

The Efficacy of Regulation as a Function of Psychological Fit: Reexamining the Hard Law/Soft Law Continuum

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Much of the legal literature discusses regulation and regulatory forms with a seemingly implicit assumption that "those to be influenced" are inherently self-interested and thus motivated to comply with legal structures only when there are sufficient external incentives to do so. This view of the person is inconsistent with recent perspectives in the field of psychology. A law and morality perspective, coupled with insights from the field of psychology, asserts that influence, compliance, and motivation are far more complex than this legal literature would suggest. In this Article, we map the varying influence structures, motives, psychological needs, emotional mechanisms, and levels of moral reasoning that various forms of regulation, from hard law to soft law, might appeal to. We provide examples from global banking and one soft law initiative, the Equator Principles, to illustrate reasons psychology would suggest why soft law may be more effective in some circumstances in influencing behavior within the firm than hard law, while recognizing important limits to such influence.

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I. THE EFFICACY OF REGULATION AS A FUNCTION OF PSYCHOLOGICAL FIT: A THEORY OF SOFT LAW

Although the notion of *homo economicus* has dominated a great deal of social science theory in the past decades,¹ a number of disciplines, even including economics, have come to embrace the view that it is not self-interest alone that drives human behavior.² Indeed we see examples in the literature of individuals acting against their own self-interest and instead acting in the name of norms,³ cooperation,⁴ fairness,⁵ empathy,⁶ and moral duty.⁷ The perspective that humans have a range of motivations for action beyond self-interest has especially been embraced in the field of psychology, where empirical and theoretical research increasingly shows the important role that both human morality⁸ and intrinsic motivation, that is motivation not driven by external incentives,⁹ play in influencing prosocial behavior.

Despite these advances, one could argue that within *law*, a discipline largely dedicated to the study of regulatory structures, many of the assumptions surrounding self-interest have remained central to influential theories in the United States. Based on the work of economist and Nobel Laureate Gary Becker, a one-dimensional view of the person being regulated has predominated, particularly within law and economics. This view is

1 See, e.g., DAVID M. HOLLEY, *SELF-INTEREST AND BEYOND* (1999).

2 See generally Russell Cropanzano, Barry Goldman & Robert Folger, *Self-interest: Defining and Understanding a Human Motive*, 26 J. ORG. BEHAV. 985 (2005) (taking a multidisciplinary perspective in arguing that other motives exist beyond self-interest).

3 See Ernst Fehr & Simon Gächter, *Altruistic Punishment in Humans*, 415 NATURE 137, 140 (2002).

4 See Gary Bolton & Axel Ockenfels, *ERC: A Theory of Equity, Reciprocity, and Competition*, 90 AM. ECON. REV. 166 (2000).

5 See Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Fairness and the Assumptions of Economics*, 59 J. BUS. 285 (1986).

6 See C. Daniel Batson, *Prosocial Motivation: Why Do We Help Others?*, in *ADVANCED SOCIAL PSYCHOLOGY* 332 (Abraham Tesser ed., 1995).

7 See Carmelo J. Turillo et al., *Is Virtue its Own Reward? Self-Sacrificial Decisions for the Sake of Fairness*, 89 ORG. BEHAV. HUM. DECISIONAL PROCESSES 839 (2002).

8 See Paul Bloom, *How Do Morals Change?*, 464 NATURE 490 (2010).

9 See EDWARD L. DECI & RICHARD M. RYAN, *INTRINSIC MOTIVATION AND SELF-DETERMINATION IN HUMAN BEHAVIOR* (1985); Edward L. Deci & Richard M. Ryan, *A Motivational Approach to Self: Integration in Personality*, in 38 NEBRASKA SYMPOSIUM ON MOTIVATION: PERSPECTIVES ON MOTIVATION 237 (R. Dienstbier ed., 1991).

predicated on the idea that the best way to ensure compliance with regulatory regimes is by appealing to self-interest, defined as rational calculation of the magnitude of liability discounted by the probability of enforcement.¹⁰ What has received less consideration within the law and economics perspective is whether (and how) law compliance could be more effectively advanced by appealing to more than rational calculation (self-interest),¹¹ although there are important strands of the literature modifying the construct of "rationality" itself, and introducing such concepts as trust and norms.¹² Still, the core person being subjected to regulation is assumed to be *homo economicus* in broad swathes of law and economics theory.

By contrast, some regulatory theorists have explored the role of moral commitment and a civic sense of a duty to comply with law, beginning

10 See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

11 See Robin B. Kar, *The Deep Structure of Law and Morality*, 84 TEX. L. REV. 877, 942 (2006) (stating that

much of the legal literature — including familiar descriptive and normative accounts from law and economics scholars — has been presupposing a psychological picture that is deeply at odds with how we respond to moral and legal obligations. Our sense of obligation may employ instrumental reason to produce actions, but the sense is in no way reducible to instrumental reason in application to any preexisting beliefs and desires for states of affairs. Hence, our capacities to reason instrumentally may not figure very centrally at all in morality and law, and we may necessarily misunderstand these phenomena if we try to shoehorn them into that model. To understand morality and law, we must instead learn to understand better how our distinctive capacities to identify and respond to obligations function.)

12 For an overview of Tversky and Kahneman's classic works on this subject, see DANIEL KAHNEMAN & AMOS TVERSKY, *CHOICE, VALUES AND FRAMES* (2000). For an excellent synthesis showing how Kahneman and Tversky's work has influenced the theory of rationality in law and economics, see Russell S. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CL. L. REV. 1051 (2000). Behavioral law and economics takes into account an expanded view of rational calculation — expanded to include common heuristics and biases by which information is evaluated, as Korobkin and Ulen's article makes clear. Moreover, there is an influential "trust" strand of the literature that has looked to the efficient use of "trust" and "trustworthiness" to reduce transaction costs in economic situations, see, e.g., Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 PENN. L. REV. 1735 (2001); Ronald J. Colombo, *Trust and the Reform of Securities Regulation*, 35 DEL. J. CORP. L. 829, 840-56 (2010) (literature review). There is a "norms" strand of writing within law and economics as well, see *NORMS AND THE LAW* (John N. Drobak ed., 2006).

with the work of Tom Tyler,¹³ while recognizing the limitations of legal theory to address how to encourage moral commitment and a sense of civic responsibility.¹⁴ Many scholars of regulation of the "new governance" or "reflective regulation" schools take as their starting point an assumption that a benefit of these governance initiatives is that they "have the capacity to influence the internal self-regulation and norms of organizations and make them more responsive (rather than merely reactive) to social concerns"¹⁵—an assumption that is borne out in case-studies,¹⁶ but has yet to be well evaluated in quantitative empirical study.¹⁷ The mechanisms by which either new governance initiatives (soft law) or prescriptive standards (hard law) could, in theory, affect the norms within the firm and support or impede a sense of civic obligation towards complying with the law and fully engaging with its goals, are under-theorized in law, however, with a few important exceptions.

