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ESSAY  
SHALLOW SIGNALS

*Bert I. Huang*

CONTENTS

INTRODUCTION .....	2229
I. LAW'S HIDDEN PERMISSIONS.....	2237
A. <i>Quiet License</i> .....	2237
1. Paradox of Monitoring.....	2238
2. Partial Information.....	2239
3. Private Permissions .....	2241
B. <i>Quiet Compliance</i> .....	2242
C. <i>Quiet Exceptions</i> .....	2244
D. <i>Quiet Tolerance</i> .....	2247
1. Legal Transitions .....	2248
2. Private Enforcers.....	2248
3. Secrecy and Discretion.....	2249
E. <i>The Observer in Context</i> .....	2249
1. Sophisticated or Naive?.....	2250
2. Charitable or Skeptical? .....	2251
II. WHEN LAW OBSCURES LAW .....	2253
A. <i>False Absolutes</i> .....	2253
1. Reverse of Chilling.....	2253
2. Crowding Out .....	2254
B. <i>False Sophistication</i> .....	2254
C. <i>False Harmonization</i> .....	2255
III. REVEALING PERMISSIONS.....	2257
A. <i>Loud Licenses</i> .....	2257
1. Beyond Monitoring .....	2257
2. The “Demodeling” Effect .....	2258
B. <i>Confessing Compliance</i> .....	2259
1. Ease and Timing of Disclosure.....	2259
2. Ex Post Cures .....	2259
C. <i>Exceptional Spaces</i> .....	2262
1. Borrowing boundaries .....	2262
2. Action Spaces .....	2263
3. The Localizing Effect .....	2265
4. Bright Lines Optional .....	2266
D. <i>Open Tolerance</i> .....	2267
E. <i>Whose Duty to Distinguish?</i> .....	2270
IV. WHEN DISCLOSURES BACKFIRE.....	2270

A. <i>Dynamics of Imitation</i> .....	2270
1. Confidently Wrong.....	2271
2. The Information Ratchet.....	2272
3. Regulatory Competence.....	2273
B. <i>Adverse Inferences</i> .....	2273
1. A Matter of Expectations .....	2274
2. Favoring Costlier Disclosure? .....	2275
3. Unraveling and Voluntary Disclosure.....	2276
C. <i>Ignorance Externalities</i> .....	2277
1. The Ignored Observer.....	2277
2. The Ignorant Observer .....	2278
V. UNSETTLING SOLUTIONS.....	2278
A. <i>Expressing Permissions</i> .....	2279
B. <i>Knowing Uncertainty</i> .....	2281
1. A Strategy for the Naive .....	2281
2. Creating Uncertainty .....	2281
3. Skeptical or Charitable? .....	2282
C. <i>Knowing Ignorance</i> .....	2284
1. “Plainly Incomplete” Disclosures.....	2285
2. A Strategy for the Sophisticates?.....	2286
CONCLUSION .....	2287

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## SHALLOW SIGNALS

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*Whether in dodging taxes, violating copyrights, misstating corporate earnings, or just jaywalking, we often follow the lead of others in our choices to obey or to flout the law. Seeing others act illegally, we gather that a rule is weakly enforced or that its penalty is not serious. But we may be imitating by mistake: what others are doing might not be illegal — for them.*

*Whenever the law quietly permits some actors to act in a way that is usually forbidden, copycat misconduct may be erroneously inspired by the false appearance that “others are doing it too.” The use of loopholes or exemptions can cause such illusions of misconduct. So can unseen licenses, cures, or private releases from liability. Selective enforcement, nonharmonization of laws, and legal transitions can also create similar misimpressions. The imitator sees others’ actions but not the crucial fact — of legal permission or tolerance — that distinguishes them. These behavior signals are “shallow,” missing a key dimension. The spread of misconduct can thus be accelerated by a peculiar, avoidable form of information failure.*

*For a regulator confronting this class of errors, it does little good to express the law in the conventional sense. What needs to be made more salient is not the law’s prohibition, but the fact of permission. This Essay offers an exploratory look at potential solutions, which vary by context and by whether actors are sophisticated or naive. Simple disclosures can sometimes do the job, but they can also be self-defeating due to what we might call an “ignorance externality.” Designing policies to work around such perverse effects may be possible, however, by drawing on heuristics introduced here.*

### INTRODUCTION

Imagine these two scenarios:

*A wedding video on YouTube has gone viral, with millions of views to date. It features the wedding party dancing down the aisle, to a hit song.<sup>1</sup> You see this video and think, “I love this*

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<sup>1</sup> Readers familiar with the story on which this hypothetical is based — the “JK Wedding Dance” video, TheKheinz, *JK Wedding Entrance Dance*, YOUTUBE, <http://www.youtube.com>

song — *I'm going to use it in my own video.*" You feel confident that there is no danger of copyright enforcement because you've just seen it used in a video seen by millions. What you don't realize, however, is that the copyright owner has granted the happy couple a license to use the song.<sup>2</sup>

*Deep inside Central Park, on a nice stretch of lawn, you and a friend find a good spot for a picnic. Nearby, other picnickers are enjoying beer and wine from the outdoor café on the same lawn. Police officers stroll by, unbothered by the drinking, despite the city's open-container law. Seeing all this, you open up your own bottle of wine. Two officers now turn and approach you — of all people, you are being cited. When you point indignantly to the other merrymakers, you are told they sit safely within the bounds of the café's private property.*<sup>3</sup>

These are illusions of misconduct. The irony is that all the original actors are acting lawfully. Those who are doing it *right* are inspiring the copycat wrongs. And precisely because their behavior is permitted, the original actors have no reason to hide it: actual misconduct may need to be concealed, but the legal variant need not. In theory, then, it could in some settings be the *lawful* actors who are doing more of the modeling for illegal copycat behavior than *unlawful* actors.

Compliance can thus metastasize into violation. This Essay explores how the law itself may enable such a mistranslation. It will suggest how both the law's structure and enforcement can prompt mistaken imitation, accelerating the spread of misconduct. This effect, when avoidable, is an unforced error of the law's design.

At root is our impulse to emulate. We imitate both good behaviors and bad. Companies may mirror their peers in choices ranging from market entry<sup>4</sup> to earnings manipulation,<sup>5</sup> from executive compen-

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[/watch?v=4-94JhLEiNo](#) (uploaded July 19, 2009) — may already be anticipating details I will raise later in the Essay. The fuller story is recounted in section III.D.

<sup>2</sup> And how could you have known? Where on the page is the tag saying "properly licensed"? (On YouTube there is a tag for licensor, but not licensee, details.) The further possibility of blanket licenses held by YouTube itself is discussed in Part I.

<sup>3</sup> As hypotheticals and thought experiments tend to be, the many illustrative scenarios in this Essay will be stylized, simplified, and abstract — even though some may be inspired by actual events. (My open-container citation was later dismissed, the reader should know.)

<sup>4</sup> See, e.g., Witold J. Henisz & Andrew Delios, *Uncertainty, Imitation, and Plant Location: Japanese Multinational Corporations, 1990–1996*, 46 ADMIN. SCI. Q. 443, 460–61 (2001); Robert E. Kennedy, *Strategy Fads and Competitive Convergence: An Empirical Test for Herd Behavior in Prime-Time Television Programming*, 50 J. INDUS. ECON. 57, 59–60 (2002); Otto Toivanen & Michael Waterson, *Market Structure and Entry: Where's the Beef?*, 36 RAND J. ECON. 680, 682 (2005).

sation<sup>6</sup> to tax avoidance.<sup>7</sup> Expert intermediaries, including those whose very purpose is to be independent minded and well informed, have been known to follow the crowd.<sup>8</sup> Democracies seem to mimic the social policies of countries that are more salient in the news.<sup>9</sup>

Imitation also pervades daily life, of course, not least in its regulated spheres.<sup>10</sup> We may be influenced by peer behaviors in dodging licensing fees,<sup>11</sup> or in defaulting on mortgages.<sup>12</sup> We may be quicker to jaywalk or to cheat<sup>13</sup> — or to violate a copyright, or to drink in the park — when we see others doing it.<sup>14</sup> Whether for individuals, corporations, intermediaries, or other actors, the signal of noncompliant behavior by peers is often taken as a cheap source of information (to put it charitably, a sort of vetting) about the degree of a law's enforcement.

<sup>5</sup> See, e.g., Peng-Chia Chiu et al., *Board Interlocks and Earnings Management Contagions*, ACCT. REV. (forthcoming) (manuscript at 1–9), available at <http://ssrn.com/abstract=1723714>; Michael K. Fung & Arnold C.S. Cheng, *Diffusion of Off-Balance-Sheet Financial Innovations: Information Complementarity and Market Competition*, 12 PAC.-BASIN FIN. J. 525, 526 (2004); Simi Kedia et al., Evidence on Contagion in Corporate Misconduct (Mar. 2010) (unpublished manuscript at 1–4), available at <http://ssrn.com/abstract=1571538>; cf. David A. Reppenhagen, *Contagion of Accounting Methods: Evidence from Stock Option Expensing*, 15 REV. ACCT. STUD. 629, 631–33 (2010) (examining how a firm's accounting methods can be influenced by the choices of other firms).

<sup>6</sup> See Michael Faulkender & Jun Yang, *Inside the Black Box: The Role and Composition of Compensation Peer Groups*, 96 J. FIN. ECON. 257, 257–59 (2010).

<sup>7</sup> See Jennifer L. Brown & Katharine D. Drake, *Network Ties Among Low-Tax Firms* (July 30, 2012) (unpublished manuscript at 1–4), available at <http://ssrn.com/abstract=1761477>.

<sup>8</sup> See, e.g., Judith Chevalier & Glenn Ellison, *Career Concerns of Mutual Fund Managers*, 114 Q.J. ECON. 389, 390–92 (1999); Harrison Hong et al., *Security Analysts' Career Concerns and Herding of Earnings Forecasts*, 31 RAND J. ECON. 121, 121–24 (2000); see also Max H. Bazerman et al., *Why Good Accountants Do Bad Audits*, HARV. BUS. REV., Nov. 2002, at 97.

<sup>9</sup> See Katerina Linos, *Diffusion Through Democracy*, 55 AM. J. POL. SCI. 678, 678 (2011). For another well-recognized example of diffusion, see Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 216–20 (2006) (exploring policy diffusion across states, including imitation of Delaware law).

<sup>10</sup> See, e.g., C. Scott Hemphill & Jeannie Suk, *The Law, Culture, and Economics of Fashion*, 61 STAN. L. REV. 1147 (2009) (discussing the interplay of imitative behavior and intellectual property law in the market for fashion).

<sup>11</sup> See Francesco Drago et al., *Compliance Behavior in Networks: Evidence from a Field Experiment* (Dec. 3, 2011) (unpublished manuscript) (on file with the Harvard Law School Library) (discussing licensee fees for television).

<sup>12</sup> See Michael J. Seiler et al., *Mimetic Herding Behavior and the Decision to Strategically Default*, J. REAL EST. FIN. & ECON. (forthcoming), available at <http://link.springer.com/article/10.1007/s11146-012-9386-8/fulltext.html>.

<sup>13</sup> See, e.g., Blake E. Ashforth & Vikas Anand, *The Normalization of Corruption in Organizations*, 25 RES. ORG. BEHAV. 1, 2–3 (2003); Scott E. Carrell et al., *Peer Effects in Academic Cheating*, 43 J. HUM. RESOURCES 173, 173–75 (2008).

<sup>14</sup> A colleague of mine, always a good citizen, reports that he takes extra care not to jaywalk — when there are children nearby. See also Brian Mullen et al., *Jaywalking as a Function of Model Behavior*, 16 PERSONALITY & SOC. PSYCHOL. BULL. 320 (1990).

But sometimes we get it wrong. We may think others are flouting the law when in fact they are complying — using a license or an exemption. Or they may be enjoying a sort of de facto permission, due to a contractual liability release, selective nonenforcement or acquiescence by the regulator, or other forms of hidden immunity.<sup>15</sup>

The signals of others' actions may thus be shallow — a critical dimension is hidden from our view. We see the behavior itself, but we miss the metadata. And what we fail to notice is *the* crucial fact distinguishing them from us, a special status they have but we do not. Unaware of the distinction, we follow their lead half blind.

This Essay introduces the “shallow signals” problem through a class of cases in which the law’s design may contribute to the misperception, and in which the misguided imitation results in illegal conduct. Taking the perspective of the regulator, I will explore a host of variations on this basic theme: *When the law quietly permits Actor 1 to act in a way that is usually forbidden, Actor 2 may be misled into taking the liberties with the law that he (mistakenly) perceives Actor 1 as taking.* Actor 1 thus becomes a false model of misconduct — not an actual bad example, but a “*bad bad example.*” And the consequences can be costly to regulators (who must spend more resources on enforcement), to potential imitators (including the costs of avoiding such errors), and to society (due to the induced misconduct).<sup>16</sup>

The law’s hidden permissions are pervasive, taking many forms, as Part I details: Loopholes and exemptions may turn on unseen facts; or they may even be hard to imagine (think of technicalities), especially if the general prohibition mirrors moral intuition. Excuses or defenses may likewise be difficult for an observer to anticipate. Selective nonenforcement may also be hard to decipher if not revealed.<sup>17</sup>

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<sup>15</sup> I adopt the term “permission” as shorthand to capture a broad range of concepts (including loopholes and even grudging toleration) while recognizing that in everyday usage, the word “permission” has a normative valence that I do not mean to imply.

<sup>16</sup> Some readers may feel sympathy (as I do) for Actor 2, in some scenarios. But for this Essay’s purposes, I take the perspective of the regulator, whose aim is assumed to be reducing the level of misconduct given enforcement-resource constraints. (Questions such as “should Actor 2 be excused for such a mistake?” are reserved for future analysis.)

<sup>17</sup> The case of former Beatle John Lennon’s efforts in the 1970s to force the federal government to reveal its “nonpriority” criteria in immigration deportation may be a familiar example of such an undisclosed selective nonenforcement policy. See Leon Wildes, *The Nonpriority Program of the Immigration and Naturalization Service Goes Public: The Litigative Use of the Freedom of Information Act*, 14 SAN DIEGO L. REV. 42, 42–43 (1976) (authored by Lennon’s lawyer, describing the nonpriority program as “shrouded in secrecy” and as a “classic example of secret law”). The difficulty of deciphering is also suggested by research seeking to uncover empirically the hidden criteria for enforcement decisions. See, e.g., Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67 BUS. LAW. 679, 682, 685 (2012) (calling for more transparency and disclosure from the SEC to aid in empirical analysis of its enforcement behavior); Mark Wu, *Antidumping in Asia’s Emerging Giants*, 53 HARV. INT’L. L.J. 1,

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More simply, when formal permits or licenses are not publicized, observers may mistake authorization for violation. And impunities arising from private ordering (think of liability releases) may remain obscure or undiscoverable even to highly sophisticated observers.

Notably, these information gaps are not filled by “expressing the law” in the usual sense, with loud warnings about what is forbidden. Actor 2 may very well know that his own action would be illegal; what he seeks to assess are his chances of getting away with it.<sup>18</sup> The problem arises from Actor 2’s failure to distinguish (he fails to understand Actor 1 to be a poor benchmark), and *not* from ignorance of the law.<sup>19</sup>

Yet the legal sophistication of the actor does matter.<sup>20</sup> This Essay’s illustrative scenarios — ranging from copyright to corruption, and from corporate compliance to public order — will suggest that the error can arise in two distinct ways: First, a more naive type of Actor 2 may not even contemplate the possibility of permission. Actor 1’s permission status is then an “unknown unknown” to Actor 2. Second, a more sophisticated type of Actor 2 may know the law, including where the permissions hide. Yet even this legal sophisticate may face a shallow signal — and may misinterpret Actor 1’s behavior — if he cannot access the *facts* determining whether Actor 1’s action is actually permitted. For instance: the key fact may be confidential (think of a deal with the tax authorities), closely held or nontransparent (think of contract terms, including liability waivers or other such releases), or otherwise extremely costly to research. Actor 1’s status is then a “known unknown” to Actor 2.<sup>21</sup>

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28–56 (2012) (empirically seeking to uncover factors correlated with China’s and India’s selective enforcement of antidumping laws).

<sup>18</sup> One might imagine actors so unwavering in compliance (in a given context) as to refrain from acting as soon as they are told it is illegal. But they are not the population of concern here. (No law enforcement would be needed for such nonpredictive, counter-Holmesian “good men” — mere education would do.) For clarity of exposition, the analysis and illustrations in this Essay generally take as a premise that Actor 2 already knows that his own contemplated behavior would be illegal; thus little or nothing is gained by reminding him about it.

<sup>19</sup> At least, not “ignorance of the law” in the usual sense of not knowing what is prohibited. Ignorance of what is *permitted*, by contrast, is one principal cause of the shallow signals problem.

<sup>20</sup> Moreover, observers will also differ in whether they tend to assume the best (that is, that Actor 1’s behavior was somehow legal; call it “being charitable”) or to assume the worst (that is, that Actor 1 violated the law; call it “being skeptical”). The default inferences that observers draw will vary by context and may very well be endogenous to legal design. This further axis will be emphasized in Parts I and VI; more generally, how observers draw inferences will be the focus of Part IV.

<sup>21</sup> By its very terms, the “known unknown” problem requires guesswork (including costly investigation) by the sophisticated Actor 2 about the illegality of Actor 1’s behavior; the resulting guess may err in either direction. This Essay will focus on errors that generate imitative misconduct. But of course it is possible that “overcompliance” may result from errors going the other

In either case, what the observer needs to know is not the law's prohibition, but rather the fact of another actor's permitted status. As Part II explains, "knowing the law" might even worsen the problem under some conditions, such as when legal regimes are not harmonized, when enforcers' powers vary, when legal transitions entail forbearance, or more generally, when law-in-action diverges from law-on-the-books.

Shallow signals are *accidental* data — and as we turn to potential solutions, this core feature of the problem becomes important to recognize. Actor 1 may not care whether Actor 2 sees the behavior; the behavior signal is an "information externality."<sup>22</sup> A parallel problem introduced in this Essay is that Actor 1 also may have no natural reason to advertise the missing distinguishing fact (for Actor 2's benefit).<sup>23</sup> One might call this extra problem an "ignorance externality."

Due to these dual externalities, certain legal solutions are inapt. Actor 1's behavior may be misleading, but not on purpose.<sup>24</sup> There may be no fraud, nor entrapment, nor other willful nondisclosure (think of conflicts of interest). It would be unusual, moreover, to assign blame to Actor 1 for unintended copycat harms — much less when the imitation is a mistake.

There *is* one body of law offering a general solution, however: the Talmudic doctrine of *marit ayin* deals with precisely this problem by taking back the granted permission. The doctrine instructs that one may not perform certain actions that appear to be forbidden, even if one is in fact doing them in a permissible way.<sup>25</sup>

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way. Whether that is a further problem — or instead, an offset — is a normative call that varies by context (and may vary in the eye of the beholder).

<sup>22</sup> See, e.g., Andrew Caplin & John Leahy, *Miracle on Sixth Avenue: Information Externalities and Search*, 108 ECON. J. 60, 60–61 (1998).

