of work in the psychology of ethical choice explains how and why people can behave selfishly or cheat but not construe their own behavior as bad or wrong. But if that is so, their (or their team’s) moral compass becomes unreliable as a matter of self-regulation, a particularly frustrating insight in the compliance realm: good people doing bad things.

This chapter surveys some of the contemporary research in what has become known as behavioral ethics,³ and its relevance to compliance. This connection is by no means new: for the last twenty-five years or so, researchers interested in managerial and organizational behavior have tapped into the psychology of good and bad moral choices to suggest how companies might manage their legal and reputational risks. By now, they seem to have agreed that ethics is an essential building block for both legal compliance and enterprise risk management. Lawyers have taken note (Killingsworth, 2012).

2. Behavioral Ethics and Compliance

Research in behavioral ethics uses “cheating” as its key word to describe what good ethics is not, and treats illegal behavior as an especially troubling form of cheating. Many of the field’s insights relate directly to legal matters. Furthermore, the line between law and ethics is very fuzzy, so that good ethics are a worthy goal within compliance regardless of how a prosecutor or defense lawyer might characterize some accusation. In that sense, behavioral ethics research is perfectly in synch with compliance programs that seek to be values-based (see Tyler et al., 2008), rather than command and control. The connections between ethics and compliance are also important to the debate about the optimal balance of emphasis between law and ethics (e.g., the relationship between the

² In the interest of limited time and space, this chapter leaves to others discussions of structural sources on blind spots in compliance, such as the diffusion or “siloing” of information. For a broader perspective, see, Miller and Rosenfeld, 2010.

³ For book-length treatments of behavioral ethics for a general audience, see Ariely, 2012, and Bazerman and Tenbrunsel, 2011. There are many literature reviews for academics. E.g., Bazerman and Gino, 2012, and Treviño et al., 2014b.

domain of the chief legal officer and the ethics/compliance function (Treviño et al., 1999, p. 146; Langevoort, 2012, pp. 499-502)).

We know from surveys of compliance officers that ethics is a potentially uncomfortable subject in organizations (Treviño et al., 2014a). People tend to think of themselves as ethical, and that ethical dispositions have been formed via religion, education and the broader culture. That provokes some level of defensiveness when the subject comes up in the workplace. One of the eye-openers in using behavioral ethics is how easily people take to psychological explanations when analyzing the riskiness of *other* peoples' unethical behaviors, as it then gradually dawns on them that they could not possibly be immune to the same forces. That is key to ethical self-awareness, in compliance and otherwise.

To repeat the punch line for behavioral ethics: people cheat less than they could get away with, but more than they should. The first part of that insight is heartening. There is indeed a great deal of pro-social behavior—loyalty, cooperation, conscientiousness—because people want to think of themselves in such a light, and want others to think of them similarly. Whether this is biological or learned behavior is deeply disputed. Certainly there are evolutionary advantages in species that suppress selfishness, and economists have long pointed out the value of a reputation for trustworthiness. No complex organization could work well without a baseline of mutual trust, and much of the theory of corporate culture involves taking advantage of these inclinations to build loyalty at the group level (Akerlof and Kranton, 2005). For most people, it is good to be part of a team, something bigger than oneself (Kliver et al., 2014).

From a compliance standpoint, however, that is a mixed blessing. Precisely the same forces that create internal bonding make it more likely—especially in the face of competition and rivalry—that the cohesion will work to displace empathy and justify aggressive behavior against perceived outsiders (Cikara et al., 2014). In business, those “others” can not only be competitors, but customers and even other units within the firm that are viewed as threats to the group's interests and identity. One of the most potent incentives to cheat is in service of others: altruistic cheating (Ariely, 2012, pp. 222-23). Corporate agents have ample room to rationalize compliance failures in the name of loyalty.

That also happens on an individual cognitive level, and takes us to the dark side of the punch line: in general (but with many exceptions) people cheat more than they should. There are now many psychology experiments built on a simple platform, testing the inclination to cheat in circumstances where detection and punishment is impossible. A common form is to give subjects a somewhat challenging matrix-based computation test (Ariely, 2012, pp. 11-22). The test is

given to a control group and externally graded, thus giving investigators the ability to see what honest performance is over a large number of subjects. The same test is then given to the self-graders, who are told to shred their exams immediately after grading and report the score to an administrator, who will give (real) money based on the number of questions that were correct. The control group scores average around 4 out of ten. Under non-detection conditions, people claim around 6. An obvious question, among others, is why not 10, which maximizes utility?

There are different possible answers (e.g., people would feel ashamed when observed claiming 10, because that seems like obvious cheating), but at least illustrates some form of ethical self-control. But then why not be completely honest? One common interpretation is that people will cheat out of temptation, but only to a point where they can maintain a self-image as a non-cheater. If the mind can somehow rationalize the act as acceptable (e.g., I wrote down the wrong digit, or I *knew* the right answer, or I'm really better at math than this), it self-justifies the cheating. While the shredder tests are fairly objective, you can see how much more easily this could occur in the face of subjective standards for right and wrong.