In this Article, we seek to employ current research in the field of

13 See TOM TYLER, *WHY PEOPLE OBEY THE LAW* (1991); TOM TYLER, *WHY PEOPLE OBEY THE LAW* (2d ed. 2006); Tom R. Tyler, *New Approaches to Justice in Light of Virtues and Problems of the Penal System*, in *SOCIAL PSYCHOLOGY OF PUNISHMENT OF CRIME* 19 (Margit E. Oswald, Steffen Bieneck & Jorg Hupfeld-Heinemann eds., 2009).

14 See Peter J. May, *Regulation and Compliance Motivations: Examining Different Approaches*, 65 *PUB. ADMIN. REV.* 31 (2005).

15 Neil Gunningham & Darren Sinclair, *Organizational Trust and the Limits of Management-Based Regulation*, 43 *LAW & SOC'Y REV.* 865, 867 (2009); see also CARY CONGLIANESE & JENNIFER NASH, *LEVERAGING THE PRIVATE SECTOR: MANAGEMENT-BASED STRATEGIES FOR IMPROVING ENVIRONMENTAL PERFORMANCE* 250 (2006); CHRISTINE E. PARKER, *THE OPEN CORPORATION: EFFECTIVE SELF-REGULATION AND DEMOCRACY* (2002).

16 See Gunningham & Sinclair, *supra* note 15, at 868.

17 For instance, the authors of this Article and others on our research team have used qualitative methods to evaluate a new governance initiative in banking that seeks to address social and environmental harm in large infrastructure development, the Equator Principles. We have found in some banks that the Equator Principles have catalyzed changes in the bank's culture such that social and environmental harm is considered more carefully across a range of industries and business relationships. See Deborah E. Rupp, Cynthia A. Williams & Ruth V. Aguilera, *Increasing Corporate Social Responsibility Through Stakeholder Value Internalization (and the Catalyzing Effect of New Governance): An Application of Organizational Justice, Self-Determination and Social Influence Theories*, in *MANAGERIAL ETHICS: MANAGING THE PSYCHOLOGY OF MORALITY* 69 (Marshall Schminke ed., 2011); John M. Conley & Cynthia Williams, *Global Banks as Global Sustainability Regulators?: The Equator Principles*, 33 *LAW & POL'Y REV.* (forthcoming 2011). The implications of this point are considered more carefully below.

psychology to develop a theory about what those mechanisms might be, and how they might differ between hard law and soft law approaches. The thesis we advance in this Article is that many forms of soft law have the potential to engage a broader range of human motivations, needs, emotions, and moral reasoning, and thus might more effectively encourage behaviors that optimize society's regulatory goals than do approaches that rely only on appeal to the instrumental considerations or self-interest of the regulated entity.¹⁸

In effect, what we are suggesting is that a more realistic picture of human psychology could inform the design of more effective regulatory instruments. We suggest that this psychologically-informed approach complements Gunningham and Sinclair's integrative theory of regulation, which is an approach to regulation that suggests the use of different mixtures of hard and soft law, or soft law with the potential for triggers to bring in government and more prescriptive elements.¹⁹ We also suggest that psychologically-informed theory complements Parker's theory of meta-regulation, which recognizes that many new regulatory initiatives are aimed at changing management processes in the firm, rather than directly setting required outcomes.²⁰

To proceed, we will first set out what we term the challenges facing a psychological theory of regulation, that is, what features of the regulatory realm today such a theory must plausibly explain or contribute towards explaining (Part II). We will then provide a brief review of three overlapping psychological perspectives that have relevance for the study of regulation and its effectiveness: the self-determination theory of human motivation; organizational justice theory; and social influence theory (Part III). Considering various types of regulation on a continuum between hard and soft law in light of these perspectives, we will highlight the

18 The concept of regulation we are using here is deliberately broad so as to encompass both hard and soft law, an approach consistent with much of the "new governance" regulatory literature. See, e.g., Julia Black, *Constructing and Contesting Legitimacy in Polycentric Regulatory Regimes*, 2 REG. & GOV. 137 (2008); Julia Black, *Decentering Regulation: Understanding the Role of Regulation and Self Regulation in a 'Post Regulatory' World*, 54 CURRENT LEGAL PROBS. 103 (2001).

19 See Neil Gunningham & Darren Sinclair, *Integrative Regulation: A Principle-Based Approach to Environmental Policy*, 24 LAW & SOC. INQUIRY 853 (1999) (arguing that "in the majority of circumstances, the use of multiple rather than single-policy instruments and a broader range of regulatory actors will produce better regulation").

20 See Christine Parker, *Meta-Regulation: Legal Accountability for Corporate Social Responsibility?*, in THE NEW CORPORATE ACCOUNTABILITY: CORPORATE SOCIAL RESPONSIBILITY AND THE LAW 207 (Doreen McBarnet, Aurora Voiculescu & Tom Campbell eds., 2006).

particular psychological needs and emotional mechanisms that these varying approaches could affect, at least in theory (Part IV). Our premise is that the strictness of a specific regulatory form makes assumptions about the psychology of those whose behavior is being regulated (or attempted to be regulated), and that better integration of psychological theory into regulatory design will optimize regulatory efficacy. A preview of our thesis is illustrated in Figure 1. We will then provide a number of examples from global banking to suggest how this psychological theory of regulation might be applied (Part V), and briefly conclude.

