“The Demise of the Reputational Model in Capital Markets: 
The Problem of the ‘Last Period Parasites’”

Jonathan Macey, Yale Law School

Introduction

One of the most vexing questions facing economists is why it is so hard for poor countries to develop workable strategies for escaping the pernicious and chronic cycles of poverty, corruption and structural unemployment with which they are plagued. Clearly, a large part of the answer is that nations’ prosperity is dependant on free markets, which, in turn are depend on the ability of people to trade (contract) with one another with a reasonable degree of confidence. And the ability to trade and to contract requires some sort of system that allows people both to: (a) establish recognized and stable property rights and (b) enter into reliable (predictably enforceable) contractual commitments with their counter-parties, including customers, suppliers, employees and other constituents.

In turn, societies in which promises tend to be kept, agreements tend to be enforced and property rights tend to be respected are those in which we observe high levels of trust and cooperative behavior. For example, Frances Fukuyama argues that the most important cultural characteristic influencing a nation's prosperity is the presence of trust and cooperative behavior based upon shared norms. Fukuyama observes that the U.S. Germany and Japan (the world’s top economies, at least as of the time when Fukuyama was writing) have innovative organizations and institutions that reduce transaction costs (i.e. lower the cost of doing business) by enabling people easily to enter into contractual relationships and make business deals because they can trust each other.

Fukuyama builds on Max Weber’s powerful theory that the Protestant religious admonition to treat all people (and not just members of one’s sib or family) in a morally acceptable way a great catalyst to economic growth. As Weber observed, these ethical and ascetic religious precepts led to growth by dramatically expanding the number of people who could transact one another by paving the way for cooperative economic activity to occur beyond one’s immediate kinship group.\(^2\) Fukuyama further observes that in recent years trust in the United States, as well as in Japan and Germany, has been rapidly eroding. For Fukuyama, the information economy and other technological and scientific advances have led to the rise of individualism, the diminution of community and a general decrease in the level of trust in society.\(^3\) Robert Putnam, working in a similar framework to Fukuyama, though focusing a bit more on “social networks” as the catalysts for trust, argued that such social networks were on the decline as people in places like the United States declined to participate in civic life.

Working within the general framework I wish to make two contributions to our thinking about the relationship between trust and growth. First, I want to explain the role that reputation plays in fostering the high trust environment that is critical to the successful operation of capital markets and corporate financing transactions generally. Both in theory as well as in practice, corporate finance and capital markets rely heavily on the ability of companies and other firms to develop what is known as reputational capital. For the industries on which I focus, credit rating agencies, law firms, investment banks, stock exchanges and accounting firms, reputational capital historically has been

\(^2\) Max Weber, "The Religion of China" (New York: Free Press, 1951) (The great achievement of ethical religions, above all of the ethical and asceticist sects of Protestantism, was to shatter the fetters of the sib.”) p. 237.

\(^3\) John G. Bruhn, The Sociology of Community Connections at 17-20 (commenting on Fukuyama’s views).
the primary mechanism by which businesses establish trust in markets and in contracting relationships. In my view reputation plays a far greater role than that played either by religion or social networks, which are the primary institutions upon which Fukuyama and Putnam, respectively, place their reliance.

Second, and more importantly, I argue that there has been a collapse in the market demand for reputation. It used to be the case that for a diverse array of companies and industries involved in the capital markets, nurturing and maintaining their organizations’ reputation was absolutely critical to their growth and continued success. I argue that this simply is no longer the case.

We have moved from a reputational paradigm to a parasitic paradigm. Clients of companies involved in the financial markets used to pay a premium to be able to trade with high-reputation companies, as well as with the clients of high reputation companies. And they used to refuse to deal with companies with little or no reputation. Nowadays, company reputation matters far less than it used to matter for two reasons.

First, improvements in information technology have lowered the costs of discovering information about people. This, in turn, has made it worthwhile for individuals involved in the financial markets -- lawyers, investment bankers, accountants, analysts, regulators -- to focus far more on the development of their own individual reputation rather than on the reputation of the companies for which they work.

Second, law and regulation serve as a substitute for reputational capital, at least in the minds of regulators and market participants. In modern times, particularly since the promulgation of the modern securities laws, market participants have come to rely far more on the protections of the law, and far less on the comfort provided by reputation,
when making investment decisions and in deciding whether or not to deal with a particular counter-party. The current financial crisis, in my view, demonstrates that, in reality, regulation is no substitute for reputation in assuring contractual performance and respect for property rights.

This Article consists of two parts, in addition to the introduction and conclusion. In Part I, I explain the role that reputation plays in corporate governance and capital markets generally. In the second part I discuss the erosion of the reputational model in four important contexts: (1) credit rating agencies (2) law firms and investment banks specializing in securities regulation and corporate law as applied to publicly held companies; (3) stock exchanges (particularly the New York Stock Exchange (NYSE); and (4) the largest accounting firms.