So that's the basic insight, suggesting that motivated inference allows people to maintain self-image while pursuing self-interest more aggressively—but to a limit. From there, behavioral ethics asks when, why and how this sort of rationalized self-interest occurs. Experimentally, what manipulations might make cheating more or less likely? That is where the most interesting results come in terms of compliance, because answers that describe real-life behaviors in the field might give compliance officials a better opportunity to predict and deter law-related cheating behaviors where such forces might be especially likely.

We will turn to these stress points shortly. But within this research program, one major question dominates and is not yet fully understood (Feldman, 2014). How much of this is unconscious? For the shredder experiments, the “excuses” I suggested seem fairly conscious ones, designed to justify the cheating. We're all familiar with our own (sometimes pathetic) efforts to resolve guilt via excuse-making, which sometimes work to normalize the activity but not so as to make awareness of the troubling act or omission disappear entirely.

What the research suggests is that self-serving inference results from cognitive activity that operates along a broad spectrum. Some is perceptual, so that we may not see the problem (we see what we want to see). Some is interpretive, so that the sense-making defines what we do see in a preferred way. Here, the ethical or legal risks are simply not processed as such. As we move

further along the spectrum, we start coming to something that might be described as awareness, but still subject to interpretation and shading that deflect the sense that something is seriously wrong—the more familiar sort of rationalization or normalization.

In other words, there are cognitive buffers that delay awareness of what is ethically or legally problematic, and maybe prevent it from ever fully being realized. Timing is key. Consequences flow from the unlawful or unethical actions or omissions, and those choices may be made without sufficient awareness or appreciation of the risk. If so, neither carrots nor sticks work as we'd hope or expect, because the person isn't aware of taking action to which the reward-penalty system applies. And once the crucial steps are taken, responsibility is locked in. If the person later comes to sense that what was done was wrong, the psychological reaction is defensive bolstering or cognitive dissonance (adjusting beliefs to justify the action), or a more active cover-up. To use a phrase from a classic in social psychology relating to the escalation of commitment, when adequate awareness comes the person is already “knee deep in big muddy” (Staw, 1976).

Max Bazerman and Ann Tenbrunsel (2011, chapter 4) describe this temporal dimension to wrong-doing in three phases. The first is anticipatory, and the domain of good intentions. You genuinely intend and expect to behave well. But people are notoriously bad at self-prediction. At the time of temptation, the mind goes to work in the ways just described: blurring, misperceiving, reconstituting so that the preferred outcome is privileged. Some call this “ethical fading” (Tenbrunsel and Messick, 2004), because the ethical dimension to the choice is deflected and put out of awareness. After the act the mind restores the original self-image, through rationalization, motivated forgetting, compensation or other mechanisms.

What we are describing is hardly unfamiliar; these are “blind spots” in which ego (or greed, fear, desire, etc.) gets in the way of good judgment. The scientific progress—today heavily focused on the neuroscience—is in understanding how and why blind spots thrive and persist. That's an evolutionary question, and gets us to whether and why this tendency might be adaptive. There are a number of intriguing hypotheses. Robert Trivers (2011) has long argued that success (survival) within species depends to some extent on the ability to deceive others who pose threats. But precisely because of the frequency of deception, others learn to detect it from small, subtle “tips and tells” like shifty eyes, etc. A person avoids these signals if he has distorted the truth in his own mind sufficiently to believe what is being communicated. To deceive others, in other words, we first deceive ourselves.

Self-deception, in turn, often takes the form of excessive confidence or optimism. And so, biologists have developed fairly intricate explanations for why each of these is a survival trait in large populations, even though the dangers might be self-evident (Johnson and Fowler, 2011 and Sharot, 2011). From a compliance perspective, this raises the uneasy possibility not only that self-deception as to legal and ethical risk is commonplace, but that it might be especially common among the most successful people in the organization—the survivors of the Darwinian promotion tournaments that operate as the pathways to influence and power. If strong ethics and compliance initiatives are resisted in many organizations—which seems to be the perception among compliance professionals—that may be one reason why. Compliance norms threaten beliefs, behaviors and cultural tropes that are instinctively success-producing. We'll come back to power issues later in the chapter; for now at least be aware of one researcher's claim that power itself makes people better liars (Carney, 2010).

3. Cheating More

The experimental studies described in the prior section set in motion wide-ranging inquiries into what dispositional or situational factors make cheating more or less likely. In the laboratory, that's testable by manipulating one potential factor while holding everything else constant, and the volume of such studies is now large (Bazerman and Gino, 2012). But contemporary research is hardly limited to that particular experimental design, especially because it has become recognized that ethics can be viewed as a form of risk-taking, and judgment and decision-making in the face of risk is a much larger project in psychology from and to which insights might be derived. For legal compliance, it's especially noteworthy that self-serving inference is indeed facilitated by ambiguity, either in the situational context or the ethical demand. This strongly suggests that compliance-related distortion will occur especially easily when the law is subjective rather than bright-line (Feldman and Teichman, 2009), as it so often tends to be.