<sup>23</sup> Advertisement for the regulator's benefit is another story. Actor 1 may very well care what the regulator perceives, while not caring what Actor 2 perceives. The shallow signals problem adds a third party — Actor 2 — into what has usually been analyzed as solely an interaction between Actor 1 and the regulator. For more, see *infra* section IV.C, pp. 2277–78.

<sup>24</sup> One contribution of this Essay is to identify and to focus on this context of externalities, in which Actor 1 does not much care what Actor 2 perceives. By contrast, ample scholarly attention has gone to those settings where Actor 1 is conscious of her signal to Actor 2, potentially entailing strategic interaction between the two actors (think of close competitors in a given market, or "social" signaling about status). A sampling of notable recent contributions includes: Jacob E. Gersen & Adrian Vermeule, Essay, *Delegating to Enemies*, 112 COLUM. L. REV. 2193 (2012); Jeremy N. Sheff, *Veblen Brands*, 96 MINN. L. REV. 769 (2012); Michal Barzuza, *Lemon Signaling in Cross-Listing* (Va. Law & Econ. Research Paper No. 2012-13, 2012), available at <http://ssrn.com/abstract=1022282>; Claudia Goldin, A Pollution Theory of Discrimination: Male and Female Differences in Occupations and Earnings (Dec. 2, 2012) (unpublished manuscript), available at <http://conference.nber.org/confer/2012/HCHf12/Goldin.pdf>.

<sup>25</sup> As the use of *marit ayin* illustrations in this Essay will suggest, there is much to be learned from the doctrine, not least its sensitivity to context and to what inferences observers



This type of broad structural solution, a total ban, may have a natural appeal in some settings — but not in others. To its credit, it has the flavor of closing loopholes. (“How can they allow any drinking *anywhere* in the park, if they don’t want people to get the wrong idea? The Talmud wouldn’t let this happen!”) Yet in many settings, banning the otherwise permitted act surely would be too extreme. For instance, does it make sense to ban the licensed use of copyrighted works whenever licensee status is hard to convey?

What other classes of solutions might be possible, then? The second half of this Essay turns to this question, adopting the lens of the regulator or legal architect. Seeing the problem as one of information failure, this Essay emphasizes information-improving solutions<sup>26</sup> — including ways for ex ante law design to harness existing perceptions.

One basic, broad class of solutions is to make known the earlier actor’s permission, so that the false behavioral precedent can be distinguished away. Part III explores variations on the most direct strategy: disclosures. Some are easy to imagine. Licenses and permits can often be displayed, and some excuses can be declared ex ante (think of a car’s hazard lights). The regulator can also assist by marking the boundaries of permitted spaces (think of the café’s private property) or by publicly preclearing certain actions (think of the SEC’s “no-action letters” or the more controversial proposal for “angel lists” from the IRS). Private enforcers can do this too, in some settings.<sup>27</sup>

Other variations may seem more unorthodox. For instance, as a matter of regulatory design it may be useful at times to “borrow boundaries” — that is, to purposely distort the regulatory line dividing what’s permitted and what’s prohibited, by pegging it to markers more familiar or salient to observers. Such a second-best regulatory line would avoid the risk of shallow signals created by an otherwise first-best line that is pegged to less-observable facts.<sup>28</sup> Another possibility,

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will likely draw. See especially *infra* sections II.B., pp. 2254–55, II.C., pp. 2255–57, and III.B, pp. 2259–62.

<sup>26</sup> One core difference between *marit ayin* (where a total ban is the favored solution) and the other settings emphasized in this Essay (where I focus instead on informational solutions) is that the former may have more of a zero-tolerance motivation. By contrast, some degree of noncompliance may be thought acceptable in other settings. But of course such acceptance does not mean abandoning the aim of improving the extent — or lowering the costs — of compliance. After all, the optimal extent is endogenous to the technologies at hand (including the informational ones) for encouraging compliance.

<sup>27</sup> For instance, publicity of a “no-action policy” by copyright holders has been proposed. See Tim Wu, *Tolerated Use*, 31 COLUM. J.L. & ARTS 617, 633–34 (2008).

<sup>28</sup> For instance, in the Central Park story, where there is no line on the lawn separating private from public property, a better rule (for shallow signals purposes) may be to artificially limit drinking to territory that is more obviously part of the café. See *infra* section III.C, pp. 2262–67.

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in settings of selective enforcement, is to broadcast who is being *ignored* in enforcement; though an enforcer may have many reasons not to say who is getting a free pass, the imitation problem offers a new reason in favor of doing so: to help observers identify those actors who have de facto permission.

Disclosures may often do the job. In a shallow signals setting, however, they can also backfire. Part IV introduces two such limitations — two ways disclosures can have unintended effects. The first arises when imitation is repeated: disclosures that occur too far down the chain of imitation can cause the next observer to become confidently wrong about whether she should follow suit. This urgency means that structural fixes at time zero, such as the closing of loopholes, may sometimes be needed. Second, observers may draw adverse inferences from silence, mistakenly assuming that any actor who has not revealed a license (or other form of permission) must be acting without one.

Designing policies to avoid these self-defeating effects can be guided by heuristics attending to two core features of shallow signals: imitation and externality. These heuristics may run against intuition. The analysis will suggest, for instance, that sometimes the *costlier* disclosures may be the ones that should be promoted. It will also explain why mandating disclosures may be needed most when enforcers rely on them *least* in monitoring.

The potential for a more radical approach is preliminarily explored in Part V, as a further response to the limitations of disclosure solutions. There I introduce a distinct class of solutions aimed at “prompting” observers to take account of the *possibility* of permission, yet without disclosure of the status of individual actors. In essence, the strategy aims to unsettle the observers’ perceptions — to give them pause — by creating uncertainty.

In sketching out the uses of such a “prompting” strategy, the analysis highlights the crucial role of the type of observer: sophisticated or naive, charitable or skeptical. Prompting is more useful for informing naive observers, as its effect is to convert unknown unknowns into known unknowns (that is, to make sophisticates out of the naive).<sup>29</sup> Yet the underlying principle of unsettling perceptions will also suggest a further solution — a hybrid approach of “plainly incomplete disclosures” — that may be useful for informing even the sophisticates.

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<sup>29</sup> Prompting is also more useful in settings where observers will tend to be charitable (that is, more likely to infer a hidden permission, rather than inferring illegality), when facing the known unknown. See *infra* Part V, pp. 2278–86.

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The desirability of any strategy will turn on costs and benefits beyond those isolated for analysis here, and this Essay will not attempt to tally all the tradeoffs for any given policy, much less to suggest any global solutions. Rather, its aims are more focused: First, to introduce a potentially pervasive but often overlooked mechanism for inducing misconduct; second, to identify its key structural characteristics; third, to consider how familiar types of legal tools might alleviate or magnify the burdens imposed on regulators, primary actors, and society; and finally, to offer thought experiments for imagining new approaches tailored to the unique features of shallow signals.

## I. LAW'S HIDDEN PERMISSIONS

The law, through its quiet approvals, can enable shallow signals. Whenever the law permits Actor 1 to act in a way that is generally prohibited, while leaving the observer Actor 2 ignorant of this distinction, a misleading impression of Actor 1's behavior may result. A mirage of misconduct is created, whose lead Actor 2 might follow into true misconduct. Moreover, because Actor 1's behavior is permitted, she may have no reason to hide it. This false model — a “bad bad example” — may thus be especially salient, while the crucial fact of permission remains obscure. This Part explores principal ways in which such information failures may be induced by the law's execution or its design.

### A. Quiet License

Including formal licenses and permits, the law issues pre-approvals — ex ante permissions — in many forms. Among them are direct reassurances from regulators, such as letter rulings or preclearances (think of “no-action” letters from the SEC).<sup>30</sup> Closely related are releases from liability issued by private parties (including private licenses, such as for the use of intellectual property). The key feature of these pre-approvals is that they work against a background of prohibition, allowing behaviors that would otherwise be forbidden. The shallow signals problem arises when the permission is hard for an outside observer to discern.

*Illustration — Ticket Scalping. Whenever I go to my favorite theater, I see people scalping tickets outside in full view of the police. I think: “The next time I need to offload some spare tickets, I’ll just do the same — obviously the ticket-scalping law is not being enforced.” But what I don’t realize is that*

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<sup>30</sup> True, the pre-approvals may range in certainty of legal effect, from more certain and license-like to more “advisory” and less of a guarantee.

*those hawkers out front (“Tickets? Tickets?”) are in fact authorized resellers. They are licensed by the state of New York.*<sup>31</sup>

1. *Paradox of Monitoring.* — In many settings, of course, pre-approvals are already advertised. Permits are displayed all around us (think of taxicabs, vendors, or construction sites). The usual rationale is to aid in monitoring. When monitoring does *not* turn on the display of a permit, however, then this usual rationale is weaker, and shallow signals may be more of a problem.

Consider again the ticket-scalping story. Why aren't the licensed resellers wearing badges or otherwise showing their permits? If there is any enforcement at all, displaying one's license would seem an obvious thing to do.

Or is it so obvious? Imagine if the resellers can readily produce their permits when asked. Or if the police on that beat already know who the resellers are. In ways unknown to the outside observer, the licensees may have little reason to put their permission on display. (Why bother to advertise a license if the licensor already knows of it, having granted it in the first place?)

Whatever the reasons may be for the opacity of permission, it imposes an “ignorance externality” on the observer. Nobody is trying to hide anything from Actor 2, necessarily. Rather, the problem is that Actor 1 simply does not care what Actor 2 perceives.<sup>32</sup> From the perspective of policy design, such a lack of intention on Actor 1's part means that the usual legal constraints against fraud and deliberate misleading are of little use. Yet the presence of the externality does suggest some potential role for policy intervention.

A paradox of sorts arises from the ignorance externality because the shallow signals concern is *not* with what an enforcer knows, but with what the potential follower, Actor 2, can discern. The enforcer may already know of Actor 1's permission (think of the copyright owner who granted the license). Or the enforcer may be able to find out easi-

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<sup>31</sup> I thank Taylor Kirklin for this example, which is based on his firsthand observation of ticket resellers at multiple sports facilities in the tri-state area. Any readers wishing to register as a broker in New York may wish to consult [http://www.dos.ny.gov/licensing/ticketresell/ticket\\_faq.html](http://www.dos.ny.gov/licensing/ticketresell/ticket_faq.html). For further discussion of ticket resales, see DANIEL DUFFY, CONN. OFFICE OF LEGISLATIVE RESEARCH, OLR RESEARCH REPORT: TICKET SCALPING (2006), available at <http://www.cga.ct.gov/2006/rpt/2006-r-0761.htm>.

<sup>32</sup> It should go without saying that Actor 1 may have other audiences in mind, such as regulators, customers, competitors, and so forth. (Some have suggested to me that licensed ticket-scalpers may be choosing not to display their permits because they *wish* to appear illegal, as some customers may think it means a better deal.) The externality point made here concerns the value of information to Actor 2: if this value is not taken into account by Actor 1, then supplying that information (in a way that reaches Actor 2) is unambiguously undervalued by Actor 1, all else equal.

ly. Either way, the enforcer's advantages do not help Actor 2. If anything, they may make the information gap worse for Actor 2, to the extent there is less need for Actor 1 to broadcast her permission. Just when the enforcer's information costs may be lowest, the potential imitator's information costs may be highest.

2. *Partial Information.* — More generally, in many contexts neither the regulator nor the actor will have any reason to disclose the pre-approval; in fact, they may well have reasons not to do so. Consider, for instance, that SEC “no-action” letters and IRS private letter rulings have not always been made public. Before 1970, neither agency regularly published such individualized rulings, which were deemed confidential.<sup>33</sup> (Even today, due to tax privacy concerns, the IRS publishes private letter rulings only as stylized fact situations stripped of identifying details.<sup>34</sup>) Consider how shallow signals might arise from such individualized regulatory rulings, should they remain undisclosed.

*Illustration — Tax. Firm 2 observes Firm 1 undertaking a transaction that should have unfavorable tax consequences, but one which Firm 1 assures investors is tax-free. Firm 2 assumes that Firm 1 is following an aggressive tax strategy, and is thus encouraged to adopt a similarly aggressive approach. What Firm 2 does not realize, however, is that Firm 1 has an undisclosed letter ruling from the tax authority declaring its transaction to be tax-free based on unusual facts specific to its case.*

Firm 2's error here is overestimating Firm 1's aggressiveness: Firm 1's strategy is actually not aggressive at all, for it faces no enforcement risk. It should be emphasized that Firm 2's problem is not ignorance of the law; Firm 2 knows its desired strategy is aggressive under prevailing legal standards. Rather, Firm 2's error is a factual one: either it does not contemplate the possibility of the undisclosed letter ruling, or it suspects the possibility but guesses incorrectly that Firm 1 does

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<sup>33</sup> Regarding the SEC, see Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019, 1021–22, 1021 n.11 (1987) (citing Adoption of Public Availability of Requests for No-Action, Securities Act Release No. 5098, [1970–1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,921 (Oct. 29, 1970)). Regarding the IRS, see Earl G. Thompson, *The Disclosure of Private Rulings*, 59 MARQ. L. REV. 529 (1976), which provides a contemporary account of the two key FOIA cases preceding adoption of the statutory provision for disclosure. See also *Grenier v. IRS*, 449 F. Supp. 834, 839 (D. Md. 1978) (“In the Tax Reform Act of 1976, the Congress evinced an intent to displace the FOIA as the means of access to unpublished IRS rulings.”).

<sup>34</sup> For the IRS's “written determinations,” see *IRS Written Determinations*, IRS, <http://apps.irs.gov/app/picklist/list/writtenDeterminations.html> (last visited May 10, 2013). For the SEC's no-action letters, see *Staff No Action, Interpretive and Exemptive Letters*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/interps/noaction.shtml> (last visited May 10, 2013).

not have one.<sup>35</sup> Whether regulatory agencies should publicize such pre-approvals is a policy choice that should be informed by the risk of shallow signals.

Similarly important, however, is the question of how much to say in any given disclosure. Partial revelation might worsen the risk of misunderstanding. It is possible, after all, for the regulatory disclosure itself to convey the “bad bad example” in the first place.

*Illustration — Tax. Imagine that Firm 1 requests a private letter ruling from a tax authority. Suppose that this tax authority’s policy, in striking a balance between disclosure and confidentiality, is to publish only minimal summaries of its private letter rulings (unlike the IRS, which discloses full rulings); each such summary gives a bare-bones account of each case and states whether it is deemed tax-exempt. Firm 2 encounters such a summary, listing as tax-exempt an aggressive strategy from which it too might benefit. Firm 2 is thus encouraged to follow this strategy. What Firm 2 does not know, however, is that the key facts qualifying Firm 1’s favorable tax treatment have been omitted from this published summary.*

This seems like an obvious fumble by the tax authority, given the potential shallow signals problem. Firm 2 might not even have known of another firm’s strategy, were it not for this disclosure. If a tax authority is going to disclose (and in effect, advertise) a tax-free ruling about an aggressive-seeming tax strategy, it should be sure to disclose the key facts distinguishing the case. A less cartoonish, more subtle, and perhaps more likely variant of this error arises where a regulatory authority simply makes public a redacted version of its actual letter to Firm 1. The danger there is that such a letter may incorporate by reference key assumptions or facts that are detailed in Firm 1’s request for a ruling; the result is that the disclosure available to Firm 2 is missing the information that would put Firm 2 on notice that its own case is distinguishable from that of Firm 1.<sup>36</sup>

<sup>35</sup> To speak in terms of naive and sophisticated observers: If Firm 2 is sophisticated, it knows it must guess whether Firm 1 in fact has such a ruling, and it may end up guessing wrong. The problem is worse, of course, if Firm 2 is naive and does not contemplate the possibility of such a hidden pre-approval. Naive observers can only underestimate permission (because they do not contemplate the possibility of permission, they cannot overestimate it). By contrast, sophisticates can err in either direction, inferring either false positives or false negatives. Whether these bi-directional errors can be said to “cancel out,” of course, is partly an empirical question and partly a normative one.

<sup>36</sup> Again, a more sophisticated Firm 2 may well recognize that some information is missing; even so, it may guess wrong about whether it is as likely as Firm 1 to receive favorable treatment.

3. *Private Permissions.* — Permissions created by private ordering (or “contracting around the law”), such as through liability releases, indemnifications, or other contractual devices, may especially suffer from a lack of transparency.

*Illustration — Copyright. You see one of today’s hit songs being played in dozens of homemade videos posted on YouTube. Feeling confident that there is little risk of copyright enforcement, you decide to use a different hit song in your own video. What you don’t realize, however, is that the first hit song happens to be covered by a blanket license arranged by YouTube itself with that specific record label.*

Unlike the law’s exceptions or regulatory policies, private permissions are usually not affected by the demands of publicity, notice, or fair warning. They thus make the shallow signals problem more difficult in several ways.

First, even sophisticated outsiders and their expert intermediaries may be unable to discover private permissions or to guess accurately about their details. Such contracts are rarely visible to third parties, and they might not follow intuitive patterns.<sup>37</sup> Even if Actor 2 might guess at the existence of some kind of liability release or license, confirming that Actor 1 has it — and in what form — may be impossible.

Second, sophistication about private permissions may itself be more rare; fewer observers will think of them. In contrast with the law’s formal permissions, private arrangements may be harder for observers to anticipate in the first place — especially given that they are seldom observed by outsiders. These manufactured arrangements may thus have a greater tendency to be unknown unknowns.

Third, some privately created impunities may not be the sort of thing one likes to advertise. Would Actor 1 be eager to publicize that she hedges against legal penalties? Consider the contrast with publicizing a formal exemption, defense, or excuse. Those permissions tend to be exculpatory facts or reasons that the action is acceptable

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As noted, the problem is worse for a more naive Firm 2 that does not contemplate that facts omitted from the published letter are the critical ones.

<sup>37</sup> Here it is useful to distinguish settings in which private permissions tend to be standardized, such as copyright licenses, from those in which they tend to be more idiosyncratic or tailored to each situation, such as partial indemnifications. The problem at hand is worse at the latter end of the spectrum.

(rather than why the law doesn't much matter, thanks to a contractual provision).<sup>38</sup>

### B. Quiet Compliance

More generally, the law may offer a way to “do it right” that might nonetheless appear as wrongdoing to an outside observer. In some settings, an extra step may be taken by Actor 1 to cure conduct that would otherwise be prohibited. Qualifying for a safe harbor, such as by putting internal safeguards in place, is a common example. In a sense, so is acquiring a license or permit. (Naturally, these categories overlap.) The shallow signals problem then arises when this curing step is not noticed by Actor 2.