II. THE CHALLENGE FOR A PSYCHOLOGICAL THEORY OF REGULATION

Simply put, a psychological theory of regulation needs to be able to contribute towards explaining at least the following four features of observed practice. First, in many instances, hard law that is either prescriptive (so-called "command and control" regulation) or reflexive (required disclosure) is quite effective in changing firms' behavior, but only up to a point.²¹ Beyond that point, resistance or resentment of "overly coercive" regulation can occur and a "culture of regulatory resistance" can develop.²² Second, many firms in many industries go "beyond compliance," undertaking more protective (and more expensive) actions than those required by law.²³ Third, soft law forms of governance are proliferating, such as self-regulatory industry standards, public/private hybrid governance, or third-party norms development, and many firms in many industries are orienting their behavior towards those governance initiatives, notwithstanding that they require actions beyond what the law requires, and notwithstanding the lack of any potential government enforcement.²⁴ And fourth, once firms participate in soft law governance,

21 See May, *supra* note 14, at 40 (finding that mandatory requirements for protecting water quality in boatyards produce greater effects than voluntary initiatives amongst marine operators, yet finding that the marine operators (voluntary) undertook eighty-two percent of the actions of the boatyard operators (mandatory)).

22 See EUGENE BARDACH & ROBERT KAGAN, *GOING BY THE BOOK: THE PROBLEM OF REGULATORY UNREASONABLENESS* (1982); Gunningham & Sinclair, *supra* note 15, at 860-61.

23 See, e.g., Robert Kagan, Neil Gunningham & Dorothy Thornton, *Explaining Corporate Environmental Performance: How Does Regulation Matter?*, 37 *LAW & SOC'Y REV.* 51 (2003).

24 The literature here is proliferating almost as fast as the new governance mechanisms. For some excellent introductions, see GERALF-PETER CALLIESS & PEER ZUMBANSEN, *ROUGH CONSENSUS AND RUNNING CODE: A THEORY OF TRANSNATIONAL PRIVATE LAW* (2010); Benedict Kingsbury, Nico Krisch, & Richard B. Stewart, *The*

we can observe changes in some of their cultures as people within the firm exhibit seemingly deeper engagement with the goals of the governance mechanism.²⁵ While ultimately there may be other important features of observed compliance to explain, at least these four are not fully explained by reference to economic theories of deterrence based purely on the self-interest of the regulated entities.

III. THREE PSYCHOLOGICAL PERSPECTIVES

A. Human Motivation

Among the most influential theories of psychology, self-determination theory (SDT), developed by Deci and Ryan, argues that the optimal human condition is one where individuals feel both a sense of motivation and responsibility.²⁶ According to this theory, in some contexts optimal motivation and a sense of responsibility can be compromised, leading individuals to "reject growth and responsibility."²⁷ One type of irresponsible behavior would be rejecting the requirements of law, which under Deci and Ryan's theory would be equated with non-optimal human functioning, assuming the background conditions of a legitimate system of law. The theory, which has received considerable empirical support internationally, posits that the responsible or irresponsible behaviors of individuals does not necessarily reflect differences in personality, genetics, or character, but rather individuals' reactions to their social environments. As such, self-determination theory is a theory about the social conditions under which individuals are able to live up to their potential for responsible, self-determined behavior.

If humans' motivation to, for example, comply with various legal structures is a function of the social context (i.e., the culture in the firm, the regulatory structure itself, and the underlying conditions of

Emergence of Global Administrative Law, 68 LAW & CONTEMP. PROBS. 15 (2005); Julia Black, *Constructing and Contesting Legitimacy and Accountability in Polycentric Regulatory Regimes* (LSE Law Soc'y & Econ., Working Papers No. 2, 2008), available at <http://ssrn.com/abstract=1091783>.

²⁵ See, e.g., Conley & Williams, *supra* note 17.

²⁶ See DECI & RYAN, *supra* note 9; Richard M. Ryan & Edward L. Deci, *Self-Determination Theory and the Facilitation of Intrinsic Motivation, Social Development, and Well-Being*, 55 AM. PSYCHOLOGIST 68 (2000); Richard M. Ryan, *Psychological Needs and the Facilitation of Integrative Processes*, 63 J. PERSONALITY 397 (1995).

²⁷ Ryan & Deci, *supra* note 26, at 68.

legality in the society), such a theory may be useful in identifying what characteristics of various regulatory forms may optimize not only compliance, but also "beyond-compliance" types of behaviors. The theory points to three contextual characteristics worth exploring, which serve to fulfill three fundamental human needs.

The first is *autonomy*, which refers to contexts where individuals have discretion over their environments. Within regulatory governance, this would refer to systems of influence that are not enforced via the threat of punishment, but rather present an opportunity for individuals to either develop the governance standards (as in many new governance initiatives) or comply with agreed upon standards of conduct as an expression of their values.

The second contextual element is one that induces feelings of *competence* in the individuals influenced by the regulatory structure. Typically such contexts provide mechanisms for receiving feedback, involve open communication, provide individuals with a sense of control, and bestow rewards as incentives (as opposed to demeaning evaluations). Systems of regulatory influence that induce competence would be those that empower individuals to participate in policymaking and provide mechanisms for seeing results.

The final contextual characteristic is *relatedness*, which in our case refers to elements of the regulatory structure that allow individuals to develop a secure relationship (i.e., attached, identified) with the governing body. For instance, Tyler has argued that people's compliance with rules is influenced by the extent to which they feel a sense of psychological identification with the governing entity.²⁸ Research has shown that even infants show motivational tendencies that are affected by their relationships. Indeed, Bowlby found intrinsic motivation to be higher among babies with secure attachments to parents.²⁹ Similar findings have been found with adults, showing that one's social environment exerts a strong effect on subsequent intrinsic motivation, with those more "securely attached" holding more positive views of both themselves and the governing entity, and showing heightened wellbeing as a result of this relationship.³⁰

28 Tom R. Tyler, *Procedural Justice, Identity and Deference to the Law: What Shapes Rule-Following in a Period of Transition?*, 61 AUSTL. J. PSYCH. 32 (2009).

29 JOHN BOWLBY, ATTACHMENT AND LOSS (1980).

30 R. Chris Fraley & Paul Shaver, *Adult Romantic Attachment: Theoretical Developments, Emerging Controversies, and Unanswered Questions*, 4 REV. GEN. PSYCH. 132 (2000).