This section will review some of the influences said to make cheating behaviors more likely. Because this field is large and growing larger, we have to be both brief and selective. Readers wanting more can consult any of a number of literature reviews and meta-analyses (e.g., Treviño et al., 2014b, and studies cited therein). Consistent with the primacy of psychology in behavioral ethics research, we will focus first on individual-level insights, even though it is generally agreed

that social forces are almost always at work in serious instances of organizational misbehavior.

3.1. LOSS AVERSION

In studies of risky choice, one of the most famous insights is referred to as loss aversion, part of the Kahneman-Tversky heuristics and biases research under the heading of prospect theory (Kahneman 2011). To be sure, rational people generally are risk averse. Loss aversion suggests that people become more risk preferring when faced with threatened loss of what they have, as compared to when faced with the opportunity to gain something of equal value. This is so even where the loss versus gain is simply a matter of framing (a famous version found different risk attitudes for a risky medical intervention based solely on whether the effort was described as avoiding deaths or saving lives.) Importantly, aspiration levels can divide the two domains, so that falling short of expectations is usually processed as a risk of loss. This leads to a fairly intuitive prediction that goals and quotas—commonplace in many phases of a business—can distort judgment especially as the goal is close but still out of reach. Researchers have described this effect under the title “goals gone wild” (Ordóñez et al., 2009).

More generally, Rick and Loewenstein (2008) make the claim that “people who find themselves 'in a hole' from which they perceive that dishonest behavior provides the only apparent means of escape, a wide range of evidence suggests, are more likely to cheat, steal, and lie,” which they refer to as hypermotivation. A business professor has collected 58 instances of corporate fraud consistent with a prospect theory account in the face of weak internal controls, including the infamous “London Whale” fiasco suffered and then mishandled by J.P. Morgan Chase (Abdel-Khalik, 2014). Perhaps when we observe some person or team hitting “stretch” goals period after period, it should be a compliance red flag, not just the cause for celebration and reward pay-outs that it is in so many firms.

3.2. CONFLICTS OF INTEREST AND TRUTH-TELLING

Conflicts of interest create the incentive to act opportunistically notwithstanding some pre-existing obligation (ethical or legal) to another, and so are of special interest in both law and behavioral ethics. Regulation often seeks to

dampen such conflicts, and a common legal strategy is required disclosure of the conflict, on the assumption that there will be more cautious assessment of the discloser's behavior. Researchers, however, have found two unintended consequences (Loewenstein et al., 2011). Under certain circumstances, the rate of opportunism in laboratory experiments went up after disclosure, not down. This seems to be motivational: more unconscious “moral wiggle room” (Dana et al., 2008) to justify the opportunism because the victim has fairly been warned of its likelihood. Compounding the problem is that the victims became more trusting, not less (although this varied depending on how the disclosures were structured). One theory is that when there is a pre-existing relationship between the parties so that trust is present, the potential victim overcompensates in response to the disclosure to assure the sender that the trust remains.

Patterns of communication can produce unethical behavior in other ways as well. Perhaps reflecting the common moral intuition that acts of omission are less blameworthy than acts of commission (on which there is plenty of psychology research in support), studies of what lawyers would call half-truths—and what the researchers called “artful paltering” (Rogers et al., 2014)—showed a greater willingness to cheat via saying something technically true but misleading than to lie affirmatively.

3.3. DEPLETION, STRESS AND TIME

One of the most interesting findings is that, cognitively, being ethical is hard work. As a result it is subject to depletion over time (e.g., Welsh and Ordóñez, 2014). Such forces as stress and tiredness (so common in the business setting) weaken the ability to resist, as can repetitive acts of goodness. The assumption here is that being selfish is the more automatic process, which deliberation has to override, and that takes a cognitive toll.

Another commonly noted bias involves overweighting present benefits over future costs, which can be seen as a simple failure of will-power but also as a cognitive distortion. This “hyperbolic time discounting” has familiar effects of impulsivity, procrastination and an excessive focus on immediate rather than delayed consequences—all associated with the potential for wrong-doing when the threat of punishment is both uncertain and distant.⁴

⁴ In legal scholarship, Manuel Utset has done a great deal to show how these time-inconsistency biases generate unlawful behavior. E.g., Utset, 2013; see also Baer, 2014.

3.4. *SLIPPERY SLOPES*

Another of the fairly intuitive predictions is that the inclination to cheat grows one step at a time (e.g., Ordóñez, 2015). In studies of criminal behavior and business disasters, we keep being reminded is that so many stories of corrupt wrongdoing begin with something fairly small and innocent. This fits with much of what we've already covered. If people are willing to step over the line only a bit, that line moves so that when another temptation comes along, the next small step over takes them further away from the baseline. And so on. Rationalizations that aided and abetted the opportunism recursively become part of a new normal.

Note the connection between the first steps down the slippery slope and some of what we covered earlier. A study of how companies get into trouble for accounting fraud discovered, not surprisingly, that one can trace backwards from the sizable falsifications that in the end led to detection to much smaller ones earlier on (Schrand and Zechman, 2012). But more interestingly, it found that those early steps correlated with indicators of managerial overconfidence and over-optimism. That is to say, managers who were genuinely convinced of the company's good prospects made more unrealistic judgments in accrual matters, presumably believing that this best captured the fair value of the company. But once there was a lock-in to that optimism, the managers resisted disconfirming information (self-serving inference) and so escalated their commitment to the rosy portrayal. Gradually that became impossible to do within the bounds of accounting discretion and so became accounting fraud.