Illustration — Corporate Misconduct.<sup>39</sup> *In Silicon Valley, technology firms compete fiercely for talent. Startup 2 hears from its recruits that they want it to follow the practice of Startup 1 in “backdating” the stock option grants in their compensation packages.*<sup>40</sup> *This practice is seen as more fair because stock prices are*

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<sup>38</sup> Although an analysis of possible policy solutions is reserved for later in the Essay, it is worth noting here that for private permissions, the range of potential interventions may be narrower in critical ways. The source of the problem here is not the law itself, but rather private dealings. Thus, there is no internal legal design fix: it is not simply a matter of “smoothing out” the law’s surface, removing tripwires and traps. Nor is it as easy to build in greater visibility (“you must agree to display the license”). In some cases, the private origin may also make a disclosure intervention harder to justify. The most direct (and most blunt) intervention might be an “inalienability” or “unenforceability” rule that bars such private ordering. This possibility is intriguing but will need to be bracketed for separate analysis. As noted above, this Essay focuses on information-based solutions, rather than “total ban” approaches.

<sup>39</sup> Though based on the widespread backdating scandal of the 2000s, this hypothetical is crafted only to illustrate the quiet compliance point; it does not claim to reveal how the practice spread or how many firms did it legally or illegally. Many academics and journalists, along with law enforcement officials and industry observers, continue to seek those answers. See, e.g., Lucian A. Bebchuk et al., *Lucky CEOs and Lucky Directors*, 65 J. FIN. 2363 (2010); John Bizjak et al., *Options Backdating and Board Interlocks*, 22 REV. FIN. STUD. 4821 (2009). The *Wall Street Journal* won a Pulitzer Prize for breaking the story. See Charles Forelle & James Bandler, *The Perfect Payday*, WALL ST. J., Mar. 18, 2006, at A1. The practice of backdating involved choosing and applying formal “grant” dates of stock options that were different from the dates on which the options were in fact granted, thus enabling the choice of a formal date with a more favorable exercise price.

<sup>40</sup> This “contagion” aspect of the hypothetical does have a basis in the actual scandal. The practice is widely understood to have spread across the industry, driven in part by competition for employees. See, e.g., Kevin Allison, *Unhappy Valley: Why a High-Tech Hub is Accused of Taking the Easy Option*, FIN. TIMES, July 28, 2006, at 11 (“By the time the ‘new economy’ kicked into full gear, stock options had become an expected part of the hiring game, with prospective employees ever more sensitive to their options’ exercise prices.”); Michael Liedtke, *Chummy CEOs Now Part of Silicon Valley’s Backdating Club*, ASSOCIATED PRESS, Nov. 9, 2006, available at Factiva, Doc. No. APRS0000200611110e2ba00045; Carolyn Said, *Options Scandal Grew Out of 1990s Strategy; Many Silicon Valley Businesses Offered the Incentives to Attract and Retain Their Top Employees in a Competitive Market*, S.F. CHRON., July 30, 2006, at F1.



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*so volatile day-to-day. But there is also an illicit benefit: backdating allows the firm to under-report its compensation costs, which looks better to investors.<sup>41</sup> Startup 2, under competitive pressure, adopts the practice and takes the liberties with accounting that it thinks Startup 1 must have taken. What it does not realize, however, is that Startup 1 had taken the extra step of accounting for the missing compensation costs; Startup 1's backdating was thus both "innocent" in intention and legal in form.<sup>42</sup>*

Notably, expert intermediaries such as lawyers and accountants may be of little help to Startup 2 in avoiding such a shallow signal, because the crucial missing facts are secreted away in the internal books of Startup 1. The expertise that is needed here is not about the law, as the scenario involves no ignorance or mistake of law, but rather about the status of other actors.<sup>43</sup>

In fact, intermediaries may well create or spread shallow signals if they are the very source of Firm 2's information about "what your competitor Firm 1 is doing" in the first place. This possibility is a concern especially if the intermediaries are also ignorant of Firm 1's confidential or obscured compliance measures, such as an undisclosed deal with the authorities or an internal accounting cure.<sup>44</sup> (Not to mention, intermediaries themselves may also imitate or mimic their competitors, without independent evaluation of the advice they are copying or the practices they are promoting.) It is possible to know just enough to be dangerous, and intermediaries can be a vector for the contagion of such partial knowledge.

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<sup>41</sup> A reader well versed in executive compensation law will notice that, among other things, this much-simplified scenario abstracts away from complex tax considerations surrounding backdating, as well as the crucial distinction between executives and nonexecutives. See, e.g., David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 609–10 (2007) (noting differences in disclosure requirements for options granted to executives versus rank-and-file employees); Robert W. Wood, *Tax Effects of the Stock Options Backdating Flap*, 115 TAX NOTES 137 (2007); *Developments in the Law — Corporations and Society*, 117 HARV. L. REV. 2169, 2205–26 (2004).

<sup>42</sup> How this punchline in the hypothetical corresponds to details of the actual scandal will be explained later in the Essay. See *infra* section III.B, pp. 2259–62.

<sup>43</sup> Lawyers and accountants can, of course, inform Startup 2 that its taking the action would be illegal (and Startup 2 is assumed to know this, in this illustration). What the expert intermediaries would need to do, in order to alleviate the shallow signals problem, is instead to inform Startup 2 that what it observes Startup 1 doing is *legal*. But if they cannot access the crucial facts, the best they may be able to do is to raise with Startup 2 the possibility that Startup 1 is acting legally; that is, they can act as prompts.

<sup>44</sup> In the actual scandal, the alleged role of Deloitte in spreading the backdating practice among its clients is even more perverse than suggested here. The story is retold in section III.B, pp. 2259–62.

### C. *Quiet Exceptions*

Exemptions, loopholes, excuses, and defenses abound. They are everyday objects of the law, common design elements in its architecture.<sup>45</sup> (Some forms of immunity, amnesty, or grandfathering may also fit in this category.) Such exceptions may be as pervasive as the prohibitions they relieve. Yet many of them turn on facts hidden in practical obscurity; whatever the salience of the exemption, it may be a key *fact* that is hard for an outsider to observe.

*Illustration — Bribery. Imagine a group of multinational firms, trying to break into an emerging market where bribery is rampant. Competitive pressure pushes the local outpost of each firm to assess how much bribery it can get away with, benchmarking against its peers. Manager 2 at the outpost of one firm learns that Manager 1, her counterpart at a competitor firm, makes frequent payments to executives of a local utility company. She infers that Manager 1 is willing to pay bribes and that enforcement appears to be lax. What Manager 2 does not realize, however, is that Manager 1's payments are in fact legal, because his bribe recipients fall within an exception to the scope of "foreign officials" under the governing antibribery law.*

For instance, think of an antibribery law that covers only payments to governmental officers or agents.<sup>46</sup> Suppose that the law includes employees of state-owned, state-run enterprises as being among the covered "foreign officials," but that it excludes such employees once the state has given up sufficient control over the enterprise, such as through privatization.<sup>47</sup> What Manager 2 may not know is that the utility company that Manager 1 is bribing has shed enough state con-

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<sup>45</sup> See generally Frederick Schauer, *Exceptions*, 58 U. CHI. L. REV. 871 (1991) (arguing that exceptions are integral to law conceptually as well as practically).

<sup>46</sup> One such example is the Foreign Corrupt Practices Act (FCPA), which covers bribes to any "foreign official," defined as any "officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public international organization." 15 U.S.C. § 78dd-1(f)(1)(A) (2006).

<sup>47</sup> Indeed, the privatization of state-owned or state-run enterprises in emerging markets has become an area of concern for FCPA compliance counsel. See Joel M. Cohen et al., *Under the FCPA, Who Is a Foreign Official Anyway?*, 63 BUS. LAW. 1243, 1267-68 (2008) (article by compliance lawyers, noting that "[b]ecause of the broad movement toward privatization in many developing countries, it remains unclear whether certain businesses are fully private or are still (at least to some extent) under the control of their respective governments").

trol that its officers no longer qualify as governmental officials.<sup>48</sup> (As it happens, a sore point of confusion for businesses and corporate counsel today is this very question of how to determine whether employees of a partially state-owned enterprise count as “foreign officials” under U.S. antibribery law.<sup>49</sup>)

Again, the observer’s problem is ignorance not of the law, but of facts.<sup>50</sup> A legally sophisticated Manager 2 may well be aware of the bribery law’s terms and know that the payments she herself is considering making (say, to executives of another utility company) would be illegal. But she is mistaken about her *competitor’s* payments, and thus fails to recognize that his behavior is a poor benchmark for her own.

Such a factual gap may arise due to practical obscurity of the key facts.<sup>51</sup> Or in some settings, it may be due to trade secrecy or confi-

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<sup>48</sup> As FCPA practitioners have noted, it can be quite difficult even for sophisticated parties to assess how much control a government retains over a once state-owned, state-run company during or after privatization. *See id.* at 1269 (“[The] analysis is more difficult . . . if the foreign government owns only a small percentage of a company but exercises substantial control over it. The ownership interest is often ascertainable but not the degree of control.”); *id.* at 1267 n.144 (“[D]uring the last decade, many of Russia’s major oil companies have been transformed from state-owned and operated entities to fully privatized entities and, recently, to entities owned by private investors but suspected to be under the control of the Russian government.”).

<sup>49</sup> One former U.S. Attorney General, Michael Mukasey, recently listed this question as a top priority for clear policy setting, stating: “It is often difficult for companies to determine when they are dealing with ‘foreign officials,’ particularly in markets in which many companies are at least partially state-owned.” *Foreign Corrupt Practices Act: Hearing Before the Subcomm. on Crime, Terrorism, and Homeland Sec. of the H. Comm. on the Judiciary*, 112th Cong. 27 (2011) (statement of Hon. Michael B. Mukasey, former Att’y Gen. of the United States), available at [http://judiciary.house.gov/hearings/printers/112th/112-47\\_66886.PDF](http://judiciary.house.gov/hearings/printers/112th/112-47_66886.PDF); *see also id.* at 23 (listing six priorities, including “[c]larifying the meaning of ‘foreign official’”). The most recent FCPA guidance from the Justice Department and the SEC does address the question in a section titled “Who Is a Foreign Official?” *See* U.S. DEP’T OF JUSTICE & U.S. SEC. & EXCH. COMM’N, A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT 19–23 (2012) [hereinafter RESOURCE GUIDE]. But critics are not satisfied, noting that the guidance “endorses an extremely fact-specific analysis that relies on a lengthy yet non-exclusive list of factors . . . [including] some that may be impractical or impossible for another company to discern or determine . . .” Letter from U.S. Chamber of Commerce et al., to Hon. Lanny A. Breuer and George S. Canellos 3 (Feb. 19, 2013), available at [http://www.instituteforlegalreform.com/sites/default/files/Coalition%20Letter%20to%20DOJ%20and%20SEC%20re%20Guidance\\_v2.pdf](http://www.instituteforlegalreform.com/sites/default/files/Coalition%20Letter%20to%20DOJ%20and%20SEC%20re%20Guidance_v2.pdf) [hereinafter Chamber of Commerce Letter]. This Essay discusses in Part IV, *infra*, how the form of this new guidance overlaps with and diverges from informational solutions more tailored to shallow signals.

<sup>50</sup> More precisely, there need not be any legal ignorance or “mistake of law” pertaining to her *own* behavior. Rather, her error is about what Manager 1 is doing; this question of interpretation is labeled here a factual one, but of course such determinations could often be called “mixed questions of law and fact.” (Both the sufficient-state-control scenario here as well as the electrical utility example in the following discussion could be seen as “mixed” questions.)

<sup>51</sup> Notably, simply knowing that a company is privatizing — or even knowing that it is no longer majority state-owned — may not be enough information. Consider how difficult it would have been for an imaginary Manager 2 to observe the crucial facts in the recent Alcatel-Lucent case concerning bribes paid to a Malaysian telecommunications company that was only 43% owned by the government — and yet was deemed to be an “instrumentality” because the govern-

dentiality of business dealings, or to unanticipated variations in how facts are characterized across contexts. (For instance, suppose that Manager 1 has been bribing an electric company — but electricity services are not considered a governmental function in *that* particular country.<sup>52</sup>) The resulting shallow signals impose costs not only on regulators and on society (due to the increased likelihood of bribery) but also on Manager 2, who must either bear the direct costs of further investigation or legal fees<sup>53</sup> (if she even recognizes that she is missing key information<sup>54</sup>) or else absorb the indirect costs of the risk of underestimating legal exposure.

For more naive observers, a further problem arises in that some exceptions are simply not intuitive or salient.<sup>55</sup> Untutored in technicalities, naive observers will be unlikely to anticipate such exceptions in the first place. (The very notion of a loophole evokes a quality of being artificial, unintended, and hard to envision based on first principles

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ment “held the status of a ‘special shareholder,’ had veto power over all major expenditures, and controlled important operational decisions.” RESOURCE GUIDE, *supra* note 49, at 21; *see also* Cohen et al., *supra* note 47, at 1269 n.156 (“As an even more extreme example of the difficulty companies face in determining the control structure of a foreign company, the *New York Times* recently reported that a pattern has developed in Russia whereby large companies have been created that are ‘controlled by executives loyal to the Kremlin.’ . . . Could the fact that a private company is owned by a person who is ‘loyal to the Kremlin’ make that company an ‘instrumentality’ of the Russian government? It would seem a tall order for the DOJ and SEC to expect companies doing business in a foreign country to ascertain where the loyalties of its counterparty’s executives lie.”).

<sup>52</sup> According to the agencies enforcing the FCPA, for instance, the bribed entity’s “provision of services to the jurisdiction’s residents” is among the factors considered in determining whether an entity performs a governmental function. *See* RESOURCE GUIDE, *supra* note 49, at 20. Some have proposed using the governmental-function criterion as a determinative factor. *See* Chamber of Commerce Letter, *supra* note 49, at 3 (“Whether an entity performs governmental functions is only one of the many factors on this list [in the guidance] and is evidently not considered dispositive by the Department or the SEC. We continue to believe that if the entity does not perform a governmental function, it should not be considered a government instrumentality.”).

<sup>53</sup> It may seem a tad generous to assume that Manager 2, at a regional outpost in an emerging market, may have lawyers readily at hand to help interpret what she sees a competitor doing — or to think that she would check in with corporate counsel back in New York about it. But the hypothetical makes this assumption in order to emphasize that it is not knowledge of the law but rather of key facts (which even sophisticated parties or their counsel may find costly or infeasible to gather) that is lacking.

<sup>54</sup> There are at least two forms of missing information that may be useful but costly for Manager 2 to acquire: First, she may wish to determine whether Manager 1 sets a relevant behavioral precedent (or is instead a bad bad example). Second, she may choose not to rely on that precedent; if so, she needs to investigate her own legal risk in other costly ways.

<sup>55</sup> One reason for a lack of salience may be a sort of “acoustic separation” between the audiences toward whom expressions of the prohibition and of the permission are directed. *See generally* Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 HARV. L. REV. 625 (1984). But note that such acoustic separation (which may leave Actor 2 aware of the prohibition yet naively unaware of the possibility of permission) does not always create a shallow signals problem. The necessary condition, of course, is that the hidden permission applies to Actor 1 but not to Actor 2.

or on the law's design.) And all the more so if the background prohibition resonates with moral intuition (think *malum in se*), is complemented by social sanctions, or is otherwise deeply ingrained. Consider this example drawn from *marit ayin*, pitting a technicality against a highly salient rule:

Illustration — *Marit Ayin*. “If a Jew hires a non-Jew to do a task for a set rate without any time constraint, and the non-Jew does the job on Shabbat, it is technically permitted. But this only applies where the public is not aware that the job is being done on Shabbat for a Jew. If instead the public knows that the work being done is for a Jew, however, then it is prohibited. People will see the non-Jew working and not know that he was formerly hired at a set rate, and they will say that the Jew hired the non-Jew to do work for him on Shabbat.”<sup>56</sup>

More generally, proverbial “islands” of permission within a “sea” of prohibition will often have this quality of unexpectedness (for naive observers) that can lead to misinterpretation. The difficulty may be yet more severe, as the next section notes, when such islands are created by the law-in-action rather than law-on-the-books.

#### D. Quiet Tolerance

A policy choice *not* to enforce a regulation against a given group creates a de facto exemption. Such selective enforcement (or, more to the point, selective *nonenforcement*) can also give rise to shallow signals. In such a case, Actor 1's behavior is not technically legal; it is merely of less interest to the enforcer. What distinguishes Actor 1 and Actor 2 here is not formal legality but different chances of detection or sanction (from their perspective) — or how much of a policy priority they each may be (from the regulator's perspective).<sup>57</sup> Yet such a distinction, if obscured, can create shallow signals just as a formal exemption or license can: Actor 1, in a passed-over group, becomes a “bad bad example” for Actor 2, who does not enjoy such a free pass. (To be clear: by “selective enforcement” I do *not* mean across-the-board low enforcement. If Actor 1 and Actor 2 are equally targeted, whether in a low- or high-enforcement setting, then there is no shallow signals problem.<sup>58</sup>)

<sup>56</sup> JOSEPH CARO, SHULCHAN ARUCH, ORACH CHAIM, 244:1 (as translated by Dina Wegh).

<sup>57</sup> For an empirical analysis of selective or differential enforcement, see Gadinis, *supra* note 17, at 685, 705–09, which finds, inter alia, that the SEC treats large and small broker-dealers differently.

<sup>58</sup> As is true throughout this analysis, a necessary condition for the existence of a shallow signal is that Actor 1 faces a different degree of law enforcement risk than does Actor 2. What's new

1. *Legal Transitions.* — One notable category of such non-enforcement occurs during legal transitions.<sup>59</sup> Dramatic revisions to the law may be met by friction-reducing policies of forbearance, sometimes publicized and sometimes not. Informal grandfathering and grace periods are among the possible variations. When these forms of de facto exemptions are used quietly, observers may mistakenly assume that enforcement of the new regime is weak or overestimate their peers' willingness to act unlawfully.<sup>60</sup>

2. *Private Enforcers.* — Quiet tolerance can be exercised not only by public enforcers, but also by private rightsholders who have a choice whether to vindicate their rights. Just as public enforcers can create de facto exemptions, so too can private enforcers create a kind of de facto license.<sup>61</sup> One notable difference (as with the “private permissions” discussed above<sup>62</sup>) is that the private enforcer's choices are less subject to transparency norms and may thus be far more costly (or may be infeasible) for the observer to discover on his own.

Illustration — Copyright. *Think again of the YouTube wedding video story. (This time, suppose that there is no license.) As before, you're tempted to use this same song in your own video. What you don't realize is that the copyright holder did notice the infringement — but has made a deliberate business decision not to sue the couple (nor to ask YouTube to remove the video). It is quietly allowing this video's use, enjoying the free publicity for the song among the millions of viewers.*<sup>63</sup>

Private enforcers may also vary in their policies or general enforcement tendencies; one copyright owner may be more tolerant of unauthorized uses — or even of outright piracy<sup>64</sup> — than another

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here is that we are now considering their distinction along the dimension of enforcement targeting, rather than of formal legality.

<sup>59</sup> The literature on legal transitions is vast; for a sample of foundational sources, see, for example, Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47 (1977); Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509 (1986); and Saul Levmore, *Changes, Anticipations, and Reparations*, 99 COLUM. L. REV. 1657 (1999).

<sup>60</sup> That is, if those peers know that they are enjoying a free pass during the legal transition.

<sup>61</sup> For fuller discussion, see generally Wu, *supra* note 27.

