The Calculus of Cooperation

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Yesterday, I wrote about Professor Rebecca File's article analyzing the merits of cooperation. Although she concluded that self-initiated investigations increased the risk of an SEC sanction, she also found that penalties are lower when an issuer undertakes its own investigation.

I noted that her study doesn't offer a clear-cut answer to whether it is better for a company to auto-critique or simply take its chances on getting caught. For the sake of discussion only, let's consider the following example.

	Internal Investigation	No Internal Investigation
Cost of Investigation	$2,000,000	0
Risk of Penalty	.2[1]	.1
Penalty	.33P[2]	P

The cost of conducting an internal investigation:

$2,000,000 + (.2)(.33)P = $2,000,000+.066P

The cost of no internal investigation:

$0+.1P=.1P

If we assume that the penalty is $40,000,000 and there is an internal investigation the cost is $2,000,000+.066($40,000,000) = $4,640,000. The cost of not conducting an internal investigation is $0+.1($40,000,000) = $4,000,000.

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This suggests that in this example it is less expensive for the firm to forego an internal investigation. Given that the costs of an internal investigation include not only the costs of the investigation but the significantly increased risk of a penalty, how much lower (x) must the penalty be in order to make the choice of an internal investigation less costly?

$$\$2{,}000{,}000 + .2(x)(\$40{,}000{,}000) < \$0 + .1(\$40{,}000{,}000)$$

$$\$2{,}000{,}000 + \$8{,}000{,}000(x) < \$4{,}000{,}000$$

$$\$8{,}000{,}000(x) < \$2{,}000{,}000$$

$$x < .25$$

The purpose of this example is not to suggest that firms forego internal investigations when presented with evidence of misconduct. In fact, firms may not have a choice because their auditors will insist on an investigation. The point is that given the often substantial costs of conducting an internal investigation and the increased risk of penalties, the SEC's reward for cooperation must be significant if it is to be meaningful.

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[1] Professor Files found that conducting an internal investigation more than doubled the risk of an SEC sanction, all other factors being equal.
[2] Professor Files found that firm penalties in the case of an internal investigation were about 1/3 of those assessed when there was no investigation.

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