In each of these contexts my story involves important variations on a single theme. The single theme is the rise and subsequent fall of a simple economic model in which companies and firms in time period 0 find it rational (profitable) to make investments in reputational capital, and then, in time period 1 it turns out that it is no long rational to do this, so they stop. The investments in human capital that occurred early on required companies and firms to make costly commitments to being honest and trustworthy in order to compete successfully in their businesses. Concomitantly, the later decline in investment in reputational capital by such companies and firms necessarily resulted in a dramatic decline in the amount of honesty and trust in the business sectors in which these companies operate. Corporate downfalls from Enron to Madoff can, in my view, best be explained by the theory of reputational decline that is the core of this Article.
I. The Reputational Model

The reputational model I employ is very straightforward. Companies and firms find it profitable (and therefore rational) to invest money immediately in developing a reputation for honesty, integrity and probity because doing so allows the company or firm to charge higher profits, and thus earn superior returns in later periods. The theory is that resources expended to develop a strong reputation enable the firms that have developed such reputations to make credible commitments to clients and counter-parties that they are honest and reliable and therefore are desirable contracting partners.

The reputational model posits that companies and firms start their corporate lives without any reputations. This lack of reputation is of far more importance and relevance in some businesses than in others. Where the quality of the product or service being offered by a business can be evaluated accurately in a short period of time at zero cost, then reputation matters little. People are willing to buy name-brand wrapped candy or newspapers at any newsstand or kiosk because the proprietor’s reputation (or lack thereof) is largely irrelevant to a rational purchaser. A Baby Ruth candy bar or the Wall Street Journal is the same price and the same quality at every newsstand.

In contrast, the industries in which I am interested (investment banking, capital markets, accounting, law, etc) require enormous amounts of human capital to deliver their products or services. Indeed in these sectors of the economy, human capital is the only significant asset that participating businesses actually have. The physical capital necessary to conduct such businesses is trivial. In these sorts of businesses, reputation plays a very important role. In such businesses, it takes a substantial amount of time for a customer to observe the quality of the businesses’ human capital. As Morrison and
Wilhem observe in these types of businesses customers can only “observe the quality of (a businesses’ human capital) after their business relationship is well advanced. Hence they depend upon their past experiences or the partnership’s reputation to determine the fees they are willing to pay”4

In my view, however, analysis of this sort, while historically accurate, has become dated. Specifically, while it used to be the case that “loss of reputation (could) be quite costly and even fatal” to accounting firms like Arthur Andersen, law firms like Vinson and Elkins and credit rating agencies like Moody’s (all of which appear to have failed flamboyantly in protecting their reputations in the Enron scandal), I will argue that this is no longer true. While these sorts of firms once depended on their reputations to attract and retain business, many such firms no longer need to do so. Instead, clients are required to use the services of particular firms, so reputation is no longer particularly important in customer and client decisions about which firm to deal with. As such reputation is no longer an asset in which it is rational to invest heavily.

The concept of reputational risk is central to the theory and practice of modern domestic and international regulatory policy. For example, the Board of Governors of the Federal Reserve System has noted that bank regulators place great emphasis on the capacity of the regulated financial institutions to manage “reputational risk,” which it defines as “the potential that negative publicity regarding an institution’s business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.”5 This statement by the Fed, however, fails to recognize that

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5 See Board of Governors of the Federal System, Division of Banking Supervision and Regulation, Memorandum to the Officer in Charge of Supervision at Each Federal Reserve Bank, subject: “Risk-
reputational risk exists only for companies that have reputations to put at risk in the first place. Where a company has no reputation for integrity and honesty in the first place (or where it has such a reputation but doesn’t rely on it to attract and retain business), then the company cannot rationally be trusted. In my view this accurately describes the state of the world for the key industries involved in capital markets and corporate finance. These companies once operated in environments in which reputation was critical to survival. As discussed below, this is no longer the case.

II. The Decline and Fall of the Reputational Model

The purpose of this section is to illustrate several ways in which the standard historical assumption that investments in reputation are necessary for success in businesses whose products and services require what Morrison and Wilhelm describe as “the human capital-intensive production of experience goods.” Where this assumption is valid, then firm reputation serves a critical role in the economy. Rational reliance on firm reputation lowers transaction costs dramatically, thereby facilitating the development of markets and the creation of wealth. Because it is no longer as rational (profitable) as it once was for firms to invest in reputation, we must reformulate our conception of the role of reputation in corporate governance and in the regulation of capital markets. This section of the Article develops in a more granular way the point that the reputation does not play the central role in the contracting process in the capital markets that it once did.

A. Credit Rating Agencies


Morrison and Wilhelm *AER* at 1683.
Credit ratings from credit rating agencies such as Moody’s and Standard and Poors provide predictive opinions on an isolated characteristic of a company – the likelihood that the company will be able to repay its rated debt in a timely manner. Credit rating agencies attempt to downplay the role that they play in corporate governance, claiming that, because their ratings are grounded on analysis of information generated by the companies themselves, they are not in the business of searching for and exposing fraud. This claim is somewhat disingenuous. It is generally accepted that the uninformed investors who inhabit financial markets clearly rely on the ratings generated by the major credit rating agencies. Why this is the case is something of a mystery.