<sup>62</sup> See *supra* section I.A.1, pp. 2238–39.

<sup>63</sup> For the full story of the “JK Wedding Dance” video and Sony's strategy, see *infra* section III.D, pp. 2267–69.

<sup>64</sup> *Game of Thrones*, it seems, offers a spectacular case of tolerated high-volume piracy. After a season premiere of the hit television series set a record for piracy the day after it aired — with more than one million downloads within twenty-four hours — one industry observer noted that “HBO has been surprisingly polite if not kind about the illegal downloads” and reported that an HBO insider admitted that the piracy was “great” in that it “really helps the show's cultural buzz.” *Pirates Steal 'Game of Thrones': Why HBO Doesn't Mind*, NPR (April 7, 2013) (quoting

owner is. Or a single rightsholder may be more tolerant of piracy in some markets than in others, or of uses of some works more than of others. Shallow signals may occur when an observer fails to notice such a distinction.

3. *Secrecy and Discretion.* — It is useful here to distinguish two rationales for enabling tolerance through discretionary enforcement. First, discretion may be left to the enforcer when ex ante specification is too difficult. (As with the choice of standards over rules, or with incomplete contracting, such situation-specific enforcement criteria may not lend themselves to ex ante articulation.) Second, there may be a need for secrecy: discretion may be left to the enforcer because it is strategically valuable to keep quiet, and thus to keep targets guessing, about who is under scrutiny at any given time.<sup>65</sup>

The distinction matters because the shallow signals problem is more likely to arise when the nontargeted groups know who they are. In the first category, some of those who are of little interest to enforcers may already know it (suspecting they are getting a free pass), even if the criteria are not easily articulated. As with formally licensed or exempt actors, those actors who know (or suspect) that they have a free pass will naturally have less reason to hide their behaviors. Moreover, they may engage in the activity more. Their shallow signals may thus be both more plentiful and more visible to observers.

A similar problem arises when the violative behavior of Actor 1 is not merely tolerated but implicitly authorized by the enforcer — and the fact of authorization must remain undisclosed.

*Illustration — Leaks. A national security official observes a steady flow of leaks of classified information from inside his agency; it appears that the leakers rarely get caught. Dissatisfied with his agency's current policy on a crucial matter, he considers leaking memos to the press to reveal internal dissent. What he doesn't know, however, is that many of those other leaks were "plants" serving the purposes of the agency's top brass.*<sup>66</sup>

#### *E. The Observer in Context*

Sensitivity to context is crucial in assessing the risk of shallow signals, as context shapes the inferences observers are likely to draw. The problem is likely to be most acute in contexts where observers tend to

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guest Graeme McMillan), <http://www.npr.org/2013/04/07/176338400/pirates-steal-game-of-thrones-why-hbo-doesnt-mind>.

<sup>65</sup> For further exploration of these two types of rationales, see *infra* section III.D, pp. 2267–69.

<sup>66</sup> For a rich analysis of leaks and “plants,” see generally David E. Pozen, *The Leaky Leviathan: Why the Government Condemns and Condone Unlawful Disclosures of Information*, 127 HARV. L. REV. (forthcoming Dec. 2013).

be naive. Where observers are more sophisticated, shallow signals are still possible, and are likely to be more acute where observers tend to see others' actions in a skeptical light (that is, assuming the worst and thus inferring illegality rather than permission).

1. *Sophisticated or Naive?* — Law's quiet approvals have the nature of "unknown unknowns" when Actor 2 does not even contemplate the possibility of Actor 1's exemption, free pass, excuse, or other distinguishing status. This mistake is not a simple matter of guessing too low in assessing a probability. Rather, Actor 2 does not even know he should be guessing.

Whether the possibility of a form of permission or other crucial distinction comes readily to mind depends on the sophistication of the observer. An "unknown unknown" to a more naive observer may be a "*known* unknown" to a more sophisticated one. The sophisticates might not have any better access to the hidden fact itself — they may still have to guess at whether the actors they observe have a license or meet an exemption — but at least they know to make such a guess. This difference in starting points implies an asymmetry in what can yet be learned: policies directed at "unknown unknowns" will naturally have less effect for sophisticates than for the naive.<sup>67</sup>

A single actor can surely be sophisticated in one context and yet naive in another. He may even be sophisticated and naive about different permissions within one context. "Everybody knows a YouTube user might have gotten the copyright licenses needed to use that song," one might suppose. But does "everybody" also know that YouTube *itself* sometimes enters into agreements with music publishers and recording companies for blanket licenses for their content?<sup>68</sup>

For a given observer, salience may depend on past encounters with the hidden permission or the missing fact. Few people in California today, when seeing someone light up a joint, would not instantly think

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<sup>67</sup> Part V elaborates on this distinction between naive observers and sophisticates, focusing on potential interventions.

<sup>68</sup> See, e.g., Elizabeth Moody, *Creating New Opportunities for Publishers and Songwriters, BROADCASTING OURSELVES* ;) (Aug. 17, 2011), <http://youtube-global.blogspot.com/2011/08/creating-new-opportunities-for.html>; Greg Sandoval, *Musical Chairs: YouTube, Labels Close to Renewing Licenses*, CNET (Jan. 13, 2012, 8:45 AM), [http://news.cnet.com/8301-31001\\_3-57358695-261/musical-chairs-youtube-labels-close-to-renewing-licenses](http://news.cnet.com/8301-31001_3-57358695-261/musical-chairs-youtube-labels-close-to-renewing-licenses); Eliot Van Buskirk, *Music Publishers Resolve Massive Copyright Dispute with YouTube*, EVOLVER.FM (Aug. 17, 2011, 4:05 PM), <http://evolver.fm/2011/08/17/music-publishers-resolve-massive-copyright-dispute-with-youtube>. The shallow signals effect is analogous to that in the original scenario: fueling the perception that users commonly post copyrighted content without bothering to clear the needed licenses. (Unlike in the original scenario, of course, here the shallow signals problem arises only if the second user is inspired to post her own video using a different song not covered by the blanket license.)



of the state's special allowance for medicinal marijuana use.<sup>69</sup> Due to heavy news coverage, what might have been a loophole unimagined by some observers is instead a very salient exemption. But past exposure to the law's *prohibition* must not be conflated with experience with the law's *permission*. A greater familiarity with the prohibition may perversely dampen the imagining of exceptions to it, and may worsen the unknown unknowns.<sup>70</sup>

2. *Charitable or Skeptical?* — The second key dimension is whether an observer will tend to view an action skeptically (inferring illegality) or charitably (inferring permission). To illustrate how these tendencies may depend on context, consider these examples drawn from expositions of *marit ayin*:

Illustration — *Marit Ayin*. *Mixing meat with dairy is prohibited under the dietary rules of kashrut. Substituting almond milk would be one way to comply. Yet, because it may give the wrong appearance, cooking meat in almond milk is prohibited under the principle of marit ayin.*<sup>71</sup>

But what of the possibility that an observer might “assume the best” rather than “assume the worst” about the actor? What if a rabbi were the one serving the dish? (Let's overlook for now that it may then be all the more important for the appearances to be above reproach.) Or what if true dairy were known to be scarce or unattainable in a given location? A more finely tuned awareness of the observer's likely inferences is shown in another group of illustrations set in a milieu of bathhouses and mills:

Illustration — *Marit Ayin*. *If a Jew owns a bathhouse, he should not rent it to a non-Jew to operate on Shabbat, because it bears his name and the appearance will be that the Jewish owner is benefiting from work being done on Shabbat. By contrast, renting out a field is permitted. The reason is that a bathhouse is not usually a tenancy (in which the tenant works for his own gain while the owner is resting). By contrast, tenancy is typical*

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<sup>69</sup> The observer's next reaction, of “no way she's a medicinal user” or “she does rather seem like one,” demonstrates the estimation that is then required, but this uncertainty is still more informed than not recognizing the possibility at all.

<sup>70</sup> The role of prohibitions in obscuring permissions is the subject of the next Part.

<sup>71</sup> See CARO, *supra* note 56, YOREH DEAH 87:3. An alternative solution suggested by the doctrine is noted below.

for a field. (For an oven — the same rule as for the bathhouse. For a mill — the same rule as for the field.)<sup>72</sup>

To see how the sophisticated/naive and the skeptical/charitable dimensions relate, consider the following stylized chart. It presents (in parentheses) the observer's estimates of the frequency of permission.<sup>73</sup>

	Skeptical	Charitable
Sophisticated "Known unknowns"	Knows permission is possible, but thinks it unlikely  (Low estimate)  1	Knows permission is possible, and thinks it likely  (High estimate)  2
Naive "Unknown unknowns"	Does not imagine permission is possible  (Estimate is zero)  3	Does not imagine permission is possible  (Estimate is zero)  4

In some contexts, an observer will tend to be charitable, as long as she knows that permission is possible (box 2). In others, an observer will tend to be skeptical, even though she knows permission is possible (box 1). When the observer is naive, she effectively estimates zero permissions (as she does not think of the possibility).

In an important sense, each dimension may be endogenous to the law's design and enforcement, as they too form part of the observer's context. For instance, a perceived ease of gaining permission can make observers more charitable; Actor 2 may then be more likely to infer that Actor 1 must have some special dispensation. Likewise, a high frequency of observable permissions may make observers more familiar with them, and thus more sophisticated and less naive. The

<sup>72</sup> This illustration has been paraphrased from the *Schulchan Aruch*. See *id.* ORACH CHAIM 243:1.

<sup>73</sup> Each axis may be imagined as a continuum, though the sophisticated/naive axis may have a more naturally discrete quality.

opposite effect is also possible, however: shallow signals may be aggravated by an overfamiliarity with the law's *prohibitions*, as the next Part explains.

## II. WHEN LAW OBSCURES LAW

Why isn't the solution simply to declare the prohibition more loudly, far and wide? If one can be led astray by seeing those other merrymakers in Central Park, why not post signs saying "No Alcohol"? Or signs at the theaters saying "No Ticket Scalping"? Why not have the SEC send daily email reminders to all regulated companies, saying "No bribery today, okay?"

In a way, this impulse is backwards. In a shallow signals problem, the prohibition may already be salient; it is the exemptions or licenses that are not. The rule may be familiar, the exceptions less so. (And where the rule is hazy, its exceptions are likely to be hazier.) This salience gap is what induces Actor 2 to jump to the wrong conclusion that Actor 1 is doing the forbidden thing Actor 2 wishes to do, when it is in fact a permitted variant. The law's permissions, not its prohibitions, are what need to be made better known.

Still, even if it is useful to shout the law's permissions, how can it ever hurt to shout the law's prohibitions? Could it backfire, for someone to know a prohibition too well?

### A. *False Absolutes*

Shouting the prohibition seems an obvious thing to do: It may well inform some observers that an action is illegal. Some listeners may become numb to the message, but nobody will become less sure about illegality. Lack of certainty is not the worry, however. The problem is certainty about too much. The more that an action is declared to be forbidden, the less likely and less easily will the listener imagine that there are legal ways of doing it. The dissonance can make the listener less attuned to the possibility of permission.

1. *Reverse of Chilling.* — This is a conceptually distinct problem from a more familiar concern about overly salient prohibitions: the "chilling" of permitted conduct.<sup>74</sup> (One might worry, for instance, that the "No Alcohol" signs might discourage a visitor from drinking beer on the café premises, where it is allowed.) To be sure, the shallow signals and chilling problems can coexist, and may share a common origin. But two dimensions of distinction bear emphasizing.

First, in a sense, the shallow signals problem is the reverse of chilling: It is not that Actor 2 might be deterred from permitted behav-

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<sup>74</sup> For a lucid analysis of "chilling," see generally Frederick Schauer, *Fear, Risk and the First Amendment: Unraveling the "Chilling Effect,"* 58 B.U. L. REV. 685 (1978).

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iors which are peripheral to the prohibition. Instead, the concern is with the *outlawed* behavior — and moreover, that it might be *encouraged* by “bad bad examples.” The worry is that Actor 2 is warmed (not chilled) to the imagined course of action.

Second, the nature of the informational error is crucially different: shallow signals arise from a mistake in Actor 2’s interpretation of Actor 1’s behavior, and unlike chilling, *not* from confusion or uncertainty about whether Actor 2’s own behavior is covered by the law.

2. *Crowding Out.* — Here is how an overly salient prohibition might worsen shallow signals. Think of the picnicker in Central Park who sees signs everywhere saying “No Alcohol.” The reinforced message may cause her to be less likely to imagine that the other parkgoers nearby who are drinking beer and wine are actually on private property. (For contrast, consider signs saying, “Alcohol on Private Property Only.”) Or think of the ticket-scalping story: imagine signs around the theater saying “No Ticket Scalping.” The message may reinforce the inference that the hawkers out front are acting illegally. (For contrast, imagine signs saying “Licensed Resellers Only” — or imagine if even a few of the resellers were wearing badges displaying their licenses.)

The problem is not about inaccuracy, but about incompleteness. The “No Ticket Scalping” sign is correctly stated. The “No Alcohol” sign is also correct, if located on public property. In a narrow sense, these messages seem self-contained and complete. Yet each *feels* incomplete, in its broader context — and that is the point. These messages would be complete *if* self-contained, but they are neither, due to the proximity of a permitted variation.<sup>75</sup>

The loud messaging of prohibition can thus create a false sense of absolutes, crowding out the contemplation of exceptions. (This may be especially so if the exceptions are technical, arbitrary, unrelated to first principles, or otherwise hard to intuit.) To speak in terms of whether the observer is charitable or skeptical: the salience gap makes it harder to “assume the best” and easier to “assume the worst.”

### B. *False Sophistication*

What if the observer tries to “look up” the law in advance of acting? It may give better notice of the prohibition, but if the source of permission is not attached to the source of the prohibition (or is not as easily found), then it might also worsen the shallow signals problem.

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<sup>75</sup> What is compelling about the alternative versions (“Alcohol on Private Property Only” or “Licensed Resellers Only”), by contrast, is that while they express the prohibition, they also puncture the self-containment and deflate the false sense of absolutes. That is, they alert the observer to the possibility of permission. This key feature will serve as the foundation for a regulatory approach to be explored in Part V.

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The observer who seeks out the law-on-the-books, and yet finds no exemption, might thus become more confidently wrong.

This counterproductive result may be most severe in the case of de facto exemptions (such as tolerance, forbearance, or nonenforcement). A formal exemption can eventually be discovered by those who do enough research, assuming they thought of the possibility in the first place. But when enforcers decide in their discretion to let alone a certain group, such a de facto exemption often cannot be uncovered by the observer's own diligence *ex ante*. The more research that is done, perversely, the more certain the observer may be that *no* permissions exist. Law-on-the-books may thus obscure law-in-action.

A word of emphasis is useful here, concerning the observer's understanding of the law as it applies to himself. For exposition's sake, this Essay's analysis and illustrations generally assume that Actor 2 already knows that the behavior he is contemplating would be formally illegal. He is wondering not, "Is this action against the law?" — but rather, "Can I get away with it?" For many actors, to be sure, law-on-the-books will matter ("I care about acting legally even aside from the chances of being caught."). But even those who care about compliance *per se* will care about the chances of enforcement and of penalty.<sup>76</sup> Moreover, some observers may implicitly take the view that an unenforced law is not a real law: they ask, "I wonder if it's *okay* to drink here?" and not, "I wonder if it's lawful to drink here?," thus privileging law-in-action over law-on-the-books as their lodestar for law-abiding behavior. (As the police officers approach, this observer may then begin to ponder the metaphysics of whether a seemingly tolerated practice can be fairly described as unlawful.) Either way, the needed information is not the kind the observer can look up in formal legal materials, nor the kind usually advertised by the authorities; hence Actor 2's reliance on behavioral signals from his peers.

### C. *False Harmonization*

A further set of ways in which law can obscure law arises from variation among legal regimes, where one regime governs Actor 1 and another governs Actor 2. This class of situations is broad. Country to country, state to state, and city to city, laws vary in what they permit and prohibit. They also vary in how forcefully a prohibition is prosecuted; for instance, a civil infraction here may be a criminal act there. Moreover, regulatory enforcement may vary from region to region, or

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<sup>76</sup> That is, unless a more extreme view is held ("Even if it is unenforced, I will not violate this law now that I know about it.").

office to office, even within the same enforcement agency.<sup>77</sup> Concurrent enforcers — for instance, federal and state agencies with overlapping jurisdiction — may also differ in the rules they enforce and the targets they choose.

These sources of variation also intersect. Consider the “sanctuary cities,” such as Chicago and San Francisco, which have vowed not to enforce certain federal immigration laws (thus merging city-to-city variation with the federal-local enforcement divide). Or consider that the powers of different agencies may vary along the criminal-civil divide, even in enforcing the same underlying law.<sup>78</sup>

When legal regimes are not harmonized, two further variations of a shallow signals mistake become possible. Moreover, they may occur in tandem, compounding the problem. First, Actor 2 may fail to notice that Actor 1 is not governed by the same regime.<sup>79</sup> The missing fact is not what law covers Actor 2, but rather, what law does *not* cover Actor 1. Second, Actor 2 may not know what is permitted by the regime that does cover Actor 1. The missing information is not what is prohibited in Actor 2’s regime, but what is permitted by a *different* regime. (Think again of the scenario involving the bribery of utility companies, where providing electricity is considered a governmental function — and hence a utility’s employees are considered “foreign officials” — in one jurisdiction, but not in another.)

The irony is that drumming into Actor 2 the prohibitions of his own governing law could worsen things by doubly reinforcing the misinterpretation.<sup>80</sup> It may crowd out attentiveness to the possibility of an alternative legal regime *and* the possibility of permission. In this sense, the mechanism of false absolutes may operate along both dimensions.

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<sup>77</sup> And, certainly, it varies country to country. *See, e.g.*, Stavros Gadinis & Howell E. Jackson, *Markets as Regulators: A Survey*, 80 S. CAL. L. REV. 1239, 1242–44 (2007) (noting divergent regulatory regimes across international financial markets); *see also* Stavros Gadinis, *The Politics of Competition in International Financial Regulation*, 49 HARV. INT’L L.J. 447, 503–04 (2008) (arguing that U.S. dominance of financial markets causes nonharmonization of regulatory structures across countries); Roberta Romano, *Against Financial Regulation Harmonization: A Comment*, in *LAW AND ECONOMICS OF GLOBAL FINANCIAL INSTITUTIONS* 27, 40–44 (Peter Nobel et al. eds., 2010) (arguing against harmonization because it would amplify systemic risk across markets).

<sup>78</sup> For example, in enforcement under the FCPA, Firm 1 may be covered only by the Justice Department (if Firm 1 is a “domestic concern” but not an “issuer”) while Firm 2 may be covered by both the SEC and the Justice Department (if Firm 2 is an “issuer”). The Justice Department’s bribery enforcement actions are coordinated with criminal prosecution — so that it tends to screen for a higher standard of proof and intent — whereas the SEC’s enforcement power is purely civil.