B. Justice and Behavioral Ethics

Similar themes can be found in the research on social and organizational justice, which has also focused on the motives behind individuals' concerns for justice and willingness to comply with systems of influence.³¹ This literature recognizes three distinct motives — instrumental, relational and moral — which influence people and their perceptions of and concerns for justice. The justice literature certainly acknowledges the role of self-interest in justice concerns, as several theories explicitly discuss a concern for equity (fairness) as a strategy for the maximization of individuals' self-interested outcomes.³² But this literature has moved far beyond simple egoistic models to consider both the relational³³ and ethical needs that justice serves.³⁴ Research suggests that instrumental, relational, and moral motives might all be at work as people evaluate and react to systems of power and influence (both whether or not to comply, as well as to what extent). And like self-determination theory, justice theories also assume that these various motives are underpinned by the psychological needs of control, belongingness, and meaningful existence.

Take, for example, research that has been conducted within behavioral ethics. This research often puts individuals in laboratory simulations where they must distribute resources between themselves and others in variations of the ultimatum game. The classic economic outcome-maximization model would suggest that individuals will strive, over time, to amass as many resources for themselves as possible. Kahneman, Knetsch and Thaler challenged this notion and proposed that justice is not always a means to an end, but can be an end in itself — a universal human value for which individuals will make sacrifices. A series of their experiments provided empirical support for this notion, showing that if individuals know that a person has been unfair to others in past allocations of resources in an

31 Russell Cropanzano & Deborah E. Rupp, *An Overview of Organizational Justice: Implications for Work Motivation*, in *MOTIVATION AND WORK BEHAVIOR* (Lyman Porter, Gregory A. Bigley & Richard Steers eds., 7th ed. 2003); Russell Cropanzano, Deborah E. Rupp, Carolyn J. Mohler & Marshall Schminke, *Three Roads to Organizational Justice*, 20 *RES. PERSONNEL & HUM. RESOURCE MGMT.* 1 (2001); Linda K. Trevino, Gary R. Weaver & Scott J. Reynolds, *Behavioral Ethics in Organizations: A Review*, 32 *J. MGMT.* 951 (2006).

32 See, e.g., J. Stacy Adams, *Inequity in Social Exchange*, 2 *ADVANCES EXPERIMENTAL SOC. PSYCHOL.* 267, 274-75 (1965).

33 See Tom R. Tyler & E. Allan Lind, *A Relational Model of Authority in Groups*, 25 *ADVANCES EXPERIMENTAL SOC. PSYCHOL.* 115 (1992).

34 See Robert Folger, *Fairness as a Moral Virtue*, in *MANAGERIAL ETHICS: MORAL MANAGEMENT OF PEOPLE AND PROCESSES* 13 (Marshall Schminke ed., 1998).

ultimatum game, the experimental subjects will punish that person — even if they must act against their own economic self-interest in order to do so. In other words, if sacrificing their own resources was the only way to punish a transgressor, experimental subjects would do so consistently.³⁵ This "deontic" effect was replicated by Turillo et al., who showed over four studies that individuals do show evidence for instrumental, relational, and morality-based motives, and when they are put in a situation where they must choose between them, morality often wins.³⁶

Related evidence was found by Rupp and Bell who showed tendencies in individuals to engage in moral self-regulation when making justice-related decisions.³⁷ Their findings parallel the notion of civil disobedience — that some individuals may choose not to comply with conventional (e.g., legal) structures, not because those individuals are immoral, but because they are processing the implications of their actions at a higher level of moral reasoning.³⁸

The justice strand of research in psychology thus has important implications for the study of regulatory compliance, as has been recognized previously by justice researchers.³⁹ It suggests, like self-determination theory, that individuals have multiple reasons for complying with the law, with their firm's requirements, or with rules established by their industry or profession — in short, with any construct fairly understood as regulation.⁴⁰ Over time, however, patterns of attachment and identification emerge as individuals form attitudes toward and perceive social contracts with governing bodies. Due to both their own social development and maturity, and their accumulated experiences with governing bodies, individuals may apply varying levels of moral reasoning to their decisions whether or not to comply with social influence. If their sense of relationship, identification or ethical standards is violated by a governing body, compliance is less likely.

35 See Kahneman, Knetsch & Thaler, *supra* note 5, at 288-92.

36 See Carmelo Joseph Turillo et al., *Is Virtue Its Own Reward? Self-Sacrificial Decisions for the Sake of Fairness*, 89 *ORG. BEHAV. & HUM. DECISION PROCESSES* 839 (2002).

37 See Deborah E. Rupp & Chris M. Bell, *Extending the Deontic Model of Justice: Moral Self-Regulation in Third-Party Responses to Injustice*, 20 *BUS. ETHICS Q.* 89 (2010).

38 See Deborah E. Rupp, *An Employee-Centered Model of Organizational Justice and Social Responsibility*, 1 *ORG. PSYCH. REV.* 72 (2011).

39 See, e.g., TOM TYLER, *WHY PEOPLE OBEY THE LAW* 270-80 (2d ed. 2006) (exploring the legitimacy of police, courts and law, based on procedural justice concepts).

40 In later Parts of the Article we discuss how the different source of regulation might differentially affect the process of attachment and identification discussed here.

C. Social Influence

A third (also related) social psychological perspective that is relevant to the study of compliance across regulatory forms is Kelman's theory of social influence.⁴¹ This theory argues that the behaviors of individuals, groups, organizations, and societies are influenced through three major processes: compliance, identification, and internalization.

Research has shown that the social context (e.g., the regulatory form) has a strong effect on the success of attempts to influence others' behavior. That is, the way in which systems of influence are structured can shape individuals' motives to comply. These varying structures are referred to as "system orientations," which largely influence how, when, and why individuals follow rules and regulations that are imposed on them. Kelman and Hamilton have noted that

[m]any social influence situations are . . . thoroughly embedded in the organizational or societal context They represent . . . part of the process whereby the society or organization . . . socializes and controls its members and carries out its daily business, and whereby the members advocate policies, protest against existing practices, or seek to advance their personal or subgroup interests.⁴²

Consequently, we can look to Kelman's model to postulate when and why various forms of governance may be more or less effective.⁴³

Compliance refers to cases where individuals or groups act in accordance with regulation in order to attain a favorable reaction from the governing party. It most often takes the form of the pursuit of reward or avoidance of punishment from the governing party. As such, compliance (interest)-orientations are created and reinforced via rules and norms, and they are effective to the extent that they elicit fear or the threat of embarrassment.