The slippery slope also sheds light on the temporal dimension to wrongdoing, how early one there may not even be recognition of an ethical or legal issue—even as the first fateful steps are taken—with awareness only later able to break through the blind spots and rationalizations, if ever. It need not be innocent at the beginning, however. Interviews with white collar criminals do often describe a slippery slope but identify the first step as a moment of weakness—being pressured by a friend or colleague into a small (and thus easily rationalized) act of wrongdoing, unaware of how that one step makes it so much harder to say no when asked again (Free and Murphy, 2015, p. 44). In broker-dealer regulation, for example, one common problem is forged client signatures on transactional or account paperwork. Note how easy this is to start—you're actually saving the client the time and hassle of signing the papers—and how

readily a year or two later this can turn into forged signatures that misappropriate funds from the client's account and into the broker's hands.

3.5. COMPETITION

That intense competition produces unethical behavior is another non-surprising finding. Competition produces both the excitement of potential gain as well as the fear of loss, and so cheating goes up as the goal gets closer but you're a step behind. Cheating is more likely when the competitor is a well-known rival, both because of the personal emotions and the ease by which rationalizations—they'd do it to us if they could, or it's just the way the game is played—can go to work (e.g., Pierce et al., 2013). Many people have noted the common invocation of sports or military imagery in such settings.

Risk-taking of all sorts—ethical and otherwise—is associated with a cluster of traits that enhance competitive fitness, including a taste for excitement, a desire to dominate, and strong ego (Malhotra, 2010). It's easy, then, to speculate about a link to testosterone, which much recent research in neuroscience tries to chase down. In the investment world, there have been a number of studies on the dynamics between hormones and risk-taking on trading floors (Coates, 2012). A study of corporate fraud found a positive correlation with evidence that the CEO had the facial structure typical of high testosterone individuals (Gia et al., 2014). Ethically, high testosterone leads to a more utilitarian, ends-justify-the-means stance (Carney and Mason, 2010).

One obvious implication of all this is with respect to gender diversity, which is well studied in both risk-taking and behavioral ethics research. On average, women are less competitive, less inclined toward risk, and less likely to cheat than men. Many researchers thus believe that gender diversity in upper echelons of organizations and other locations of economic power is a crucial step toward better ethics and responsibility (van Staveren, 2014). This raises the much-debated problem, however, of whether women who self-select into highly competitive fields are substantially different from men along these dimensions. A research paper in the Proceedings of the National Academy of Sciences studied the testosterone levels of MBA students at the University of Chicago, and found the expected differences between men and women (Sapienza et al., 2009). But that small segment of women who chose investment banking as a career had somewhat higher relative testosterone levels than even the men who were going into investment banking. Hopefully, successful efforts at diversity would alter the

desirability of entering such occupations, and gradually change the cultural dynamics and expectations that today treat hyper-competitive fields as the domain of alpha males.

3.6. CULTURES AND CONFORMITY

As noted earlier, one of the big interdisciplinary battles in the study of business wrongdoing is between psychologist and economists, on one hand, and sociologists on the other. The latter tend to reject highly individualized explanations for good and bad behavior, in favor of memes, norms, culture. People act with consciousness constrained by cultural belief systems, and immense pressures to conform, which sometimes promotes group-level wrongdoing (Greve et al., 2010; Regan, 2007).

Social psychology mediates between the individual and collective extremes (Darley, 2005), and some conventional research psychologists are taking a greater interest in the neuroscience of “groupishness” (Kluver et al., 2014). We’ve known for some time that groups moderate some cognitive biases, and exacerbate others. Identities can strengthen in group settings, enhancing competitiveness, aggression and the inclination to cheat. We saw before the finding that cheating increases when done for the betterment or protection of someone else, and it’s not hard to see how the bonds of loyalty and team cohesion can embolden someone to take ethical risks that he or she might not undertake out of pure self-interest. Perhaps the most classic experimental study in all of social psychology came from Stanley Milgram, who found a higher-than-expected willingness of subjects to inflict pain on others simply out of obedience to the orders of an authority figure. There are many forces potentially at work here—denial of responsibility, conformity, escalation etc.—and many disturbing lessons to be considered as applied in hierarchical organizations.

Cheating is contagious; observing it by others makes it more likely the observer will then cheat, too (Ariely, ch. 8). In social networks, which are of special interest in business settings, well-positioned actors can amplify via retransmission what is observed into what seems normal.