<sup>79</sup> This mistake may sometimes be easy to make. *See, e.g.*, Gadinis & Jackson, *supra* note 77, at 1243 (“The NYSE-Euronext markets are directly regulated by the administrative agencies of six different jurisdictions . . .”); Romano, *supra* note 77, at 40 (“[S]imilar financial products could be subject to totally different regulations.”).

<sup>80</sup> For that matter, informing Actor 2 about the permissions in his own law may also be unhelpful, but at least such information would not crowd out the general idea of permission.

What Actor 2 needs to know is not the prohibition he faces, but rather the permission that the *other* actor enjoys under the *other* regime.

### III. REVEALING PERMISSIONS

If the whole problem is that a key fact about Actor 1 is hidden, then why not simply reveal it? The impulse to fix an information gap by filling it may seem a natural policy reflex.<sup>81</sup> In addressing a shallow signals problem, however, some of the usual heuristics are flipped. This Part first explores how individual disclosure and other “revealing” policies might work, both in familiar and in more unusual ways. The next Part then offers a deeper analysis of some of the less intuitive drawbacks of such policies (such as how disclosures may be self-defeating or may even backfire). For exposition’s sake, the following analyses will not rehash all the tradeoffs for any given policy; rather, the aim is to isolate and highlight those pros and cons specially arising from shallow signals effects.

#### A. Loud Licenses

The easy answer to a quiet license is to publicize it. Policies of this sort are familiar: Display your parking permit on the windshield. Wear your “Visitor” tag where it can be seen. Yet these policies are not universal, and in particular, are often not used where shallow signals may be a problem.

1. *Beyond Monitoring.* — Existing disclosure policies of this sort mainly serve a regulator’s monitoring purposes, of course. They have not been designed with shallow signals in mind, though they have side effects (an informational externality) on Actor 2’s understanding of Actor 1’s conduct or special status. These distinct purposes may overlap, but they are not identical. In settings where the needs of monitoring do little to motivate such a disclosure policy, the (further) concerns caused by shallow signals nonetheless may weigh in favor of such a policy where it would not otherwise exist. It may be where such a policy is least needed for enabling monitoring that it is most needed for avoiding shallow signals.<sup>82</sup>

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<sup>81</sup> See, e.g., Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 650 (2011) (“Mandated disclosure is ubiquitous.”).

<sup>82</sup> The logic of this “paradox of monitoring” is that where the regulatory monitor does not rely much on such disclosures, there may be especially little reason for Actor 1 to make disclosures voluntarily (thereby depriving Actor 2 of needed information, and thus increasing the need for a policy requiring disclosure — for Actor 2’s sake, not the regulator’s sake). See *supra* section I.A, pp. 2237–42 for the basic idea; *infra* section III.B, pp. 2259–62 explains a more complicated variation.

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Illustration — Copyright. *Why not create a space, on each YouTube video's page, for a tag certifying that all of the video's uses of copyrighted materials are properly licensed?*<sup>83</sup>

2. *The "Demodeling" Effect.* — There are also differences in the structure of the disclosures needed for these two separate purposes: For addressing the shallow signals problem (unlike for monitoring), the displayed marker need not carry detailed information, nor even directly convey specific permission.<sup>84</sup> Rather, a loud license can work solely through "demodeling" — by tipping off Actor 2 that Actor 1 is not a relevant model, in a generic way. The details of the permission need not be spelled out. The regulatory monitor may need to know those details, but Actor 2 only needs to know that Actor 1 is distinguishable.

Think of the familiar demodeling effect of seeing people in uniforms, for instance. Uniforms convey license, but not by enumerating specific permissions. When an art museum guard wearing a uniform touches a sculpture, we do not assume we can touch it too. Even if the sculpture is meant to be an interactive piece, we may hesitate until we see another visitor touch it.

The guard's specific permission is not articulated; we may not know if the guard is actually permitted to touch the art. Regardless, we are unlikely to follow her in doing so. The generic distinguishing effect suffices to stop imitation, even when it may be insufficient for monitoring purposes (the guard's supervisor might not be quite so impressed by the uniform, and may want to know whether the curator in fact asked the guard to move the artwork).<sup>85</sup>

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<sup>83</sup> Or why not a space for listing the individual copyright licenses that the poster (or YouTube itself) has acquired — just as movies often do in the closing credits? The current design of the YouTube page has a dedicated space for the poster to express the poster's intentions as a *licensor*. But it has no similar marker for information about the poster as a *licensee*, beyond the general description text area; nor does YouTube publicize its own licensee status. (Intriguingly, there has been some spread of a practice of posters' marking their videos with language to the effect of "this is not my creation" or "I don't claim ownership of the content.")

<sup>84</sup> Thus avoiding some familiar problems with mandatory disclosures, including oversaturation. See Ben-Shahar & Schneider, *supra* note 81, at 720–29 (describing cognitive responses to disclosures).

<sup>85</sup> Familiar examples of this disjunction abound: On an airplane, if the person I see walking in the aisle shortly after takeoff is wearing a United Airlines outfit, I would be less tempted to ignore the seatbelt light myself. (Does it matter if the flight attendant is actually allowed to stand up right then?) Or consider a t-shirt saying "STAFF"; it need not also say "can go on stage during concert." This mechanism lowers the information demands both for the observer (who need not process the expression of a precise permission) and possibly for the discloser (who need not anticipate which permission needs to be conveyed). See Samuel Issacharoff, *Disclosure, Agents, and Consumer Protection*, 167 J. INSTITUTIONAL & THEORETICAL ECON. 56, 59–61 (2011) (discussing behavioral insights into what makes disclosures effective).



### B. Confessing Compliance

The permission that one achieves by meeting an exemption or taking extra steps toward compliance — a cure that converts an illegal act into a legal variant — can also be conveyed to an observer in some settings.<sup>86</sup> For an intriguing example, consider again the *marit ayin* lesson about cooking meat with a dairy substitute (almond milk). Beyond banning this otherwise permitted practice, the doctrine does suggest one further solution:

Illustration — *Marit Ayin*. *Because it may give the wrong appearance, cooking meat with almond milk is prohibited — unless almonds are sprinkled around, to make clear it is not real milk.*<sup>87</sup>

Although they overlap, loud licenses and confessions of compliance differ in one respect: for the latter, it may be more necessary to convey precisely how the cure achieves compliance. The marker of the cure can still be subtle, though, even when it is specific (consider: an almond).

1. *Ease and Timing of Disclosure*. — One useful quality that pre-approvals, exemptions, and compliance cures share is that Actor 1's permitted status can readily be certified by the time the action is taken — and thus before it is observed. The permitted status is certain; it is not merely a guess at what an enforcer or a court might do. A pre-approval may even be accompanied by a license or permit, which can easily be advertised. (By contrast, consider excuses or defenses, some of which can be determined only during enforcement or adjudication.) But timing should not be confused with ease of disclosure. As will be explored in section IV.B, in some cases the *more* difficult disclosures will have a better policy effect. For the policymaker facing a shallow signals problem, early disclosure is almost always an advantage, but easy disclosure may not be.

2. *Ex Post Cures*. — Disclosing a compliance cure earlier, rather than later, may be critical. In this respect, there can be a notable difference between *ex ante* and *ex post* compliance cures.<sup>88</sup> Recall the hypothetical regarding backdated stock options. The scenario is based on an actual episode, one involving an *ex post* cure.

Illustration — Corporate Misconduct. *After the backdating scandal broke in 2006, sweeping up hundreds of companies that had adopted the practice, many insiders pointed to Microsoft as*

<sup>86</sup> Acquiring a license can be seen as a special case of a compliance cure.

<sup>87</sup> Paraphrased from CARO, *supra* note 56, YOREH DEAH 87:3.

<sup>88</sup> See *infra* section IV.A, pp. 2270–73.

*the original model for many firms' nearly identical practices.<sup>89</sup> Microsoft had not, in fact, done its accounting properly when it began backdating in 1992.<sup>90</sup> Yet it did so in 1999, accounting for the hidden compensation costs on its public books.<sup>91</sup> Microsoft's correction was barely noticed by the industry, however.<sup>92</sup> It is clear that other technology companies not only continued, but even started improper backdating after 1999<sup>93</sup> — that is, even after Microsoft had demonstrated how to “do it right.”*

Here, Actor 1's cure was overlooked even though it was publicly disclosed. How could it have been missed or ignored? Was it because the correction was buried deep inside a quarterly earnings disclosure, worded in sterile language? As an initial matter, this episode suggests the problem of Actor 1's weak incentives to advertise ex post cures for prior misconduct (a confession with the flavor of an admission of error) — in contrast to advertising ex ante compliance measures (with perhaps a more self-congratulatory flavor).<sup>94</sup>

Yet that cannot be the only reason. Even the most expert of experts failed to react: stunningly, it seems that Microsoft's own auditor, Deloitte, allegedly continued to advise at least one other client to use backdating — in the improper way, without adjusting for the underre-

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<sup>89</sup> Its practice seems to have been invoked by recruits and new hires at other firms, and many firms adopted the same “30-day look-back” version of backdating. See Allison, *supra* note 40 (“Defenders of stock options insist that backdating was a well-intentioned if careless practice . . . [to] ensur[e] that fast-growing but cash-strapped companies could hire and retain the best managers.”); Said, *supra* note 40 (“Several tech insiders said Microsoft's scheme [of granting options that were retroactively keyed to its stock's monthly lows] was common knowledge and may have inspired other companies to follow suit.”); *Dates From Hell*, *ECONOMIST*, July 22, 2006, at 67, 68 (“[T]ech firms . . . were engaged in a fierce war for talent . . . . Offering to price options at, say, the monthly share-price low was useful in recruitment negotiations.”).

<sup>90</sup> See Charles Forelle & James Bandler, *During 1990s, Microsoft Practiced Variation of Options Backdating*, *WALL ST. J.*, June 16, 2006, at A1 (“Microsoft awarded options at monthly lows each July from 1992 to 1999, with varying dates.”).

<sup>91</sup> Press Release, Microsoft, Microsoft Announces Record Fiscal Year Revenue and Income (July 19, 1999), available at [http://download.microsoft.com/download/8/f/f/8ff51efb-c2cd-484b-844e-0e943af91628/FY1999Q4\\_earnings.doc](http://download.microsoft.com/download/8/f/f/8ff51efb-c2cd-484b-844e-0e943af91628/FY1999Q4_earnings.doc) (“Historically, exercise prices of grants of employee stock options were struck at the lowest price in the 30 days following July 1 for annual grants and the 30 days after the start date for new employees. In connection with this practice, which is no longer employed, a charge of \$217 million was recorded in the fourth quarter for fiscal 1999 compensation expense.”).

<sup>92</sup> See Said, *supra* note 40 (quoting industry observers as saying that “[w]hen Microsoft said it had to restate its earnings for backdating, the reaction of the market was ho-hum” and that “Microsoft's motivation [for backdating] appeared innocent” (internal quotation marks omitted)).

<sup>93</sup> See *Options Scorecard*, *WALL ST. J.* (Sept. 4, 2007), <http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html>.

<sup>94</sup> One lesson might seem to be that this natural tendency of the curing party to downplay its own past wrongdoing needs to be counteracted by requiring the cure to be broadcast loudly. Yet one might also wonder if this would simply reduce the incentive to cure, or even to find out, past errors.

ported compensation — even *after* Microsoft had decided that the practice needed to be corrected.<sup>95</sup> (Notably, this troubling allegation undermines the assumption that corporate actors must be immune to imitative misconduct because they are advised by expert intermediaries. Recall that it could very well be the intermediary who promotes the imitation by spreading shallow signals — explaining to clients that it knows of competitors who do the same thing.<sup>96</sup>)

Could another reason be that, after seven years, enough other firms had already copied the practice<sup>97</sup> — including Apple<sup>98</sup> — that Microsoft's example mattered far less? One might also speculate that even the expert intermediaries (such as Deloitte) had been lulled by the extra “vetting” that seemed to be evident from how widespread the practice had become.

This episode thus points to potential lessons for policy design: What if Microsoft had been made to cure its backdating accounting sooner, before the next round of imitators began spreading the practice themselves? What if disclosure rules had required it to implement the cure with much more publicity? Or more importantly, what if the rules demanded publicity directed not only at investors but also at other tech firms? The dynamics of imitation that may have caused Microsoft's belated cure to go unnoticed are worth keeping in mind.

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<sup>95</sup> See *Deloitte & Touche Settles Suit Alleging that It Approved Options Backdating*, CNNMONEY (Mar. 8, 2007, 6:15 AM), <http://features.blogs.fortune.cnn.com/2007/03/08/deloitte-touche-settles-suit-alleging-that-it-approved-options-backdating/> (“Micrel kept using [the] 30-day pricing policy for two more years [after Microsoft had ceased to], until November 2001. By that time, however, according to Micrel's complaint, the lead Deloitte partner on the Micrel account had changed. . . . [His successor] then allegedly disavowed his predecessor's opinion, and advised Micrel to discontinue the policy and make a restatement . . . .”); see also David Reilly, *Micrel Says Deloitte Approved Options-Pricing Plan*, WALL ST. J., June 1, 2006, at C3 (“In a lawsuit filed in 2003, Micrel Inc. alleges Deloitte, its former auditor, signed off on an arrangement in which the company would set the strike price for employee stock options at the stock's lowest price during the 30 days after the grant of options was approved.”). Deloitte settled without admitting responsibility. *Deloitte & Touche Settles Suit Alleging that It Approved Options Backdating*, *supra*.

<sup>96</sup> Kevin LaCroix, *Options Backdating: Sue the Gatekeeper?*, THE D&O DIARY (Mar. 14, 2007, 11:56 PM), <http://www.dandodiary.com/2007/03/articles/options-backdating/options-backdating-sue-the-gatekeeper/> (“According to the allegations in the . . . lawsuit, Deloitte proposed that Micrel set the exercise price at the lowest point in the 30-day period from when the grant was approved. The lawsuit also alleged that Deloitte advised Micrel that this 30-day pricing method followed the rules and would not have adverse accounting consequences.”). The exceptions that prove the rule are the stories of good advice from Ernst & Young (though its client, Broadcom, disregarded the advice) and Towers Perrin. See James Bandler & Charles Forelle, *Probes of Backdating Move to Faster Track*, WALL ST. J., Feb. 16, 2007, at A1; Mark Maremont, *Tyco Backed Off Stock-Option Plan*, WALL ST. J., Sept. 5, 2006, at A2.

<sup>97</sup> Frank Ahrens, *Scandal Grows over Backdating of Options*, WASH. POST, Oct. 12, 2006, at D1 (“[CNET Networks Inc., McAfee Inc., and Monster Worldwide Inc.] are the latest of at least 135 companies to acknowledge or be investigated for backdating stock options . . . .”).

<sup>98</sup> Nick Wingfield, Steve Stecklow & Charles Forelle, *Jobs Helped Pick 'Favorable' Dates for Option Grants*, WALL ST. J., Dec. 30, 2006, at A1.

Similar dynamics may also confound the effectiveness of belated disclosures: after misbehavior has already begun to spread, a disclosure policy might well backfire by advertising the wrong examples.<sup>99</sup>

### C. *Exceptional Spaces*

Aside from direct disclosure by individual actors, a further class of informational strategies relies on the regulator to convey permissions by designating exceptional spaces (whether physical or metaphorical) for permitted conduct. This class includes a less intuitive variation that one might call “borrowing boundaries” — an approach that entails rethinking the scope of regulations.

The purpose of marking exceptional spaces is not to quarantine those who are prohibited, but rather to make obvious those who are permitted. This approach may be especially useful when loud licenses or other individual declarations are not feasible. Would the patrons buying beers at the café in Central Park be willing to wear bright pink wristbands, as if at a nightclub downtown?<sup>100</sup> In the bribery context, is it realistic to mark each gift as “exempt” or not, in a publicly accessible way?

The simplest case is the most literal: when territorial divides, such as between public and private property, separate legal from illegal behavior.

Illustration — Central Park. *If you had noticed that all the beer drinkers on the lawn were inside a rope fence around the café, would that have been enough to make the distinction obvious?*

Note that a necessary condition for the distinction to remain clear is that the drinkers stay inside the area. In this sense, the figurative “duty to distinguish” is shared by the regulator who marks the space and the actors who are asked to stay within it.

1. *Borrowing boundaries.* — Where marking the true (or ideal) legal boundaries is infeasible, it may nonetheless be possible to “borrow boundaries.” This means pegging the line of legality to preexisting, salient markers. Rather than trying to trace out the first-best (but nonintuitive) limits of an exemption, it may at times be more effective

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<sup>99</sup> See *infra* Part IV for a fuller exploration of this perverse effect, and of the complexities that quickly arise in attempting to fix it.

<sup>100</sup> Note that this strategy, which identifies the patrons if they bought their drinks at the café, is not the same as identifying them as being on private property. Yet it could have the desired effect — through demodeling — even if some of these patrons wandered beyond the boundary. (Other parkgoers might think, “Maybe you can only drink if you buy it at the café” — incorrect, but achieving the same result.)

to stretch or compress the regulation to fit second-best (but more familiar) bounds.

Illustration — Central Park. *Suppose the parks authority does not allow the roped area. But there is already a well-defined outdoor seating area, plainly within the café's property. What if the café were required to restrict beer and wine sales to only those patrons sitting within that area?*

There is a regulatory distortion, and a real tradeoff, to such a workaround solution: the seating area is only a subset of the private grounds where drinking is otherwise permitted; the actors are thus artificially limited in their actions by the revised rule.<sup>101</sup> Yet in some settings, where the contagion of misconduct caused by shallow signals is severe, the benefits of demodeling or distinguishing will justify the ex ante regulatory distortion that borrowing boundaries entails. Furthermore, the borrowing-boundaries approach need not be taken as far as altering the true legal constraints. A milder strategy might aim only at creating the *perception* that the line of legality follows the more salient boundary.

2. *Action Spaces*. — The approach of marking clear boundaries, or else harnessing preexisting architectures, also extends to more metaphorical “action spaces.” In its public communications, the regulator may be able to detail which behaviors it considers *permissible* under the law, or sees as low enforcement priorities. The principle is the same: to make clear to the observer, based on visible facts, that certain behaviors seen in the field are permitted. The strategy pegs inferences of legality to what the observer can easily see. Thus, to be useful against shallow signals, the guidance would need to identify criteria that are readily observable to the outsider.<sup>102</sup>

As a thought experiment, consider again the bribery scenario from section I.C and imagine this rather fanciful possibility:

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<sup>101</sup> There is some similarity here with the *marit ayin* doctrine, a more extreme regulatory distortion that also imposes a superconstraint on behaviors that would otherwise be permitted.

<sup>102</sup> The SEC's “no-action” letters may serve as a model; these describe fact patterns (based on ones submitted by private parties) in which the SEC has determined that there is *not* a cause for enforcement. For the archive, see *Staff No Action, Interpretive and Exemptive Letters*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/interp/naaction.shtml> (last visited May. 10, 2013). The argument here is to urge the publicizing of such determinations — not to provide a “map” to exemptions or nonenforcement, but rather to aid observers in interpreting the legality of their peers' choices. Note again that, before 1970, these “no-action” letters were *not* made public by the SEC. See Lewis D. Lowenfels, *SEC “No-Action” Letters: Some Problems and Suggested Approaches*, 71 COLUM. L. REV. 1256, 1256 (1971). I thank John Briggs for this point.