Identification refers to a case where individuals or groups act in

41 See Herbert C. Kelman, *Interests, Relationships, Identities: Three Central Issues for Individuals and Groups in Negotiating Their Social Environments*, 57 ANN. REV. PSYCH. 1 (2006).

42 HERBERT C. KELMAN & HAMILTON, CRIMES OF OBEDIENCE: TOWARDS A SOCIAL PSYCHOLOGY OF AUTHORITY AND RESPONSIBILITY 89 (1989).

43 See Herbert C. Kelman, *Social Influence and Linkages Between the Individual and the Social System: Further Thoughts on the Process of Compliance, Identification, and Internalization*, in PERSPECTIVES ON SOCIAL POWER 125 (James Tedeschi ed., 1974).

accordance with rules set forth by a governing body in order to develop or maintain a self-defining relationship with the party imposing the influence. Consequently, identification (relationship)-orientations are created and reinforced via systems of roles and are effective to the extent that they elicit pride and affiliation, as well as the motivation to avoid guilt and shame.

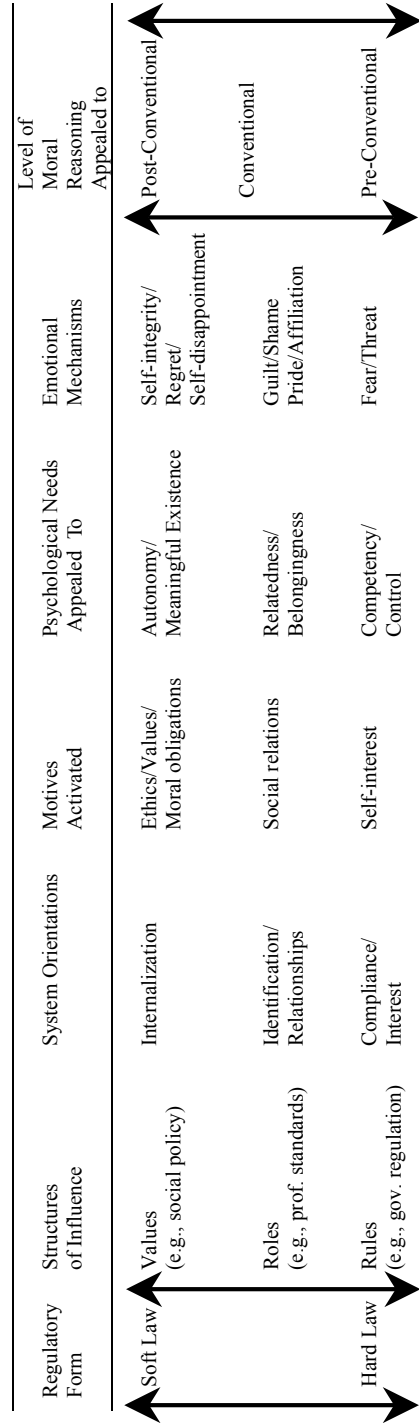
Finally, *internalization* refers to the case where individuals or groups act in accordance with regulation due to an alignment in values between themselves and the governing body. In this case, we posit that complying with regulations provides reinforcement to individuals that their actions are consistent with their ethics, values, and moral obligations. Likewise, internalization-orientations come about via shared social values and are effective to the extent that they promote self-integrity, adherence to personal standards, and the avoidance of regret and disappointment in oneself.

These three orientations are said to serve as both "the process and criteria by which perceived legitimacy is generated, assessed, and maintained."⁴⁴ Thus, the psychological efficacy of regulatory structures will depend on the mechanisms of influencing behavior those structures employ. So, for example, threat-based attempts to influence behavior will only achieve compliance; attempts to influence behavior that appeal to relationships will likely achieve identification; and only attempts to influence behavior in ways that allow individuals to promote their personal ethical standards will lead to stable, enduring adherence at the level of internalization. Thus, we posit that it is only when the regulatory context creates a state of shared values and mutual problem-solving among parties that transformative change can be expected.⁴⁵ As we will discuss below, this insight by Kelman suggests a productive line of inquiry for evaluating the efficacy of different sources and structures of regulation, from soft law to hard law of a reflexive nature (such as required disclosure) to hard law setting substantive standards of conduct or outcomes.

⁴⁴ See Kelman, *supra* note 41, at 15.

⁴⁵ See Kelman, *supra* note 41; Herbert C. Kelman, *Social-Psychological Dimensions of International Conflict*, in PEACE-MAKING IN INTERNATIONAL CONFLICT: METHODS AND TECHNIQUES 61 (I. William Zartman & J. Lewis Rasmussen eds., 1997); Herbert C. Kelman, *Negotiation as Interactive Problem Solving*, 1 INT'L NEGOT. 99 (1996).

Figure 1: The Efficacy of Regulation as a Function of Psychological Fit



The relevance of Kelman's model (which has received a great deal of empirical verification⁴⁶) to our thesis is apparent. By positing contextual categories with which to evaluate systems of influence, and by pointing to how, when, and to what extent various forms of influence will be effective, it provides us with a psychological basis for evaluating various forms of regulatory governance. Thus, in the Parts that follow, we will turn our focus back to the legal domain. In the next Part we will apply the psychological theories just discussed to address the regulatory behaviors which, we suggested in Part II above, are a challenge to purely instrumental theories of regulation. Then, taking as an example a soft law initiative in global banking, the Equator Principles, we will consider the influence of this initiative within the firm through the lens of human motivation, justice, behavioral ethics, and social influence theories (summarized in Figure 1). On the basis of this analysis, we will propose the contextual elements most likely to influence pro-social behavior via governance structures that vary on a hard-to-soft law continuum.

IV. THE PSYCHOLOGY OF GOVERNANCE: MAPPING THE HARD LAW/SOFT LAW TERRAIN

There are a number of features of compliance with law and modern regulatory developments that are illuminated, we suggest, by theory informed by social and organizational psychology. Here we merely sketch out some preliminary ideas, recognizing that interactions between actors, firms and types of psychological effects of different regulatory approaches would need to be specified in a fully developed theory that could serve as the basis for empirical testing.