Another cross-cutting idea of importance to ethics is legitimacy. In terms of the willingness of people to obey the law in settings of relatively weak detection and prosecution, evidence suggests that people assess the legitimacy of the legal demands (Tyler et al., 2008). If either individually or by reference to the

prevailing corporate culture, those legal demands are denigrated rather than respected, compliance rates drop. We can hypothesize that those beliefs are adaptive, enabling aggressive risk-taking a lesser burden of doubt. I've long believed that in highly regulated industries, the tendency of employees to view regulatory demands as those of mindless bureaucrats run amok is a defense mechanism that lets business get done, at the price of higher compliance risk. Cynical cultures therefore can be particularly dangerous from a compliance standpoint. Even without cynicism, the inclination within organizational cultures to interpret the law in a self-serving fashion increases compliance risk (Feldman 2015).⁵ Consistent with the survey evidence that the legitimacy of a compliance and ethics program is heavily contested within many organizations (Treviño et al., 2014), a similarly pernicious form of self-serving inference about internal compliance demands could be at work.

3.7. IDENTITY AND ENVIRONMENT

We've already tied much of the research in behavioral ethics to identity maintenance. Identity issues are well-researched in both psychology and sociology, with even inroads into economics (Akerlof and Kranton, 2005). There is great utility in a positive identity, individually and organizationally. But with strong professional identity comes heavy baggage. Recently, some well-respected European researchers gave a version of the standard cheating experiment to large-firm bankers, divided into two groups. In one, their identities as bankers were primed (i.e., the experimental conditions pointedly reminded them of their profession). In results reported in the prestigious scientific journal *Nature* (Cohn et al., 2014), the level of cheating was normal *except* in the priming condition, where it was higher. The bankers' identity itself, in other words, was the motivator to cheat.

Much could be going on here, of course. The results are reminiscent of a series of experiments that measure pro-social and anti-social behavior (including cheating) by framing the experiments so as to prime certain attitudes or emotions. In particular, the trappings of money and wealth—expensive cars, for example—will when made salient increase the likelihood of opportunism (Kouchaki et al.,

⁵ How organizations (including compliance and human resource personnel) interpret the law is a distinct and fruitful subject of research in sociology as well. E.g., Edelman and Suchman, 1997.

2014). “Banker” may trigger similar feelings, or simply bring to mind a workplace where ample cheating had recently been observed.

Apart from cultural or professional identity, there are other effects noticed by researchers in multi-person settings. We’ve already seen the ability of loyalty to drive unethical behavior. Not surprisingly, people cheat more if they can do so indirectly, as by having an agent cause the harm (Paharia et al., 2009). Motivated inference also affects monitors, who may have incentives to avoid seeing trouble—so they miss the danger signs. Ethical misbehavior that occurs on the slippery slope is not only more likely to grow, but harder for others to detect precisely because it evolves so slowly (Gino and Bazerman, 2009). These latter observations also make the important point that research in behavioral ethics is relevant to the compliance function not only in the ways described above but because compliance monitors themselves have blind spots.

4. Behavioral Compliance

Most people find all the foregoing interesting and more or less intuitive. The question is whether it is useful on the ground, in building a successful compliance program. Some of these are methodological doubts, such as whether we should rely so much on experiments using ordinary people as subjects. These are fair concerns, because lab results can easily be misconstrued and are sometimes misleading (researchers have their own behavioral biases and self-interests, after all). I will leave these challenges to literature reviews, and simply note the volume of this work and that, increasingly, it involves professional subjects in the laboratory and field studies to confirm or refute experimental predictions. All social science must be used cautiously, this included, in formulating practice and policy.

The increasing interest in adaptive biases also helps justify using this learning in sophisticated business settings. We know that heuristics and biases don’t always translate well when applied in settings that reward skill and savvy when mistakes are costly and there is opportunity to learn from experience. But again, without undertaking to prove the point here, the case has been made in the best peer-reviewed journals that certain biases help people compete and win. Anecdotal observation suggests that the business world has more than its share of blind spots.

So if you're a compliance officer and want to take this learning seriously, how would you do so? This question connects to the subject of organizational correctives, which has been of interest for some time.⁶ Many companies have shown an awareness of the risks of self-serving bias, and there are tactics to combat it. Perhaps the best-known example is the practice of banks removing authority from the original loan officers to renegotiate or work out arrangements when a large borrower is nearing default. Otherwise, the loan officer is subject to an escalation of commitment, driven by the desire to justify the original decision.

As this example shows, all organizational correctives are based on the particular challenge in question, compliance included. For now, we'll have to generalize, which is dangerous because compliance challenges vary greatly. The template for a smart antitrust compliance program focused on potential cartel activity (Sokol, 2014) poses different problems from the one a brokerage firm worried about financial advisers pushing unsuitable securities on naïve customers might put in place.

4.1. COMMUNICATION

Compliance begins with effective communication (Killingsworth, 2012), and many people—lawyers in particular, I think (other than trial lawyers)—are poor communicators even when their diction is exquisite. They assume that others will understand and process what they mean to say, as long as they are clear enough. But communication research stresses that what people hear and think is often very different from what the speaker says or intends. Compliance messages are apt to be filtered through eyes, ears and brains that are skeptical, resentful or merely uninterested, and by all means, adept at self-serving interpretation.