Illustration — Bribery. *What if the antibribery regulator provided an “okay-to-pay” list for each country or region, in its published guidances? This hypothetical list could include individuals or categories of personnel who are permitted to receive bribes.*<sup>103</sup> *The shallow signals motivation is to make clear to Manager 2, when she observes Manager 1 paying such a recipient, that Manager 1 is not acting illegally.*<sup>104</sup>

Individual bribes cannot easily be tagged as “permitted” in real time, but such an okay-to-pay list might serve the same purpose. Because it would be pegged to observable criteria (assuming the observer knows who is receiving payments), this list would make clear the status of each bribe, even without individual disclosure.

Some such lists of permitted acts already exist. The collected corpus of no-action letters (such as by the SEC) or private letter rulings (by the IRS), already mentioned, can be seen in this light. More directly parallel are the “angel lists” that have been the subject of debate in the IRS context.<sup>105</sup> Note the further advantage of such guidance from the regulator: unlike individual disclosures, they need not implicate privacy concerns (such as for tax filings), as they can operate without identifying the prior actors.

The general point is that guidances, circulars, press releases, and other advisories from these and other enforcement agencies can be used to express permissions as well as prohibitions. In fact, both the U.S. and the U.K. authorities have recently published guidances concerning the enforcement (or the enforcers’ interpretations) of their re-

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<sup>103</sup> One might further imagine that such a list could be drawn from determinations made in response to requests for advance rulings. The current U.S. antibribery law, for instance, provides for a process to request such rulings. See Foreign Corrupt Practices Act Opinion Procedure, 28 C.F.R. pt. 80 (2009) (released by the Department of Justice).

<sup>104</sup> Other reasons, no doubt, counsel in favor of or against use of such a guidance. The analysis here seeks only to isolate and highlight the underexamined shallow signals consequences.

<sup>105</sup> “[M]any commentators have requested that the IRS draft ‘angel lists’ for transactions, noting that the case law pertaining to the economic substance doctrine involves ‘only tax shelter types of transactions,’ and thus ‘does not provide any guidance whatsoever about the application of the doctrine to common business transactions.’” Tracy A. Kaye, *United States, in A COMPARATIVE LOOK AT REGULATION OF CORPORATE TAX AVOIDANCE* 335, 353 (Karen B. Brown ed., 2012) (IUS GENTIUM: COMPARATIVE PERSPECTIVES ON LAW AND JUSTICE SER. NO. 12) (quoting Monte A. Jackel, Letter to the Editor, *Jackel Urges Tax Professionals to Comment on Economic Substance Codification*, TAX NOTES TODAY, June 15, 2010). But the IRS has refused to do so. See Amy S. Elliott, *Practitioners Blast Economic Substance Guidance with No Angel List*, TAX NOTES TODAY, Sept. 14, 2010. For further analyses of the potential use of “angel lists,” see, for example, Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1671–78 (2009).

spective bribery laws.<sup>106</sup> Each presents descriptions or fact patterns articulating both the behaviors that the regulator believes to be illegal (or worth enforcing against) and those that are compliant (or likely to be left alone).

This Essay is not the place to rehearse the many other pros and cons of the use of such guidances or lists. But one drawback, notably raised in the literature about the proposed use of “angel lists” by the IRS, does relate to the shallow signals problem in an instructive way. The argued drawback is that there is a potential for some taxpayers to take a mile when given an inch — to aggressively analogize a desired transaction to one listed as permitted on the angel list.<sup>107</sup> This phenomenon — which is a general possibility, not limited to taxpayer behavior — is the mirror image of the shallow signals problem. In a shallow signals analysis, the danger is that Actor 2 might overanalogize Actor 1’s behavior to what is known to be *prohibited* behavior by failing to distinguish them. In that case, it would be the publication of lists of the prohibited (not the permitted) actions that might worsen Actor 2’s exaggerated view of Actor 1’s noncompliance. Where overanalogizing is a concern, it is the publicity of bad-acts lists (not of angel lists) that is the problem from the shallow signals perspective.

3. *The Localizing Effect.* — One further benefit of an exceptional-spaces strategy is containment. In the thought experiment above, the listed okay-to-pay recipients may well “get all the business.” The effect is that bribery is steered toward its legal variants. In the Central Park story, drinkers are more likely to stay on private property (or go there) if they know where the boundary lies. The behavior is thus less likely to spill over into other (prohibited) areas, and may be drawn away from them.<sup>108</sup>

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<sup>106</sup> See MINISTRY OF JUSTICE, THE BRIBERY ACT 2010 (2011), available at <http://www.justice.gov.uk/downloads/legislation/bribery-act-2010-guidance.pdf>; RESOURCE GUIDE, *supra* note 49.

<sup>107</sup> The list might thus be seen as a “playbook for aggressive types.” I borrow this vivid phrase from an analysis of taxpayer *disclosure* strategies (rather than of the actual use of abusive transactions) — not the same point, but related in spirit. Blank, *supra* note 105, at 1677 (“The IRS’s use of anticipatory angel lists, which would describe potentially distracting nonabusive transactions earlier rather than later, thus might offer aggressive types a head start on overdisclosure.”); *see also id.* at 1676 (“[T]axpayers analogize to transactions on the list in order to conclude that they do not have to disclose transactions that, in light of the purposes of the regime, should be disclosed.” (quoting David M. Schizer, *Enlisting the Tax Bar*, 59 TAX L. REV. 331, 358 n.64 (2006) (internal quotation marks omitted))).

<sup>108</sup> The tradeoff is the potential for increased activity of the permitted sort, which is a concern if the use of the exception may be disfavored even if permitted (consider loopholes). It is also possible that such crowding may then cause spilling-over beyond the permitted space. But this is a tradeoff already faced in the choice of whether to create such a loophole, exemption, safe harbor, or carve-out (or other metaphor) in the first place. Making an exception more salient is not the same as creating it; among other things, the former helps with the shallow signals problem that the latter causes. Eliminating the exception altogether remains an option.

This localizing effect may be its own reward, but it can also mitigate the shallow signals problem. The clarity of contrast in behavior across the boundary is important to the observer. Note that nothing about the rope fence around the café needs to say that drinking is permitted on one side and forbidden on the other; the message can come from the visible behaviors on the two sides of the boundary. (One might think of this as “reverse engineering” the law.) And the localizing effect helps maintain the visible contrast, thereby harnessing the strength of behavioral signals.

4. *Bright Lines Optional.* — The reason suggested here for marking distinct spaces is *not* the generic aim of clarifying the law. For the shallow signals problem, it is not necessary to trace the precise metes and bounds of the exceptions. Rather, the aim is to induce the correct inference that certain observed acts are permitted. Thus, one priority in publishing guidances should be to identify the most often occurring permissible acts that are hard for outside observers to distinguish from illegal acts.<sup>109</sup> These easily confused behaviors need not be in the gray areas at the boundaries of the exemptions. Even some cases well on the permissible side of the boundary may need to be identified because the determinative fact may be obscure to observers.

Consider again the imaginary okay-to-pay list of bribe recipients from the thought experiment noted above. The aim of such an approach is to help Manager 2 recognize when the behavior of others is permitted. Doing so does not require clarifying the law. Conversely, clarifying the law may not help Manager 2 very much with respect to shallow signals from observing Manager 1, if the facts on which the law turns remain obscure.<sup>110</sup>

A corollary is that the exceptional-spaces approach can be used even when the actual legal boundary remains blurry. (The most familiar analogy may be the common law’s aversion to drawing lines in the abstract, in favor of providing examples case by case. Such pointillist guidance might answer most cases, without ever drawing a bright line.) Not having to clarify the law can be a further plus for the poli-

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<sup>109</sup> More generally, the list should focus on marking as permissible those acts most likely to be confused for illegal acts, or those for which such confusion would lead to the worst consequences due to mistaken imitation.

<sup>110</sup> To make this point more concrete: Consider how the recent FCPA guidance compares with the more direct permission-disclosing okay-to-pay list imagined here. The recent guidance, though mostly vague on the question of who counts as an officer of an “instrumentality” of government (and thus is a covered “foreign official”), does offer this bit of relative clarity: “While no one factor is dispositive or necessarily more important than another, as a practical matter, an entity is unlikely to qualify as an instrumentality if a government does not own or control a majority of its shares.” RESOURCE GUIDE, *supra* note 49, at 21. Yet even this clarifying point leaves Manager 2 with the costly or even infeasible task of assessing whether the entity being paid off by Manager 1 is in fact majority owned or controlled by the government. The okay-to-pay list, by contrast, relieves Manager 2 of that burden — even while doing little to clarify the law.



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cymaker, either if blurriness is strategically useful for the enforcer, or if achieving clarity is costly or undesirable.

Moreover, recall that a strategy of “borrowing boundaries” may well *distort*, rather than clarify, perceptions of the true legal boundaries. Like the artificially confined drinking area in Central Park, a regulatory advisory can be useful for the shallow signals problem even if the behaviors it lists *fall short* of the boundaries of what is truly legal. For instance, the imaginary okay-to-pay list might describe permitted recipients based on preexisting or intuitive categories, although doing so would be underinclusive.<sup>111</sup> This approach would not clarify, and might in fact obscure, the true boundary of the law. But in cases where the spread of misconduct is a sufficiently serious regulatory concern, measures aimed at preventing illusions of misconduct will be worth this distortion in perceptions.

#### D. Open Tolerance

A somewhat more radical variation of disclosure is possible in cases of selective enforcement: the enforcer may actually wish to announce who is getting a “free pass” — a sort of reverse crackdown.<sup>112</sup> The basic logic is familiar, as the choice *not* to target a given actor can be likened to granting a license or de facto exemption.

In some settings, the purpose of tagging the nontargets may already be served by existing markers (though unintentionally so).

Illustration — Copyright. *The actual story of the viral “JK Wedding Dance” video is that Sony Music chose not to sue Jill and Kevin, the happy couple — deciding instead to make money from the video’s popularity.<sup>113</sup> Now that this strategy of “monetizing” is becoming more common, YouTube offers the option for rightsholders like Sony Music to add purchasing links, placed*

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<sup>111</sup> Incompleteness might be a further advantage in managing the observer’s inferences, as Part V explains.

<sup>112</sup> Because selective enforcement is a sort of reverse crackdown, there is a shift in the usually imagined tradeoff. In a (normal) crackdown, the worry is that alerting the targeted groups may lead them to take evasive measures; the potential gain is that they may comply. But here, alerting the nontargeted group that they are getting a free pass may encourage them to do more of the illegal (but unenforced) activity. The potential gain is that alerting the observer about who is not targeted may prevent shallow signals.

<sup>113</sup> This is now a famous episode within the music industry, and even the subject of a business school case. See generally John Deighton & Leora Kornfeld, *Sony and the JK Wedding Dance*, HARVARD BUSINESS SCHOOL (2012), <http://www.hbs.edu/faculty/Pages/item.aspx?num=38243>. It is possible that this practice of forbearance for profit’s sake will become so well known that it no longer will be obscure or un contemplated by observers. Similar to the public awareness of medicinal marijuana use, exemptions or permissions may change in salience over time. Naive observers can naturally become sophisticates.

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*next to the video itself.*<sup>114</sup> *Although it is not their purpose, those links implicitly convey the “free pass” — the fact that Sony must be tolerating the unlicensed use.*

Strangely enough, in the case of YouTube, it is now easier for an observer to know who is getting a tolerated-use style of de facto license (made obvious by these purchasing links) than to know who has a standard copyright license.

More express statements, of course, are also possible. Published guidances — or other public statements — by the enforcer can convey a policy of nonenforcement for a category of actors, just as those guidances can convey the scope of a formal exception. This strategy may be usable by private as well as public enforcers. Indeed, a private enforcer version of such a “no-action” statement has also been proposed in the copyright context.<sup>115</sup>

As recent examples, consider the Obama Administration’s announcement that as a matter of immigration policy it would not target so-called “dreamers”<sup>116</sup> for deportation.<sup>117</sup> Or consider President Obama’s statement in a televised interview that marijuana would not be a “top priority” for federal enforcers in those states that have legalized recreational marijuana use.<sup>118</sup> (Imagine the potential for shallow signals if such an enforcement policy had been decided upon, but had gone undeclared.)

Yet isn’t it sometimes unrealistic to disclose de facto permissions? Aren’t they often kept secret for a reason? How often is ex ante disclosure even feasible? Besides, won’t the group with the free pass take advantage of it? Let us return for a moment to the distinction between two kinds of rationales for discretionary enforcement.

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<sup>114</sup> In fact, YouTube uses the story of the JK Wedding Dance for advertising its “monetization” tools. See Chris LaRose & Ali Sandler, *I Now Pronounce You Monetized: A YouTube Video Case Study*, YOUTUBE BIZ BLOG (July 30, 2009, 9:19 AM), [http://ytbizblog.blogspot.com/2009/07/i-now-pronounce-you-monetized-youtube\\_30.html](http://ytbizblog.blogspot.com/2009/07/i-now-pronounce-you-monetized-youtube_30.html).

<sup>115</sup> See generally Wu, *supra* note 27.

<sup>116</sup> A “dreamer” typically refers to an individual who entered the United States illegally at a young age, remained there, and has not been convicted of a significant crime or crimes. See *Who and Where the DREAMers Are*, IMMIGRATION POLICY CTR.: AM. IMMIGRATION COUNCIL (Aug. 18, 2012), <http://www.immigrationpolicy.org/just-facts/who-and-where-dreamers-are>.

<sup>117</sup> See U.S. CITIZENSHIP & IMMIGRATION SERVS., DEP’T OF HOMELAND SECURITY, I AM A YOUNG PERSON WHO ARRIVED IN THE UNITED STATES AS A CHILD (CHILDHOOD ARRIVAL) (2012), available at [www.uscis.gov/USCIS/Resources/daca.pdf](http://www.uscis.gov/USCIS/Resources/daca.pdf).

<sup>118</sup> Devin Dwyer, *Marijuana Not High Obama Priority*, ABC NEWS (Dec. 14, 2012), <http://abcnews.go.com/Politics/OTUS/president-obama-marijuana-users-high-priority-drug-war/story?id=17946783#.UYrOuSvwJWI>.

First, ex ante specification of the policy may be too difficult, and so the choice is better left to the enforcers ex post.<sup>119</sup> Disclosure ex ante is thus also infeasible. An ex post disclosure might not be too late, however, as it may still be ex ante to the observer.

As for the potential for increased activity by the free-pass group, under this rationale there may be less reason to find it troubling: if ex ante specification had been feasible, one might imagine this forbearance would have been written into the law as a formal exception. In this sense, the behavior getting the free pass from the enforcer was not meant to be made illegal in the first place.

Under the second set of rationales, discretion may be left to the enforcer because it is strategically valuable to keep quiet about who is being targeted at any given time. Here, a further distinction should be made. Opacity may be valuable because enforcers do not want to tip off the most-targeted group. If so, announcing who is *least* targeted may be less of a worry (as this may be done without necessarily giving away who is *most* targeted).<sup>120</sup> A different possibility is that opacity may be valuable because the enforcer has limited auditing resources — and yet wants to give the impression of comprehensive monitoring. (Think of the tax authorities.) If so, publicity may be unrealistic, as announcing the free pass defeats the purpose. In this case, an open tolerance approach may be ruled out.

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<sup>119</sup> One might analogize to the choice of using standards over rules, or to the familiar logic of incomplete contracts. For analyses expressly drawing together these two conceptual frameworks, see Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581 (2005); Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2006); and Steven Shavell, *On the Writing and the Interpretation of Contracts*, 22 J.L. ECON. & ORG. 289 (2006). For a small sampling of foundational works in the analysis of rules versus standards, see, for example, Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Frederick Schauer, *Rules and the Rule of Law*, 14 HARV. J.L. & PUB. POL'Y 645 (1991); and Cass R. Sunstein, *Problems with Rules*, 83 CALIF. L. REV. 953 (1995). For some of the core literature on incomplete contracting, see, for example, Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848 (2010); Gillian K. Hadfield, *Judicial Competence and the Interpretation of Incomplete Contracts*, 23 J. LEGAL STUD. 159 (1994); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755 (1988); Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990); and Alan Schwartz, *Incomplete Contracts*, in 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 277 (Peter Newman ed., 1998).

<sup>120</sup> To be clear, the imagined breakdown is that there is a least-targeted group, a somewhat-targeted group, and a most-targeted group. The breakdown is endogenous: the least-targeted group (to be announced, for shallow signals' sake) can be sized to avoid tipping off the most targeted group.

*E. Whose Duty to Distinguish?*

We can see these policy options as allocating a figurative “duty to distinguish” — the job of supplying the critical fact making clear why Actor 1 provides poor behavioral precedent for Actor 2. A disclosure policy shifts this duty from Actor 2 to Actor 1 (think of wearing badges). The use of exceptional spaces shares the duty between the regulator and Actor 1 (who must act only in that space). And sometimes the enforcer does all the distinguishing (think of announcing the free pass). At first blush, such allocations make sense, as either Actor 1 or the enforcer will have the missing information, and its revelation will almost surely be cheaper than Actor 2’s due diligence. One might even think that Actor 2 should be excused for making shallow signals errors, in some settings. (The design of such defenses or excuses for mistaken imitation is a potentially rich area of analysis, but one reserved for future consideration.)

Yet in the shallow signals setting, a simplistic least-cost heuristic can lead policy design astray. The consideration of costs will need to be more nuanced, taking into account not only the actual costs of disclosure, but also how they compare against the observer’s expectations. As the following analysis demonstrates, because disclosures may be self-defeating or may backfire, there are times when leaving the duty to distinguish with Actor 2 will be superior.

## IV. WHEN DISCLOSURES BACKFIRE

Disclosures can be self-defeating. A policy of revealing permissions may backfire in unfamiliar ways, due to two core features of shallow signals: first, that they arise in a setting of imitation; and second, that they are externalities. This Part explains how these dual features give rise to two classes of mechanisms that may limit the value of a disclosure solution by causing perverse effects on observers’ perceptions. In these ways, policies that deepen some shallow signals can make others still more misleading. Working around these limitations may be possible, but new heuristics are needed, tailored to the complications of imitation and externality.

*A. Dynamics of Imitation*

When imitation is iterated, the chance of backfire due to disclosures grows as time passes. Early disclosures may be critical: if disclosures occur after other imitators have begun to set bad examples themselves, the disclosures can entrench the mistaken choices that have already begun to spread. Moreover, as imitation is iterated, the necessary disclosures become far more complex. While it is true in theory that supplying more information can still cure a lack of information,

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the amount and complexity of the information that needs to be communicated will rapidly become infeasible.<sup>121</sup>

Part of the basic intuition will be familiar from the Microsoft story, as recounted in Part III: After several years of backdating stock options without using proper accounting methods, Microsoft cured its practice. But its compliance was largely disregarded by other technology firms (and allegedly even by Microsoft's own accounting firm, Deloitte), which continued to use and spread backdating in its illegal form. As noted earlier, this episode may hold a lesson for belated *disclosures* as well as belated cures. Imagine this hypothetical.