First, we pointed out that hard law (required behaviors, processes, or disclosure) is effective to induce compliance,⁴⁷ but only up to the point where resistance and a defensive culture ensues. Self-determination theory shows that external reward and punishment structures can thwart individuals' pursuit of activities for their intrinsic value, the so-called "crowding out" problem. So even if individuals perceive legal structures as just and agree with the moral foundation of the rules, if behaviors are regulated strictly by threats of punishment or promises of rewards, within narrow requirements, it can undermine the development of more psychologically based motivations

⁴⁶ For an overview, see Kelman, *supra* note 41.

⁴⁷ See *supra* text accompanying notes 19-21.

for individuals to fully meet the spirit as well as the letter of the law. When regulation develops in principles-based fashion, with cooperative relationships between regulator and regulated becoming part of the regulatory environment, as in many new governance initiatives, theory would suggest that values-based behaviors are more likely to evolve.⁴⁸

Second, firms often go beyond "mere" compliance with law. While firms may initially comply with the law for instrumental reasons, the justice theories discussed above suggest that doing so can begin a process of top management or employees internalizing the values the law is seeking to promote. From a justice perspective, the actions of meeting community views and supporting the firm's "license to operate" become perceived as important in their own right (as "ends in themselves"), rather than as a means to an end (avoiding liability). This shift in focus is consistent with many of the comments relayed in Kagan, Gunningham and Thornton's studies of firm behavior "beyond compliance."⁴⁹

Third, soft law initiatives are proliferating, from voluntary industry self-regulation (such as the Responsible Care Initiative in the chemical industry), to public/private hybrids (the Voluntary Principles on Security in the Extractive Industry is an example here), to multi-stakeholder dialogues leading to voluntary standards either for behavior (Social Accountability 8000) or expanded disclosure (the Global Reporting Initiative), and so on.⁵⁰ There are a number of pragmatic reasons for this development that do not rely on psychology, including that transnational governance gaps are being addressed through this multiplicity of regulatory forms, solving some management issues for global firms, while also reducing reputational risks from failing to meet community norms. But evaluated from a psychological perspective, soft law initiatives, we suggest, give greater range for peoples' need for autonomy and a meaningful existence, allowing participants to grapple with complex social issues and calibrate and develop their moral

48 There are a number of interacting variables that affect how effective principles-based or cooperative regulatory approaches will be at achieving their regulatory goals, such as the commitment of the top-management team in a firm to the regulatory goals, and the level of trust between workers and management within the firm. See Gunningham & Sinclair, *supra* note 15, at 867.

49 See Kagan, Gunningham & Thornton, *supra* note 23.

50 See Margaret M. Blair, Cynthia A. Williams & Li-Wen Lin, *The New Role for Assurance Services in Global Commerce*, 33 J. CORP. L. 325, 338-46 (2008) (discussing these and other soft law initiatives).

reasoning by processing ethical dilemmas.⁵¹ At least for those people within the firm responsible for participating in developing the standards, or implementing them within the firm, soft law initiatives challenge participants to think about multiple perspectives and the demands of justice, and present dilemmas for reflection, all of which can lead to greater internalization of the values of the initiative and the exercise of higher levels of moral reasoning. While we recognize self-interested reasons for firms to participate in soft law initiatives, from attracting socially concerned consumers or investors to forestalling regulation⁵² (and by our discussion in this Article we do not mean to suggest that self-interest is not a primary factor in many firm decisions), we do suggest that self-interest is not the only factor operating to shape the behavior of people within the firm.

Finally, we have observed instances in which the culture within firms has changed as a result of participating in a soft law initiative, and where one can observe deeper engagement with the values and goals of particular initiatives. One such example in global banking is discussed immediately below. Here justice theory suggests that justice can be a "social contagion" within the firm, supporting the emergence of a justice climate that changes the normative structures concerning how the firm should be managed and how it should relate to internal and external stakeholders.⁵³

V. EXAMPLES IN FINANCE

In the short sections that follow, we suggest a number of ways in which this approach to using psychology could be applied to understand the effects of different regulatory mechanisms on people within a firm. Much further work, both empirical and theoretical, needs to be done to track the different kinds of mechanisms, the kinds of interactions within firms to be expected, and the range of possible effects. We suggest, however, that looking at these

51 See Lee K. Trevino, *Moral Reasoning and Business Ethics: Implications for Research, Education, and Management*, 11 J. BUS. ETHICS 445 (1992).

52 See Ruth V. Aguilera, Deborah E. Rupp, Cynthia A. Williams & Jyoti Ganapathi, *Putting the "S" Back in Corporate Social Responsibility: A Multilevel Theory of Social Change in Organizations*, 32 ACAD. MGMT. REV. 836 (2007) (discussing the instrumental (self-interested), relational and moral reasons why different actors would press firms to adopt corporate social responsibility initiatives, and recognizing that most actors display a mixture of these motives).

53 See Peter Degoey, *Contagious Justice: Exploring the Social Construction of Justice in Organizations*, 22 RES. ORG. BEHAV. 51 (2000).

examples shows how understanding the multiple psychological motives and needs of people within firms, and the structures of influence and contexts for moral development of different regulatory instruments, can inform regulatory design.

A. The Equator Principles: Global Sustainability Regulators?

One example of the potentially transformative effects of soft regulatory forms of regulation is an initiative called the Equator Principles, which developed in reaction to the privatization of public infrastructure finance. Prior to the 1980s, public infrastructure projects in emerging markets were primarily funded by multilateral public development banks. The landscape changed in the 1980s and 1990s, however, when many public and state-owned services (e.g., power, water, and resource extraction) were being privatized, and the World Bank and International Finance Corporation (IFC, a private lending entity within the World Bank Group) were under pressure from NGOs to withdraw from some particularly controversial projects such as the Three Gorges Dam in China. As a result of increased business opportunities and somewhat decreased support from international financial institutions, private banks began to do more infrastructure financing in emerging economies.⁵⁴ Most of the private, international banks that have taken over the role of project financing since this shift occurred have formulated and signed on to a voluntary set of standards for managing the social and environmental risks of the projects. Known as the "Equator Principles" (EPs),⁵⁵ these standards largely reflect — indeed rely upon — previous social and environmental sustainability standards imposed by the IFC⁵⁶ and the World Bank Group⁵⁷ in the public infrastructure financing system.