A case study from the management literature illustrates (MacLean and Benham, 2010). A financial services firm was increasingly concerned that its insurance brokers might be churning policies—substituting an old one for a new one for a customer just to generate fees. Regulators were making threatening noises about the practice, so it was a salient compliance issue. The executive

⁶ Philip Tetlock (2000) notes in a fascinating article that there are wide variations in organizations about the validity of behavioral predictions and explanations, varying based on political ideology and cognitive style of the observer. More conservative managers have less tolerance for complicated behavioral assessments, preferring a more authority-based assessment of blameworthiness.

team sent reminders and notices, and to make clear its seriousness, instituted a heightened compliance review of policy substitutions within 90 days of each other.

That was presumably well-intentioned. But the message as received was completely different. The firm's brokers were churning to some extent. Performance and compensation expectations were fixed on that level of productivity, and so the brokers were threatened by these new compliance demands. When the brokers saw the 90 day procedure, they decided management wasn't really serious, and soon, the churns were done in 91 days. They were convinced among themselves that headquarters didn't really want the profitable practices stopped if their "solution" was such an easily evadable compliance procedure. So they interpreted the whole situation as management winking: mere window-dressing designed to appease the regulators but not cut into productivity. They acted accordingly, no doubt with an added dose of cynicism about regulators, as well. The rate of churning went *up*. Perhaps they were right, and management wasn't serious. But this story doesn't seem far-fetched as describing a poorly executed compliance initiative, and one that ultimately cost the firm greatly in legal costs and penalties.

Communication also involves timing, which is very tricky. Remember that most people in the firm see themselves as ethical and responsible, without the intention to misbehave. Ethical warnings and lessons delivered well in advance of temptation will be met with the mental mute button. Behavioral ethics stresses the need to intervene very close to the time of the act or omission, but by no means after. As to good intentions alone, there should candid recognition that they can, indeed, line the road to hell.

There is a fascinating illustration of good and bad timing. Certifications are commonplace in the business world: promises that what was or is about to be said is true and complete. One wouldn't think that there is much difference as to when, but psychologists hypothesized that it did—that there would be more honesty when people promise to be truthful than when, after the fact, they promise that they have been truthful (Ariely, 2012, pp. 48-51). The intuition is that the advance certification (think about a witness being sworn in at trial) is a reminder in advance of ethical demands, and therefore more efficacious. If the person is inclined to lie, confronting them after the fact with the need to promise that there were no lies will just produce more lying. The researchers were able to convince an insurance company to do a randomized test with its customers, who were asked once each year how many miles they had driven (useful in rate-setting because of the risk associated with additional miles). The only difference was the before or after certification instruction. When forms came back that year, those

who signed before-the-fact reported, against interest, significantly (15%) more miles traveled than the after-signers.

Encouraging whistle-blowing is a common strategy within compliance, and notoriously difficult to incentivize. Norms of loyalty are immensely powerful, as we've seen, and self-serving inference will often cut against forming the impression that a colleague is cheating. Tone at the top and peer support seem crucial; as one set of commentators put it, "it takes a village" to have the right support and incentives for whistleblowers to act (Mayer et al., 2009). And any whistleblower has to anticipate that the inferences from the message may be processed in a self-serving way, so that the rejection of the complaint is deemed justified (Sumanth et al., 2011). More constructively, research on the psychology on whistle-blowing has found that the countervailing pressure generally comes from fairness outrage, which may give hints on how to frame the outreach programs to better elicit these acts (Waitz et al., 2013).

4.2. SURVEILLANCE

Another core aspect of compliance is internal surveillance. Advances in information technology allow extraordinarily sophisticated real time and retrospective observation of activity within a firm, albeit at substantial cost. Both hard data and soft clues—scrubbing e-mail traffic for words and phrases of a particular tone—can yield valuable compliance intelligence. Although we are still distant from this point, it's not hard to imagine the modern day compliance version of Jeremy Bentham's prison "panopticon," which sees everything without being seen.⁷

Short of that, all surveillance is necessarily risk-based, and behavioral ethics research can help inform what to look for. Here again one size never fits all, and each compliance issue must be analyzed by breaking down the choice architecture of any sensitive decision to see who makes it, under what circumstances, when and how. Once can then put the behavioral learning to work, looking for particular temptations (goals gone wild), especially in the form of loss frames. Once again, sequentially high levels of success can be a red flag, especially if you can't figure out how they did it.

⁷ The compliance-based reference to Bentham's idea comes from James Fanto.

This suggests that the use of big data analytical tools may permit compliance departments to predict misbehavior, based on the large scale analysis of prior failures and their precursors. Such efforts indeed seem to be on the horizon.⁸ Given the rapidly growing body of research on the correlates with fraud and other forms of wrongdoing, one can readily imagine a behaviorally attuned program that seeks to identify markers as they point toward more intense motive and opportunity. MIT economist (behavioral and otherwise) Andrew Lo (2015) has suggested that a linear factor model could eventually be constructed for each executive that estimates risk appetite at any given time, and which in the aggregate might depict the taste for risk in the firm as a whole, or in individual sub-units.