*Illustration — Corporate Misconduct. Suppose Microsoft had been “doing it right” all along, quietly but properly accounting for the backdating from day one. What if new regulations requiring it to publicly disclose its accounting were only adopted seven years into its use of backdating — by which point other firms (such as Apple) and expert intermediaries (such as Deloitte) had already miscopied and begun to spread the uncured variation of the practice, themselves?*

The potential futility of a belated disclosure is evident in this illustration. Yet the problems created by belated disclosures can be more complex than mere futility.

*I. Confidently Wrong.* — Consider this simplistic story of iterated imitation: Actor 1 takes an action. Actor 2 decides whether to copy Actor 1's action. Actor 3 decides whether to copy Actor 2's action. And so forth.<sup>122</sup> Actor 1 is licensed, but later actors are not. Taking the action is thus legal for Actor 1 but illegal for the others. The fact of the license is what is missing from the shallow signal conveyed by Actor 1 to Actor 2.

Imagine a very early intervention (before Actor 2's decision about copying) in the form of a disclosure of the fact, “Is Actor 1 licensed?” Answer: yes. This disclosure deepens the signal, allowing Actor 2 to see that Actor 1 is a “bad bad example.” Actor 2 then refrains from

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<sup>121</sup> For an example of how quickly information must be disclosed to prevent iterations of errors, consider that when news outlets mistakenly reported a bankruptcy, that company's stock price dropped over seventy-five percent and took a week to recover — even though Bloomberg corrected the story twenty-six minutes after the false report's publication. See CARLOS CARVALHO ET AL., FED. RESERVE BANK OF N.Y., *THE PERSISTENT EFFECT OF A FALSE NEWS SHOCK* 5 (2011).

<sup>122</sup> For an example of how quickly iterations of misconduct can accumulate, consider that Napster went from zero to seventy million users within about a year. See Lior Jacob Strahilevitz, *Charismatic Code, Social Norms, and the Emergence of Cooperation on the File-Swapping Networks*, 89 VA. L. REV. 505, 512–13 (2003).

following. The intervention has thereby also stopped the chain of further repetition (by Actor 3 and so forth).

But notice how this same intervention can backfire, if timed slightly later. Suppose Actor 2, though lacking a license, has mistakenly followed Actor 1's lead because no early disclosure occurred. Now Actor 3 is deciding whether to follow Actor 2. What would the basic disclosure do, at this point? It would answer the question: "Is Actor 2 licensed?" Answer: *no*.

Perversely, the disclosure now entrenches the error. Actor 3 knows for sure that Actor 2 has the same status as herself (unlicensed) and thus copies the action, with confidence. Actor 3 now "knows" that a license is not necessary. The result is a false complacency about acting without license. The disclosure has made Actor 3 confidently wrong.

2. *The Information Ratchet.* — But how can it be that revealing information does not solve what is at core an information problem? What confounds the usual solution is that, in a chain of imitation, there can be more than one way for a prior actor to be the wrong example to follow. For instance, a sloppy imitator should not be imitated by a later actor. (This is well known to anyone who has played the childhood game of "telephone.") But in a basic disclosure scheme, only the "key" fact — permission — is sought out or made to be disclosed. Other dimensions — such as sloppiness — are overlooked or may be inaccessible.

The natural question at this point is: can the information be made more complete through *fuller* disclosures? Potentially yes. But such further disclosures will likely be infeasible.<sup>123</sup> What needs to be disclosed are higher-level facts. For instance, it is no longer enough for Actor 3 to know whether Actor 2 has a license. To induce Actor 3 to recognize that Actor 2 is a "bad bad example," the disclosure must now also answer: "Did Actor 2 himself copy this action? Did he know to look into the licensing status of whomever he copied?"

The information demands at this stage are more complicated than at the first stage — for they include not only the prior actor's legal status, but also that actor's level of sophistication.

The problem becomes trickier, quickly. Imagine that disclosure occurs still later in the chain of imitation. Suppose Actors 1, 2, and 3 all acted without intervention. Actor 4 is now deciding whether to copy Actor 3. Again, the disclosure only of Actor 3's first-level fact would perversely reveal that Actor 3 is not licensed, and Actor 4 could become confidently wrong.

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<sup>123</sup> And possibly ineffective due to oversaturation. See Ben-Shahar & Schneider, *supra* note 81, at 743 ("[L]ength, complexity, and difficulty are the enemies of successful [required disclosures].").

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But for Actor 4, even adding the higher-level fact is not enough of a fix. Suppose that the disclosure answered, “Did Actor 3 herself copy this action? Did she know to look into the licensing status of whomever she copied?” And suppose the answers are both “yes.” These answers might seem reassuring for Actor 4. But actually, they no longer contain enough information and the answers may again mislead Actor 4 into becoming confidently wrong. The answers would both be “yes” even if Actor 3 were herself confidently wrong in following Actor 2 — that is, if Actor 3 had learned that Actor 2 is *not* licensed. To avoid this counterproductive result, what further information must now be revealed to Actor 4?

Actor 4 needs to know a further answer: “Did Actor 3 know to look into whether whomever she copied also knew (in turn) to look into the licensing status of whomever *that actor* copied?” What’s needed now is knowledge not only of the prior actor’s status and her sophistication, but also her sophistication *about sophistication*. The demanded information (or meta-information) thus ratchets upward with each iteration.

3. *Regulatory Competence* — There is yet one further, overarching complication: this entire analysis has implicitly assumed that the policymaker designing the questions for the disclosures knows how many iterations of imitation have already occurred. That information is needed to calibrate the number of layers of inquiry to require. Yet it is sure to be difficult to determine — never mind to communicate — in promulgating the policy. Even if a general formulation for the disclosure’s inquiry is possible, one cannot get around tracking down the sequence of imitation. (Imagine asking the question in this general form: “Did the actor being observed fully discount for the quality of information she gained from observing the earlier actor?” But answering this would still mean working backward through each round of copying. That is, ensuring Actor 10 has the correct information would require knowing whether Actor 9 did, which would require knowing about Actor 8, and so forth.)

Moreover, note that these complexities have arisen from perhaps the simplest possible setup for a hypothetical (Actor 2 copies Actor 1, Actor 3 copies Actor 2, and so forth). This simplicity is sure to be unrealistic. What if Actor 3 looks to both Actor 1 and Actor 2 but is forgetful of her sources, while Actor 4 looks only to Actor 3, and Actor 1 has disappeared by the time Actor 5 arrives? What if multiple chains of imitation emerge or intersect? The information needed to craft a suitable disclosure policy might overwhelm the regulatory mind.

### B. *Adverse Inferences*

Illustration — Street Parking. *What is a driver likely to think if half the cars parked on the street have residential per-*

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*mits in their windshields but the other half do not? Would she think, "I'm sure these are all residents — though it seems some forgot to put out their permits"? Or would she think, "It's probably fine to park here — there are plenty of nonresidents"?*

Adverse inferences from silence create a further way for disclosure policies to backfire. In some contexts, once observers see that disclosures are possible, they may assume that actors not revealing a license must be acting without one. This assumption is a mistake if in fact the actor being observed is licensed but has failed to disclose that fact. When there is a gap between those who are licensed and those who disclose, observers may make the wrong inference — by inferring too many wrongs.

Moreover, once observers have encountered disclosures, they may feel more certain that they know everyone's status. The shallow signals may thus leave a firmer impression on the observer (who believes himself to be informed) than in the absence of a disclosure policy — making the observer, in a further way, confidently wrong.

1. *A Matter of Expectations.* — The problem of overly adverse inferences arises from a mismatch between the reality of disclosures and an observer's expectations about them. It is most obvious where observers make the easy mistake of assuming that disclosures are complete — that everyone with a license is disclosing it.

Illustration — Copyright. *If a special marker is available on YouTube pages for certifying that all works used are "properly licensed," then a viewer might assume that any poster who has acquired a license will make use of that tag: "Why wouldn't they? Seems easy."*

Licensees who fail to disclose are then mistaken for acting unlawfully, becoming "bad bad examples" for the observer.

The problem extends beyond this polar case. To state it generally: if the observer overestimates how many original actors will disclose their licenses, then the observer may misperceive some licensees (who have failed to disclose) as unlicensed actors. The critical variable is how the true disclosure rate compares with the assumed disclosure rate. In policy design, then, what matters is not only the actual extent of the disclosures but also the observers' expectations about them. Potential solutions can thus be addressed to either side of this gap.<sup>124</sup>

Why might an observer have wrong expectations? For one thing, there's the reason she is relying on behavioral signals to begin with:

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<sup>124</sup> See *infra* section V.C, pp. 2284–86.



because she does not know the regulatory regime. Think again of the parking scenario. The driver may not know the street parking rules or how intensively the street parking rules are enforced. How can she be expected to know the second-order rule about displaying permits (if there is one) or how seriously it is enforced?<sup>125</sup>

Two principal areas of the observers' ignorance are worth analyzing in more detail. First, the observer may know little about the private costs of disclosure for the observed actor. Second, and more likely (as well as more analytically interesting), the observer may know little about the private benefits of disclosure. Each sort of factual ignorance will intersect with the regulatory ignorance noted above.<sup>126</sup>

2. *Favoring Costlier Disclosure?* — When it comes to the costs of disclosure, our usual policy intuitions may be misplaced. It is tempting to assume that the cheaper or easier it is to disclose, the more desirable (or less objectionable) it is to require disclosure.<sup>127</sup> But this intuition overlooks the crucial role of the observer's expectations. Even if the needed information is cheap or easy to disclose, the observer may draw excessive adverse inferences if she imagines disclosure to be even cheaper or easier. What matters is not only the actual cost of disclosure, but also how it compares with the cost imagined by the observer.

Illustration — Copyright. *Imagine again that there is a “properly licensed” tag available on the YouTube layout. The viewer assumes disclosure is easy. What the viewer doesn't know, however, is that YouTube demands careful documentation of each license, in order for a video author to use that tag; more time and paperwork are required than a viewer would think.*

It may often be the more difficult disclosures — not the easier ones — that have a better claim to being promoted or mandated by

<sup>125</sup> In some cases, one might imagine that Actor 2 may know more about the disclosure regime (“I know residents must show parking permits, and the authorities enforce this.”) than the underlying regulatory regime (“I wonder how much they enforce the residents-only parking rule around here.”). But this knowledge seems implausible if the means of enforcing the disclosure mandate are linked to the means for enforcing the underlying behavior: do traffic police ever go from car to car, checking only to see whether residents are displaying their permits — without at the same time enforcing the actual parking rules?

<sup>126</sup> A further influence on the observed actor comes from extralegal (such as market-based) norms of disclosure. See generally Eric Talley, *Disclosure Norms*, 149 U. PA. L. REV. 1955 (2001). Observers may be poorly informed about these norms as well.

<sup>127</sup> To be clear, it is trivially true that “all things equal,” a less costly policy is more desirable. The point here is that all things might not be equal, because the actual cost may be correlated with how much it differs from the observer's expectations.

policy.<sup>128</sup> Such a policy is needed more where observers tend to underestimate the burdens of disclosures and hence overestimate the frequency of disclosure; and this condition may be more likely to hold when disclosures are more burdensome. (With a truly easy or cheap disclosure, there is not much room for the observer to guess that it is still easier or cheaper.) In sum, addressing the problem of adverse inferences calls for attention to the observer's expectations about costs, in addition to the actual cost, of disclosure.

3. *Unraveling and Voluntary Disclosure.* — The private benefits from disclosure may also be obscure to an outside observer. An intriguing policy lesson arises from considering this side of the ledger: there may be a stronger case for promoting or mandating disclosures precisely when those disclosures are less useful for enforcing the underlying law. If the enforcers do not rely much on the disclosures in their monitoring, then those with licenses will have little reason to volunteer that fact.

But if the enforcers rely heavily on disclosures, then licensees will more often wish to disclose voluntarily.<sup>129</sup> This motivation is further enhanced if “unraveling” occurs — that is, if the regulator draws stronger adverse inferences against those who do not disclose when more of the relevant population does disclose. This much-discussed phenomenon can in theory (under some circumstances) lead to complete voluntary disclosure by all who are able to do so credibly.

The critical turn in this analysis is driven by the presence of Actor 2 — and by his regulatory ignorance. Actor 2 does not know whether enforcers rely on the disclosures, much less the degree of unraveling that should be expected to occur. Actor 2 may thus tend to underestimate Actor 1's incentives to disclose voluntarily when enforcers rely heavily on disclosures, and Actor 2 may tend to overestimate these incentives when the reliance is less.

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<sup>128</sup> “Promoted” is used here as a shorthand that includes other means of encouraging Actor 1 to disclose, such as reducing costs of disclosure, more avidly enforcing an existing mandate, or otherwise rewarding disclosure.

<sup>129</sup> An ample economics literature (usually stylized as a story of a seller disclosing product quality to the buyer) and law-and-economics literature (focusing on disclosures of information during litigation) have explored voluntary disclosure and unraveling. See, e.g., George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970); Robert H. Gertner, *Disclosure and Unravelling*, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 605, 605–06 (Peter Newman ed., 1998); Sanford J. Grossman, *The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & ECON. 461 (1981); Paul R. Milgrom, *Good News and Bad News: Representation Theorems and Applications Prior to Sale*, 25 RAND J. ECON. 20 (1994); Steven Shavell, *Acquisition and Disclosure of Information Prior to Settlement or Litigation*, 20 RAND J. ECON. 183 (1989); Talley, *supra* note 126; W. Kip Viscusi, *A Note on “Lemons” Markets with Quality Certification*, 9 BELL J. ECON. 277 (1978).

The more troubling case occurs when enforcers rely little (or not at all) on the disclosures. Suppose Actor 1 understands the enforcer's practice but Actor 2 does not. (Recall that the ticket resellers may have little reason to advertise their licenses if the police already know who they are, or if their permits are readily produced on demand. Likewise, in the YouTube scenario, the copyright holder may already know that it granted a license.) In such cases, Actor 2 may expect more disclosure than is realistic. If so, he will thus draw overly adverse inferences, mistaking the permitted for the prohibited.

A policy promoting disclosures is needed more in such cases precisely because the disclosures are less useful to the regulators in the first place. Actor 2 does not know how unhelpful the disclosures are to the regulator, and thus does not know how little incentive Actor 1 has to disclose.

### C. Ignorance Externalities

The externality relationship assumed here between the model Actor 1 and the observer Actor 2 is worth emphasizing, as it sets apart the present disclosure concerns from standard accounts of voluntary or mandatory disclosure.

1. *The Ignored Observer.* — The shallow signals analysis introduces an outsider, Actor 2, beyond the more basic (and more often studied) interaction between Actor 1 and the enforcer.<sup>130</sup> Actor 1, in making the disclosure (or not), is concerned about what the regulator will learn from its revelation. But as a general matter, Actor 1 is not concerned about what the observer Actor 2 will make of it. (Think of the other drinkers at the café in Central Park, who are wholly unconcerned that an observer on park property might get the wrong idea.<sup>131</sup>) The effects of Actor 1's signals on Actor 2 are externalities, as far as Actor 1 is concerned. Actor 1's disclosure is an "information externality" just as her visible behavior is. One might thus call her failure to disclose an "ignorance externality."

The ignorance externality accounts for the curious conclusion that a policy promoting disclosures may be more useful precisely when they are less useful to the monitoring regulator (as detailed above). Even when there is little to be gained either for Actor 1 or for the regulator, disclosures may nonetheless benefit Actor 2. Thus, as the internal, preexisting usefulness for the original parties goes down, the need for a

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<sup>130</sup> Or seller and buyer, or plaintiff and defendant, as is common in the literature. See, e.g., Talley, *supra* note 126, at 1995 (depicting the "[d]isclosure [g]ame" between buyers and sellers).

<sup>131</sup> Contrast them with that colleague of mine, mentioned above, who makes sure not to jaywalk when children are also standing at the curb. One might also see the Talmudic *marit ayin* doctrine as compensating for (or morally instructing about) such a lack of concern.

disclosure policy to compensate (to serve the interests of the third party) goes up.

2. *The Ignorant Observer*. — Actor 2's external position also adds to his hardship in assessing whether voluntary disclosure (or unraveling) will occur. Disclosure is motivated by Actor 1's concern with the regulator — not with Actor 2. Actor 2 thus has no special insight into Actor 1's incentives for disclosing or for unraveling (as he might have if Actor 1 were instead concerned with Actor 2's response). And as emphasized above, nor does Actor 2 know the mind of the enforcer.

Note the contrast with standard economic analyses of disclosure: This is not a story of strategic or game-theoretic interaction between the two actors.<sup>132</sup> Any such strategic “signaling” or monitoring game is assumed to be between Actor 1 and the regulator.<sup>133</sup> Actor 2 is merely an outsider affected by the information externality and the ignorance externality. These analyses thus do not depend on assumptions about common knowledge, discount rates, or game structure. The relative simplicity means that the lessons may be more robust — even if some may seem unusual.

## V. UNSETTLING SOLUTIONS

“How intuitive is the exemption?” “How salient is the licensing?” It may seem unusual to ask such questions, and odd to worry about them. We are more often troubled by *prohibitions* that are not intuitive or not salient, for the familiar reason that such laws may not offer notice and fair warning of their demands. The usual concerns are publicity and notice of the law's prohibitions, not of its permissions.

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<sup>132</sup> Actor 2 may try to take Actor 1's incentives into account, but those incentives do not involve Actor 2's response — there is no feedback loop. One can readily imagine an extension of this basic account, in which the regulator's disclosure interests include the shallow signals problem noted here (this regulator being especially forward-thinking, or familiar with *marit ayin*, or a reader of this journal) — and thereby brings into Actor 1's analysis an attentiveness to Actor 2 (via the regulator's payoffs). This complication must be saved for another day.

<sup>133</sup> Such interactions are, of course, familiar and much studied in many contexts. See, e.g., IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION* 101–32 (1992) (examining strategic monitoring interactions within the framework of proposed “self-regulation” policy approach); DOUGLAS G. BAIRD ET AL., *GAME THEORY AND THE LAW* 79–119 (1994) (discussing strategic disclosure games generally); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Merritt B. Fox, *The Issuer Choice Debate*, 2 THEORETICAL INQUIRIES L. 563 (2001); Robert Gibbons & Lawrence F. Katz, *Layoffs and Lemons*, 9 J. LABOR ECON. 351 (1991) (empirically assessing signaling model of employers' inferences about workers); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995) (focusing on monitoring by investors and shareholders); Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387 (2001); Robert E. Scott & William J. Stuntz, *Plea Bargaining as Contract*, 101 YALE L.J. 1909, 1944 (1992) (discussing “signaling” through plea bargaining); Matthew C. Stephenson, *Information Acquisition and Institutional Design*, 124 HARV. L. REV. 1422 (2011).

In a shallow signals problem, however, what is lacking is awareness of the permissions. There is overnotice of what the law forbids, relative to undernotice of its exceptions. Disclosures can fill this gap by making known the permitted status of specific individuals' conduct. But as detailed above, disclosure policies have their drawbacks, not the least of which is the potential to backfire.