The evolution of the EPs as regulation highlights many of the structural characteristics of the psychological theories reviewed above. First, analysis

54 Conley & Williams, *supra* note 17.

55 See THE EQUATOR PRINCIPLES, <http://www.equator-principles.com> (last visited Oct. 3, 2010).

56 See IFC PERFORMANCE STANDARDS ON SOCIAL AND ENVIRONMENTAL SUSTAINABILITY (2006), available at [http://www.ifc.org/ifcext/sustainability.nsf/AttachmentsByTitle/pol_PerformanceStandards2006_full/\\$FILE/IFC+Performance+Standards.pdf](http://www.ifc.org/ifcext/sustainability.nsf/AttachmentsByTitle/pol_PerformanceStandards2006_full/$FILE/IFC+Performance+Standards.pdf).

57 See WORLD BANK GROUP ENVIRONMENTAL, HEALTH & SAFETY STANDARDS (2007), available at [http://www.ifc.org/ifcext/sustainability.nsf/AttachmentsByTitle/gui_EHSGuidelines2007_GeneralEHS/\\$FILE/Final+-+General+EHS+Guidelines.pdf](http://www.ifc.org/ifcext/sustainability.nsf/AttachmentsByTitle/gui_EHSGuidelines2007_GeneralEHS/$FILE/Final+-+General+EHS+Guidelines.pdf).

of this case reveals that the banks were primarily motivated by self-interest in pushing for the adoption of the EPs. Project finance is carried out via non-recourse loans, meaning banks are only repaid through the revenue generated by the project that is being funded following its completion. As such, any risk to project completion (e.g., an environmental disaster, a high-profile human rights controversy, or labor unrest) puts the banks at direct risk of losing substantial sums of money. Thus, the standards of the EPs for identifying and managing social, environmental and human rights risks are perceived by participants as mitigating risks of default, and so are directly related to the banks' financial interests.⁵⁸ A second motive, also instrumental, for banks to participate is to reduce the "reputational risk" of being targeted for the problematic implications of large infrastructure developments in fragile ecosystems or politically contentious areas.⁵⁹

There are two aspects of the EPs that suggest that once undertaken, these voluntary self-regulatory initiatives or public/private hybrids have the capacity to exert influence within the firm or industry and to change the culture within it. First, in a number of EPs banks we have observed a gradual shift in motives within the bank, a seeming internalization of environmental and social values, and a commitment to ethical norms that are in many ways well beyond the "minimum" requirements of the Principles. In these banks EPs analysis, including greater attention to social, environmental and human rights issues in evaluating and managing lending relationships, is being used to structure the banks' transactions in a broader range of business than project financing (including underwriting and commercial lending), and in a broad range of industries such as agriculture, energy, fishing, forestry and mining.⁶⁰ As those banks impose a range of social, environmental and human rights requirements on their borrowers, it is in that sense we can think of their actions as being regulatory.⁶¹

Second, in the development of the EPs itself one can see a similar

58 See Conley & Williams, *supra* note 17 (discussing these motivations based on interviews with bankers, NGOs, investors, scientists and environmental and social consultants hired to do reviews of projects both before and over the duration of the project). For an example of these motivations, see *Sustainable Finance*, HSBC GLOBAL SITE, <http://www.hsbc.com/1/2/sustainability/sustainable-finance#risk> (last visited Mar. 20, 2011).

59 See Conley & Williams, *supra* note 17.

60 *Id.*; see also *Sector policies*, HSBC GLOBAL SITE, <http://www.hsbc.com/1/2/sustainability/sustainable-finance/sector-policies> (last visited Mar. 20, 2011).

61 See Ronen Shamir, *Corporate Social Responsibility: Towards a New Market-Embedded Morality*, 9 THEORETICAL INQUIRIES L. 371 (2008) (discussing the regulatory role of banks participating in the Equator Principles).

shift in motives, a trend towards both more rigorous standards being imposed and a broader range of issues being incorporated. This suggests (but doesn't prove) that the values of the Principles are being internalized by people in the leading banks and then within systems those people develop. The first edition of the EPs was drafted in 2003 and adopted by forty-one banks, including leading global banks such as Barclays, Citibank, Credit Suisse, HSBC, ING, and JP Morgan/Chase. A revision was drafted in 2006, which contained far stricter standards for managing labor issues, community health, workplace safety, and public reporting. To date, sixty-eight financial institutions have signed onto the revised Principles, and it is now estimated that over seventy-five percent of project finance is carried out by EPs-adopting banks.⁶² As of 2010, the EPs Financial Institutions have also adopted publicly declared governance principles, with the goal of greater transparency about the effects of the Principles and as an effort to ensure that participating financial institutions meet their responsibilities under the EPs.⁶³

We see both of these aspects as evidence of the "contagion" effects of this regulatory initiative, as we see the EPs being used as a benchmark for setting up social and environmental standards for other financial practices within adopters' businesses (note that project finance typically makes up only about five percent of a typical bank's total operations). In other work we have suggested that these kinds of events within the firm are evidence of a shift over time in motives for engaging in a soft law initiative, from self-serving, to relational, to more truly ethics-based.⁶⁴ Further, the success of the EPs in encouraging some banks to become concerned with promoting social justice and environmental sustainability, even beyond project finance, we would attribute to the psychological processes evoked by looser forms of regulation — those processes involving motivation and the meeting of psychological needs, as discussed at the start of this Article.

That is, what was originally a rules-based system of influence imposed by the IFC became looser and more voluntary, and was then initiated by the banks themselves as a voluntary enterprise and carried out in close dialogue with NGO critics. Such a structure is imbued with the autonomy, relatedness, and competence that self-determination theory would suggest are highly motivating in influencing behavior. Over time, actors saw the EPs less as a mechanism for mitigating risk and more as representing a consensus

⁶² See Conley & Williams, *supra* note 17.

⁶³ See THE EQUATOR PRINCIPLES, THE EQUATOR PRINCIPLES ASSOCIATION GOVERNANCE RULES (2010), available at http://www.equator-principles.com/documents/EP_Governance_Rules_April_2010.pdf.

⁶⁴ See Rupp, Williams & Aguilera, *supra* note 17, at 71.

on a set of standards aimed at promoting business practices consistent with collective ethical norms. This is reminiscent of an internalization/identities-based system orientation, where shared social values serve as an effective mechanism for influencing behavior.