Three cautionary points have to be made. First, as Lo points out, such artificial intelligence—surely helpful in at least allowing the centripetal processing of all available information about a persons and situations—would have to have the capacity to learn and evolve. People surely do, as the 91 day rule experience noted earlier shows. What happened in the past to produce misbehavior was the function of a set of interpersonal and situational forces that may be gone by the time the model is built. The value-at-risk models in investment banks in the time leading up to the financial crisis did poorly precisely because the data inputs were from a time when housing prices rose consistently, because that had been the only available prior experience. Second, any predictive software will inevitably generate a large number of false positives (and false negatives), which may lead to behaviors by those in charge of responding that are not optimal and leave hiding places about which people in the field gradually learn.

The third is a bigger point. One of the central insights in behavioral economics is that people react poorly to close monitoring (Falk and Kosfeld, 2006). Heavy surveillance is a signal of distrust, which may produce less trustworthy behaviors in response to expectations. Control has the ability to crowd out the kind of autonomy that invites ethical behavior,⁹ and can make people less entrepreneurial and productive (Tenbrunsel and Messick, 1999). Imagine a bank with a perfect panopticon. Though I concede the experiment would be an interesting one, I would wager that over time its productivity and

⁸ “J.P. Morgan Knows You’re a Rogue Trader before You Do,” Bloomberg Business, April 8, 2015.

⁹ Related to this is the phenomenon whereby both promised rewards and threatened sanctions are “priced” and lead to more calculative behaviors where integrity is called for. See Gneezy and Rustichini, 2000.

competitive position would lag behind peers with less surveillance intensity, even if its compliance record might be better (Langevoort, 2002). And given the capacity of complex human systems to frustrate even the best of plans, I'm not even sure about the compliance superiority. Values-based compliance and risk management is important, by most accounts, to success (Trevino et al., 1999; Tyler et al., 2008). If so, the best systems invite intra-organizational trust, even though the trust will sometimes be abused. (I wish prosecutors and regulators understood this better, but suspect that the induced evolution of surveillance, technology-driven and otherwise, will steadily be in the direction of more intensity and less trust.)

4.3. GOALS, QUOTAS AND COMPENSATION

The kind of work in behavioral ethics we've been surveying meshes with orthodox economics in agreeing that incentives matter. Thus it is probably safe to say that most all compliance failures happen because incentives pushed or pulled in that direction. The main difference between the psychologists and the economists on this is that the former see compliance choices as mediated by a state of mind that obscures perception and judgment in pursuit of self-interest, while the economist sees the actor as a nimble Bayesian updater responding precisely to changing incentive cues. As we've seen, that difference complicates the tasks of compliance and ex ante risk management.

The common ground on the matter of incentives means that conventional economic analysis of the incentive structure relating to any compliance setting, as a matter of parsimony if nothing else. (My sense is that many compliance programs ignore both good economics and good psychology.) From that base can be added the psychological and organizational twists to see how messages might be distorted in transmission or reception. One of the famous examples in the compliance literature involves Sears and the financial and reputational penalties for overcharging customers for auto repair work (Bazerman and Tenbrunsel, 2011, p. 106). Sears had been a leader in auto work, and had a good reputation for that and other customer services. But firms like Wal-Mart and K-Mart destabilized the retail marketplace via cost-cutting, and Sears suffered a loss of revenue. To compete (perhaps to survive) Sears instituted more rigorous profitability targets that matched others in the industry. Apparently to its surprise—but not to the surprise of any economist or psychologist—the shop floor reaction read that as a directive to ignore good customer service. On the shop

floor, the redesigned incentive structure likely led to “seeing” more problems with customers’ cars than previously, and a lower perceptual threshold for when repairs are thought necessary.

The optimal design of compliance-sensitive incentives is well beyond the scope of this chapter. There is a school of thought among some behavioralists that aggressive incentives and quotas are not only dangerous and less important to productivity than commonly assumed. They crowd out conscientiousness. Others contest that and consider those arrangements efficient, even as they acknowledge the compliance risk when they are baked into the organization’s strategic plan (for a review, see Kamenica, 2012). Given the time lag between revenue (now) and a compliance sanction (later if ever), attention to the former is fairly natural and increased all the more in the face of hyperbolic discounting of the future over the present. Executive contracts might be designed to address this through deferrals, clawbacks and the like, though that is certainly a contested topic. But much of the motivation for wrongdoing isn’t entirely top down. As Chuck Whitehead and Simon Sepe (2015) point out, risk often comes from the up-and-coming strivers, for whom mobility is important and hence incentive structures have to be short-term to attract the best talent. I confess some pessimism that entrenched incentive structures will ever make compliance a priority in settings that are perceived internally as hypercompetitive, or that there is a particularly productive way to do this by external regulatory fiat. The genetic structure of firms seems to understand that survival and success come first, and that optimal compliance is about the organization’s taste for risk. Given what we said earlier about biases that promote competitiveness, both regulation and compliance will usually be chasing the greased pig from behind (Langevoort, forthcoming).