There is another approach to expressing the law's permissions, one that may at first blush seem a half-measure relative to disclosures. But it is also a more general form of intervention, one that will often be feasible when disclosures are not — and at times superior to disclosures even if both are possible.

*Illustration — Central Park. Imagine there are signs up nearby saying “No Alcohol.” You might assume, from seeing other picnickers drinking beer and wine, that everyone just knows that the open container law goes unenforced. (Besides, you can see this for yourself, as police officers stroll right past the other drinkers.) But how would you interpret these behavioral signals if the posted signs said “Alcohol on Private Property Only”?*

The strategy is simply to alert the observer to the *possibility* of permission, generically, without reference to any individual actor. Its effect is to prompt the observer to think of the unknown unknown.

This limited effect is also the main shortcoming of such a “prompting” approach: it affects only the naive observers, who have yet to notice the unknown unknown. The prompt does less work for the sophisticates. (They naturally think, “I wonder if those people with the beers are actually on private property?” No signs needed.) Even if the prompt might cause some sophisticates to think harder about the form of permission, they have already spotted the issue. Facing a *known* unknown, the sophisticates have in effect already been prompted.

This Part begins a tentative (and more theoretical) exploration of this prompting approach. Naturally, its focus is on the effects on the naive. But the thought experiments that follow also suggest a possible solution for the sophisticates: a hybrid approach — based also on the principle of “unsettling” false certainty — that might reach the naive and the sophisticated alike.

#### *A. Expressing Permissions*

It is clarifying to think of individual disclosure as serving two distinct functions: First, it prompts the observer to consider the hidden dimension of the shallow signal (such as the possibility of license, exemption, or other permission). Second, it reveals the status of the earlier actor. For instance, seeing a residential parking permit in a car's

windshield both prompts the observer to the existence of such permits, and also discloses the status of that car.

The prompting function provokes a reaction of the form, “What, there is an exemption for that?” The revealing function provokes a reaction of the form, “I see that Actor 1 meets the exemption.” Disclosure merges these two effects: revealing Actor 1’s hidden fact also necessarily prompts Actor 2 to contemplate the possibility of such a hidden fact. Because of this link, these functions are not usually analyzed separately. But these two functions need not be linked. It may be a better solution, in some settings, only to prompt the observer into an awareness of the hidden dimension — without directly revealing the status of specific actors.

The aim of such a prompting solution is to cause Actor 2 to contemplate what he had not: that Actor 1’s behavior might be legal. The message is, “Have you considered that she might have permission to do that?” Actor 2 is left uncertain about Actor 1’s actual status, but at least he has been alerted to this further dimension.

*Illustration — Street Parking. Driver 2 sees a street-parking spot behind Driver 1’s parked car. Despite the sign saying “No Parking,” Driver 2 is tempted to follow Driver 1’s lead. But what if the sign instead says “Parking for Residents Only”? Or if it says “Drop-Off Zone”? Each suggests to Driver 2 a possible distinction from Driver 1, by conveying the possibility of permission.*

The various familiar means for publicizing prohibitions should also be useful for publicizing permissions. True, signs in the park or along a street may be rather limited in what they can articulate. But many legal contexts lend themselves readily to far more detailed communications from regulators; for instance, think of the circulars and advisories publicized by the IRS or SEC (as explored above in section III.C).

*Illustration — Bribery. A regulator’s published guidances may do well, for obvious reasons, to include contrasting fact patterns showing how to distinguish permissible payments from illegal bribes. But imagine, as a thought experiment: What if a guidance also listed fact patterns in which the legal and illegal variants would be indistinguishable to the outside observer? Isn’t it also useful for Actor 2 to know when he cannot tell whether Actor 1’s action is in fact permitted or prohibited?*

The point here is to emphasize that the purpose of prompting is to force Actor 2 to confront the *possibility* of permission (and thus to avoid jumping to conclusions, now that he knows that permitted and prohibited look-alikes exist). This awareness (and hesitation) is useful

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even if Actor 2 ultimately will not be able to access the specific facts about Actor 1.

### B. *Knowing Uncertainty*

“There’s something you should know.” Prompting leads the naive observer to notice the unknown unknown. For the sophisticated observer, however, who is already aware of the possibility of the license, permission, or other key distinction, the prompt is old news — “I already knew.” The effect is one of leveling-up the naive, not of creating a greater asymmetry.<sup>134</sup> It is the preexisting imbalance in starting points between sophisticates and the naive that causes the asymmetric policy impact.

1. *A Strategy for the Naive.* — This natural leveling effect can be an advantage for the policymaker. For one thing, it reduces information demands; there is no need to assess how many sophisticated or naive observers will be affected. Any naive observers (however many) will become better informed, and any sophisticates (however many) will be left as they were.

Notably, it is also the problem of naive observers that presents the clearest case for intervention. Theirs is the grosser error. They have nowhere to go but up. If Actor 2 is unaware of even the possibility of an exemption, for instance, then he will only ever mistake exempt acts for illegal ones (never the other way around). The unknown unknown does not create mere noise, which may cancel out to a degree. Rather, it causes biased errors always in one direction.

2. *Creating Uncertainty.* — A disclosure yields the answer; a prompt gives pause. A prompt provides crucial information for the naive observer, but it does not resolve uncertainty. Quite the opposite: it *creates* uncertainty. But the newfound uncertainty is a good thing, as it arises from Actor 2’s noticing a pivotal variable that he had failed to consider. In leveling up the naive to the sophisticates’ state of knowledge, a prompt also levels them up to the sophisticates’ state of uncertainty. Unimpeded by doubt, Actor 2 might have followed Actor 1’s lead, but the prompt has forced him to face a new unknown.

Prompting solutions disabuse Actor 2 of a false sense of certainty. (They do what disclaimers do — they unsettle.) At the same time, they do not go so far as to cause a false certainty in the other direction, the

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<sup>134</sup> It may be instructive to compare prompting with more obvious (and blunter) means for leveling-up the naive that may be available in some settings — for instance, by “lawyering them up” (or more generally, by providing or assigning intermediaries who can help the naive observer interpret others’ actions as permitted or prohibited). Or one might imagine “gatekeeping” strategies that allow only (certifiably) sophisticated actors to participate in the first place, which may encourage the naive to become better informed.

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way a disclosure regime might. The prompted uncertainty might thus be a less *distorted* state of knowledge, even though there is less information. It is, in this sense, an antidote to being confidently wrong.<sup>135</sup>

3. *Skeptical or Charitable?* — Prompting may be superior to disclosures (meaning, it may better discourage misconduct) if Actor 2 perceives more permissions in a state of uncertainty than when they are disclosed. How could this occur? Recall the contrast between skeptical and charitable observers, and consider again how it intersects with being sophisticated or naive, as indicated in the chart below (which mirrors the chart presented in section I.E).

Prompting moves the observer from naive to sophisticated. This impact is greater in the charitable context<sup>136</sup> (“What, there is an exemption for that? So *that’s* how they’re all doing it legally.”). The impact is not as great if prompting merely converts the naive into the skeptical<sup>137</sup> (“Fine, there’s an exemption, but I doubt anyone’s using it. They’re just breaking the rules.”).

Now imagine the impact of disclosures. In contexts where an observer will tend to be skeptical (box 1), seeing the actual disclosures is more likely to pull up his low estimates.<sup>138</sup> But where observers guess charitably (box 2), there is more of a risk that the actual disclosures will drag down their high estimates. They would have guessed higher, but the actual disclosures reveal the ugly truth.<sup>139</sup>

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<sup>135</sup> The problem of being “confidently wrong” is explored in sections II.B and IV.A.

<sup>136</sup> This move is from box 4 (zero) to box 2 (high estimate).

<sup>137</sup> This move is from box 3 (zero) to box 1 (low estimate).

<sup>138</sup> Recall that disclosures also serve a prompting function, so once a naive observer encounters a disclosure, he has in effect become a sophisticate.

<sup>139</sup> The point here is the comparison between the skeptical and the charitable contexts. It is certainly possible that disclosures (if low enough) can reveal an “ugly truth” to even those skeptical observers who are guessing a low estimate. Likewise, disclosures (if high enough) can still pull up even the charitable observer’s guess.



	Skeptical	Charitable
Fully informed	Knows which actors have permission	Knows which actors have permission
	↑ DISCLOSURES ↑	
Sophisticated “ <i>Known unknowns</i> ”	Knows permission is possible, but thinks it unlikely  (Low estimate)  <span style="float: right;">1</span>	Knows permission is possible, and thinks it likely  (High estimate)  <span style="float: right;">2</span>
	↑ PROMPTING ↑	
Naive “ <i>Unknown unknowns</i> ”	Does not imagine permission is possible  (Estimate is zero)  <span style="float: right;">3</span>	Does not imagine permission is possible  (Estimate is zero)  <span style="float: right;">4</span>

This ugly-truth effect can be avoided, however — by prompting without disclosing. Start with the naive observer in the charitable context (box 4): he is not yet thinking charitably because he does not know of the possibility of permission. Once he is prompted, he thinks charitably (“So *that’s* how they’re all doing it legally.”), adopting a high estimate (box 2). At this point, he has not encountered the ugly truth. So why not leave him in this state of blissful (and useful) ignorance, without disclosures? Moreover, when the so-called ugly truth is not

even true — for instance, due to the problem of overly adverse inferences<sup>140</sup> — then this option may be especially compelling.<sup>141</sup>

### C. *Knowing Ignorance*

One key advantage of prompting is that the observer is unlikely to fall into a false sense of being completely informed. Quite the opposite: the alert will have knocked a naive Actor 2 out of complacency. (Think of the warning, “Don’t try this at home.”<sup>142</sup>) More importantly, Actor 2’s own ability to discover the missing information about Actor 1 will be limited — and Actor 2 knows it.

With prompting, the work of distinguishing remains with Actor 2.<sup>143</sup> Any shortcomings are his own. Thus, in the prompting regime, Actor 2 knows better the limits of his information than in a disclosure regime, where he might not consider that other actors’ revelations are incomplete.<sup>144</sup>

Knowing his own ignorance, Actor 2 may avoid the overly adverse inferences that might mislead him in a disclosure regime. Instead, he will view the permissions he does discover among other actors (if any) as a lower bound: “Probably more of these actors have licenses that I don’t know about; it is hard for me to tell, because there is no disclosure.”

This comparison suggests a convergence of sorts between prompting and disclosure. Prompting can be likened to an extremely incomplete form of disclosure. (Think of the sign saying, “Parking for Residents Only.” You know there are cars with permission, but you don’t know which ones they are.) And disclosures also serve a prompting function, as noted. Beyond that, they provide individualized data. These data, however, may be incomplete or unreliable. In the limit, as these data become worthless, disclosures in effect serve only the prompting function. This point of convergence is notable because it

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<sup>140</sup> See *supra* section IV.B, pp. 2273–77.

<sup>141</sup> Or, one might say, less troubling. The more general question of whether it is ethical and justifiable for the regulator ever to hide (or to leave hidden) information about other actors’ illegal activity is one that likely varies by context and must be bracketed for now.

<sup>142</sup> As Justice Kagan warned the circuit courts, in a recent case. See *Genesis Healthcare Corp. v. Symczyk*, 133 S. Ct. 1523, 1534 (2013) (Kagan, J., dissenting) (“So a friendly suggestion to the Third Circuit: Rethink your mootness-by-unaccepted-offer theory. And a note to all other courts of appeals: Don’t try this at home.”). Notably, Justice Kagan is in essence seeking to prevent a shallow signal (to future courts) due to an outcome in *Symczyk* that was based on a technicality (a waiver of an argument by this litigant) rather than on a merits-based determination. *Id.* (noting that the majority opinion “assume[d], without deciding” the mootness outcome (internal quotation marks omitted)). She is reminding the circuit courts that the issue has not yet been decided on the merits by the Supreme Court — a reminder quite in the spirit of “knowing ignorance.”

<sup>143</sup> To speak in terms of the figurative “duty to distinguish”: unlike disclosures, prompting does not shift the duty away from Actor 2.

<sup>144</sup> Or, as Part III discusses, Actor 2 may underestimate the incompleteness.

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underpins a hybrid solution — what we might call “plainly incomplete” disclosure — which functions like prompting and yet can affect not only the naive but also the sophisticates.

1. “*Plainly Incomplete*” Disclosures. — Avoiding the adverse inferences problem may seem to be a unique feature of a prompting approach. But could this same effect be achieved through disclosures? It might be — if the disclosures are *plainly* incomplete.

The key is for Actor 2 to know that the disclosures are incomplete. This unsettles Actor 2’s false sense of certainty. The aim, as with prompting, is for Actor 2 to be aware of the limitations of his own knowledge. Encountering the obviously deficient disclosures, Actor 2 reasons: “Surely more of these actors have licenses that I don’t know about, because the disclosures I do observe cannot be all of them.”

Up to this point, the focus has been on making disclosures *more* complete. As detailed in Part IV, this may be done by either lowering the costs or increasing the incentives for Actor 1 to disclose. Despite the seeming contradiction, the aim of increasing disclosures is compatible with — even complementary to — the incompleteness strategy suggested here. After all, the source of the problem is the *gap* between actual disclosures and Actor 2’s expectations. Why not intervene on the expectations side, too? Short of complete disclosures, one might think of an ideal policy result as causing true disclosures to be high, while Actor 2 nonetheless knows them to be incomplete.

Even though it may seem unorthodox in concept, this strategy may at times be simple in operation. The easiest case is when the disclosures are publicly provided, such as in guidances from enforcement agencies. Common statements such as “this list is not exhaustive” might suffice. It helps, moreover, if the nature of the information itself does not yield easily to a complete listing — and the observer knows it.

Illustration — Bribery. *Imagine again the hypothetical okay-to-pay list, published by the regulator, of exempt bribe recipients in a given country. Such a list would be plainly incomplete. Any observer would know there is no way that all possible legal recipients are listed. The publication need not declare “this list is not exhaustive” (though it could), as its underinclusive nature is obvious.*

When disclosures come from other actors, not the regulator, then the strategy may need to rely more on disclosures that are obviously deficient by their nature (as there may be no easy way to alert the ob-

server that “these disclosures by other actors are not exhaustive”).<sup>145</sup> A disclosure policy might yet reduce the problem of adverse inferences, for instance, if the disclosers are sure to be underreporting — and the observer knows it. More precisely, the key condition is familiar by now: for Actor 2 not to estimate Actor 1’s disclosure to be likelier than it actually is.

Obstacles and resistance to disclosure may thus be useful. Recall the compliance challenges in mandating disclosure of private permissions (such as liability releases). Unlike law-created permissions, which tend to be neutral or positive in valence, private ordering is often hidden for a reason. But this disadvantage for a simple disclosure strategy can be an advantage for a “plainly incomplete” strategy; the key is whether such a difficulty is obvious to the observer.

2. *A Strategy for the Sophisticates?* — In two related ways, this strategy of “plainly incomplete” disclosures may do better than the prompting solution alone. First, it sets a higher floor for Actor 2’s estimates, given that some disclosures are actually observed. Incomplete disclosure is still more than none at all, which is what would occur under pure prompting.<sup>146</sup> (Note that this advantage depends on the observer not “anchoring” his perceptions on the small number of incomplete disclosures that he sees.<sup>147</sup> What may work against such anchoring, again, is Actor 2’s heightened awareness that the observed permissions are incomplete.) As with prompting, the advantage over a more complete disclosure regime is that the observer knows the information is too incomplete to serve as a basis for drawing adverse inferences.

A corollary advantage is that this strategy affects not only the naive but also the sophisticated. The floor set by plainly incomplete disclosure is a lower bound for Actor 2’s estimation, whether Actor 2 started off as naive or as sophisticated. The prompting function does not affect the sophisticates, as noted above. But a higher floor does. Both groups come to share the reasoning that “obviously the disclosures I do see are only a subset; there must be more.”

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<sup>145</sup> One roundabout way might be for the regulator to exhort, “More of you need to disclose! We know you’re out there!”

<sup>146</sup> There does remain the possibility, worthy of further analysis, that a prompt might induce Actor 2 to do “homework” more than plainly incomplete disclosures would. (Note that this differential is likely smaller than that between prompting and a *simple* disclosure strategy, where the observer may not feel any need to do due diligence.)

<sup>147</sup> If it does, then the number observed could drag down Actor 2’s estimates, even as it provides a higher floor on the possible range.

## CONCLUSION

This introduction to shallow signals no doubt invites further questions. How might shallow signals accelerate the spread of *legal*, rather than illegal, behaviors? How might they lead to “overcompliance”? What if an observer guesses wrong in the other direction, thinking that others enjoy special permission when in fact they do not?<sup>148</sup> What if an observer mistakenly follows others in *not* acting, when a prohibition applies only to them? The ways that shallow signals are doubly distinct from “chilling” — different in mechanism, opposite in effect — have been emphasized;<sup>149</sup> but could these two types of externalities align and magnify each other, in some scenarios?

The range of possible variations on the basic shallow signals issue is evident here, and the core themes this Essay has introduced should provide a useful foundation for their pursuit. Foremost is the importance of attending to how the law’s design, expression, and execution can affect observers’ perceptions of the compliance behavior of others. In particular, I have emphasized the need to express the law’s permissions (not only its prohibitions) — and to do so for the sake of the observers, even if the permitted actors and the regulatory monitors already know of those permissions.

Another principal theme has been the risk of knowing just enough to make mistakes; this is the very trouble with behavioral signals that are shallow, lacking the metadata needed for correct interpretation. But this sort of risk can also accompany sources of information usually assumed to increase actors’ sophistication: regulatory guidances, by expressing too little, may leave actors unable to distinguish away behavioral precedents (think of the tax authority scenario); and, similarly, lawyers and expert intermediaries may perversely serve as vectors for the spread of shallow signals (think of the corporate misconduct scenario).

Concerning the design of potential solutions, this Essay’s emphasis here has been on sensitivity to context and to the type of observer. Where observers tend to be naive, “prompting” policies — informing them of the possibility that other actors may have permission — may do some good, whether through public provision (such as regulatory guidances) or private means (such as legal counsel). For sophisticates, the policies explored in this Essay range from the familiar (such as simple disclosures) to the less obvious (such as “borrowing boundaries” or “plainly incomplete” disclosures).

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<sup>148</sup> The “plainly incomplete” disclosures intervention suggested in Part V implicitly makes use of this possibility.

<sup>149</sup> See *supra* section II.A, pp. 2253–54.

But of course the inquiry into policy design has hardly been exhausted: What about the possibility that extra-sophisticated actors may seek, through mimicry or fraud, to make use of the legal permission or tolerance offered to others? And what about extra-naive actors who are unaware that the imitated act is legally questionable in the first place? Under what conditions should an actor be excused from liability for mistaken imitation caused by shallow signals? Should assessments of fault depend on whether the permission or prohibition is more intuitive (for instance, more aligned with moral beliefs or more familiar legal regimes)? When might it make sense to allow new norms arising from shallow signals to “feed back” into the law itself, reshaping enforcement policy or even the lines of legality?