B. But What About the Rest of Banking?

While the EPs can be interpreted as an example of soft law that is promoting collective ethical norms and thereby raising social and environmental standards (at least so far as we can tell without intensive fieldwork), much of the rest of global banking in 2010 is not such an exemplar. Thoughtful scholarship has suggested that the global financial crisis should give pause for further reflection on a number of central elements of new governance regulatory design. Such new governance constructs as principles-based regulation (which influenced securities regulation in the U.K.) or "regulation that is informed and underpinned by a bottom-up, de-centered, horizontal experimental processes by private actors,"⁶⁵ such as the capital adequacy models in Basel II, can be interpreted to have failed.

An evaluation using psychological theory could provide interpretive power, however, to put those failures in context. Ironically, one of the central problems could be not enough self-interested risk assessment at the firm level, in conjunction with too much self-interested executive compensation at the individual level — all in conjunction with a justice climate polluted (injustice as a negative contagion) by a lack of moral interpretation of the risks being transferred to society. The "originate to distribute" model of banking does not engage a bank's "healthy" self-interest, critical to intelligent credit extensions, since banks were using special purpose vehicles and securitization to sell their credit onto a secondary market. Contrast this approach with the EPs banks self-interest in internalizing negative social and environmental externalities, given the non-recourse nature of project finance. At the same time, stock option and bonus-driven executive compensation exacerbated the self-interest of bankers, notwithstanding longer-term risks they were creating, and no industry relationships or self-regulatory initiatives required greater moral deliberation.

Identifying the problems thusly (albeit with an extremely broad brush) suggests approaches to regulatory redesign that are, unfortunately, inconsistent with developments in either Europe or the United States.

⁶⁵ See Cristie Ford, *New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation*, 2010 WIS. L. REV. 441.

Banks should be required to keep some substantial percentage of the credit risk that they originate (and five percent, as in current requirements, is likely not enough).⁶⁶ And executive compensation systems ought to be designed to dampen, not inflame, bankers' self-interest by better mechanisms for aligning bankers' compensation with profits or long-term economic value added of the firm, not stock prices — that is, with the real economic interests of the firm. Ideally, accounting measures would include the costs of social harm, such that a relationship between the firm and its society could become tangible, and such that the self-interest of the employees and the interests of society would be brought into better alignment. By so doing, what would begin with instrumental motives (developing accurate financial statements and so reducing the risk of litigation) could develop into greater awareness of harms to society and moral reflection, much like the trajectory within some firms that have enacted the Equator Principles.⁶⁷

As this last suggestion emphasizes, our theory does not condemn self-interest or think it needs to be erased from firm interactions: No realistic theory based on psychology would posit a world without self-interest. But psychological theory, especially justice theory, does assert that self-interested motives can be tempered with structures and interactions to promote higher-level moral reasoning, and ultimately to bring self and other into better balance.⁶⁸

CONCLUSION

This Article has summarized decades of research in psychology and used that summary to address broad issues of regulatory design. As such, it has taken a necessarily general approach to the points being developed, and there is much further work to be done filling in the necessary details and identifying important interactions between regulators, regulations, industries and firms.

66 See Mary C. Condon, *Products, Perimeters, and Politics: Securities Regulation and Systemic Risk*, in *THE EMBEDDED FIRM: CORPORATE GOVERNANCE, LABOR AND FINANCE CAPITALISM* (Cynthia A. Williams & Peer Zumbansen eds., forthcoming 2011) (discussing regulations in Europe and the United States requiring firms to hold five percent of securitized products as a result of regulatory changes in reaction to the financial crisis).

67 We stress the word "ideally" here.

68 See LYNN STOUT, *CULTIVATING CONSCIENCE: HOW GOOD LAWS MAKE GOOD PEOPLE* (2010).

One point needs to be addressed here, however. We've argued that thinking more carefully about the psychological reactions of individuals to regulation could ultimately lead to a better fit between regulatory instruments and the individuals whose behavior is being addressed. One central question this argument gives rise to is whether individual-level psychological reactions can accurately be expanded to the level of the firm. Psychological research on the justice climate of firms clearly suggests that the answer to that question is yes. The formation of individual-level justice perceptions does not occur in isolation. Events, emotions, cognitions, perceptions, and reactions are occurring for all individuals, each of whom belongs to and is active in multiple complex social networks.⁶⁹

The study of the justice climate in organizations considers how social experiences within groups can lead to group-level cognitions regarding organizational justice, and provides evidence of collective perceptions of justice that differ from a simple aggregation of individual members' perceptions.⁷⁰ Through a number of distinct social processes that have been identified in the literature, and combined with top-down, contextual influences such as the organizational structure,⁷¹ over time, the justice perceptions of individuals working together are said to converge. Furthermore, these shared, collective justice perceptions are predictive of variance in work attitudes and behaviors, as well as group— and organizational-level outcomes, above and beyond the effect of individual-level justice perceptions.⁷² In the words of Colquitt, Zapata-Phelan, and Roberson, group "contexts can magnify the importance of justice."⁷³

Thus, we suggest, understanding the collective justice perceptions concerning the regulatory environment, whether and to the extent determined by hard law or soft law, can lead to more precisely tailored regulation that encourages internalization of regulatory goals, the exercise of autonomy, and values-led actions by those whose regulatory cooperation is being invited.

69 See Quinetta M. Roberson & Jason A. Colquitt, *Shared and Configural Justice: A Social Network Model of Justice in Teams*, 30 ACAD. MGMT. REV. 595 (2005).

70 See *id.*

71 See Marshall Schimke, Russell Cropazano & Deborah E. Rupp, *Organization Structure and Fairness Perceptions: The Moderating Effects of Organizational Level*, 89 ORG. BEHAV. & HUM. DECISION PROCESSES 881 (2002).

72 See Kevin W. Mossholder, Nathan Bennett & Christopher Martin, *Multilevel Analysis of Procedural Justice Context*, 19 J. ORG. BEHAV. 131 (1998).

73 See Jason A. Colquitt, Cindy P. Zapata-Phelan & Quinetta M. Roberson, *Justice in Teams: A Review of Fairness Effects in Collective Contexts*, 24 RES. PERSONNEL & HUM. RESOURCE MGMT. 53, 53 (2005).