That goes for human resources as well. It’s probably right that good compliance is heavily influenced by who gets hired and who gets promoted. And it’s self-evident that most competitive firms don’t hire at seminaries or schools of social work in order to seek out the most ethically sensitive. Nor do they seek out sociopaths, of course. But how many consider the compliance implications of hiring practices that, say, seek out college-level athletes or fraternity/sorority presidents? That may seem merit-based and innocent enough, and probably not a bad heuristic in predicting employment success. But the firm is also raising its aggregate testosterone level, plus whatever other traits correlate with such resumes. Researchers have noted how sought-after characteristics in the business world like energy, self-confidence, the need for achievement and independence, can have evil twin pairings: aggressiveness, narcissism, ruthlessness and irresponsibility (Miller, 2015).

Promotion practices are another subtle source of frustration. Economists have modeled the internal promotion tournament at competitive firms and noted how they reward the overconfident risk-taker (Goel and Thakor, 2008). If we assume that risk-taking includes compliance risks with a significant economic upside, we can see how the path to the top may favor those with an extra willingness to push against regulatory demands. If regulatory demands are under-enforced either systematically or at a particular time (e.g., when the economy is booming), the lottery wheel tilts even more in favor of the legal risk-takers (Langevoort, 2012, pp. 504-06). If so, no matter what the official rhetoric, the tone at the top can degrade audibly to anyone listening carefully enough.

4.4. CONSTRUCTIVE INTERVENTIONS

The pessimism of the last subsection is sobering, and I do fear that the compliance function has to work hard—and use all the economic and behavioral tools at its disposal—even to moderate the temptations to take excessive legal risks, much less eliminate them. But compliance efforts are crucial, in that without that, things would surely be worse. Behaviorally, organizational correctives are sorely needed.

Earlier, we said that there is much research trying to tease out when cheating becomes more likely than the baseline. It also looks for the opposite, interventions that lessen cheating. There are some amusing findings. Pictures of eyes in the room, or posting the Ten Commandments (even as to non-believer subjects), reduce cheating (Ariely, 2012, ch. 2). Behavioral ethicists urge the display of ethical reminders as close to the time of temptation as possible, which is behind the intuition noted earlier that an oath or certification just before making a statement can be helpful. Another effort looks to the choice architecture inside the firm to see if nudges will work—making the ethically more risky course of action require affirmative effort rather than be the default.¹⁰

These are low-powered interventions, to be sure. But they do help give content to something often invoked but otherwise ill-defined: tone at the top. Tone can be viewed in terms of the bad—where senior management give off signals of disinterest or hypocrisy,¹¹ saying one thing but doing another.

¹⁰ For an experimental study showing some promise in nudging greater awareness of the effects of conflicts of interest, see Feldman and Halali, 2015.

¹¹ Even if the hypocritical CEO genuinely believes his own sanctimony, which is not unlikely.

(Ostentatious displays of wealth don't help, or over-claiming business travel privileges on the company jet.) But more positively, *persistently* addressing ethics and values offers the same kind of close-to-the-moment reminder opportunity. How senior management and the board of directors interact with the ethics and compliance function, in terms of both frequency and expression, will be noticed, too. And to stress a point Tom Tyler (2008) has persistently emphasized in his research, fair treatment of employees is key not only to good morale but any perception that management's compliance expectations have legitimacy.

Organizational processes may also be addressable from a compliance and ethics perspective. Decision-making usually tries to be as nimble as possible, and bureaucratic roadblocks—repetitive committee approvals—can be deadening. That said, a psychologically savvy look at decision process and decision speed can be helpful at points where compliance risks lurk.¹² But being more specific than this requires that we hone in on the particulars of the legal subject in question, competitive context and many other factors, beyond what we can profitably explore here. Miriam Baer (2014) offers a useful sketch of architectural and policing strategies that a company might employ to target time-inconsistency driven misbehavior, a search for pre-commitment devices that better align employees' present and future selves.

5. Perspective

So in the end, what is behavioral compliance? To be clear, it is not some new or different brand of compliance design, but rather an added perspective. Just as compliance requires good economics skills, it requires psychological savvy as well, to help predict how incentives and compliance messages will be processed, construed and acted upon in the field. All compliance functions and challenges should be deconstructed and thought through rigorously to anticipate responses and counter-responses, an effort at game theory in both its classical and behavioral (Camerer, 2003) forms. The behavioral approach to compliance offers some concrete interventions to consider, but is mainly about doing conventional things (communication, surveillance, forensics) better.

¹² On the benefits of delay from a cognitive perspective, see Partnoy, 2014.

Behavioral compliance also demands self-reflection. As we saw, one research agenda in behavioral ethics looks at how people observe and react to cheating by others, and the role of motivations, biases and blind spots in all this. People in the compliance field should appreciate that their own efforts are potentially biased, too. Compliance is very hard, and often frustrating. It has to fight for its own internal legitimacy, against pushback both blatant and subtle. Finding wrongdoing inside the firm is painful in terms of hard choices about self-reporting that might bring on penalties, the political difficulties of assigning blame, and institutional shame and anger. Those conditions can easily prompt self-serving or self-protective construals within the compliance function, not just outside it. Given how important the job is, that risk has to be confronted openly, too, lest the compliance function devolve into defensive routines and habits that make it the merely cosmetic touch-up critics have long feared (Krawiec, 2003).

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