Moreover, as Frank Partnoy has observed, there is a great deal of evidence indicating that the product generated by the rating agencies, information, is both stale and inaccurate. The truly abominable performance of the credit rating agencies in their ratings of a whole host of debt issues, including Orange County, Mercury Finance, Pacific Gas & Electric, Enron, WorldCom, and most recently General Motors and Ford, amply illustrates the point, as do a plethora of academic studies showing that credit ratings changes lag the market.

In particular, the Enron case provides a rather illustrative example of the credit ratings’ lag behind the market.

Neither Standard & Poor’s nor Moody’s downgraded Enron’s debt below investment grade status until November 28, 2001, four days before the

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9 “Numerous academic studies have shown that ratings changes lag the market.” Id. See also, Rating Agencies and the Use of Credit Ratings Under the Securities Laws, Concept Release No. 33-8236, 68 Fed. Reg. 35258 (June 4, 2003).
firm’s bankruptcy, when the company’s share price had plunged to a paltry sixty-one cents . . . For Enron, the corporation’s $250 million in rated senior unsecured debt had declined in value from ninety cents to thirty-five cents on the dollar in the month preceding its downgrade. In other words, the market rejected the investment grade rating on Enron’s debt before the credit rating agencies exercised their power to downgrade it.10

Credit rating agencies have not lived up to their promise as important components of the corporate governance infrastructure. And, as with accounting firms, public choice theory and the economic theory of regulation provide the best explanation for the failure of credit rating in American corporate governance. Historically, companies that utilized the public markets for debt and equity utilized credit rating agencies for the same reason they utilized the services of accounting firms: they wanted their financial condition to be verified by a credible, independent source that is, by a highly reputable source. Demand for the services of rating agencies derived from the fact that companies lowered their capital costs when they subscribed to the services of credit rating agencies, and the savings from such lower capital costs were greater than the costs of the subscription fees charged by the credit rating agencies for assigning a rating to a company’s securities.

In the case of credit rating agencies, genuine demand fueled by market forces was displaced by ersatz demand fueled by regulatory requirements. This, in turn, led to the cartelization of both of these industries, as the number of accounting firms auditing large public companies dropped to four, and the number of credit rating agencies that enjoy the coveted status as SEC-sanctioned “Nationally Recognized Statistical Rating

Organizations” (NRSROs) has dropped to three. As cartelization occurred, consumers were given little, if any, choice about whether to do business with credit rating agencies and over time we observed a marked and undeniable diminution in the quality of the services provided to investors and markets.

SEC regulation, in the form of the NRSRO designation, has created an artificial demand for ratings, despite their lack of usefulness to investors. These regulations require that investors limit their investments in companies to those whose debt is rated by one of the three companies designated by the SEC as NRSROs. The SEC uses NRSRO credit ratings to determine how much capital broker-dealer firms must maintain when they hold debt securities under Rule 15c3-1 of the Securities Exchange Act of 1934 (the “Exchange Act”). The ratings of NRSROs are also used to measure the credit risk of short-term instruments in the regulation of money market funds under Rule 2a-7 of the Investment Company Act of 1940 (the “1940 Act”). Issuers of certain debt securities that receive an investment grade rating from an NRSRO are entitled to register under the Securities Act of 1933 (the “Securities Act”) on the shorter Form S-3.

11 In 1975, the SEC developed the concept of the “nationwide recognized statistical rating organization” (“NRSRO”) to identify particular companies supplying credit ratings that could be relied on by the Commission for regulatory purposes. The term “NRSRO” was originally adopted by the Commission in 1975 solely for the purposes of Rule 15c3-1. See Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Capital Requirement for Certain Brokers and Dealers, Exchange Act Release No. 11497, 40 Fed. Reg. 29795 (July 16, 1975).


13 Partnoy, supra note 26.
regulators similarly rely upon NRSRO credit ratings to protect the capital of financial institutions. Thus, many regulated financial institutions can only purchase certain types of securities if they have received an investment grade rating from an NRSRO.14

Thus, the best explanation for the puzzle that credit rating agencies simultaneously enjoy great success while providing no information of value to the investing public is that the SEC inadvertently created an artificial regulatory demand for the services of a small number of favored ratings agencies when it misguidedly invented the NRSRO designation. This designation has, over time, caused an artificial demand for ratings, despite their lack of usefulness to investors.

B. Law Firms and Investment Banks Specializing in Corporate Law and Securities Regulation for Public Company Clients

The existing general theory of law firm reputation is very simple. Law firms serve as "gatekeepers." A gatekeeper, in turn, is a reputational intermediary" whose role is “to assure investors as to the quality of the 'signal' sent by the corporate issuer" 15 As John Coffee, and many others have observed, a gatekeeper is a “repeat player” in the capital markets who enjoys both a reputation for integrity and privileged access to their clients who are issuers (i.e. companies trying to borrow money (either directly or by selling securities or by engaging in related financing transactions)).


The basic idea, of course, is that, because of their reputations, investors and other counter-parties who have never heard of and don’t trust a particular issuer have heard of and are willing to trust that issuer’s highly reputed law firm when that law firm. Therefore, high reputation law firms (and accounting firms and investment banks) “rent” their reputations to issuers, who, by hiring the law firms send a costly (costly because these law firms are, presumably, more expensive than their lower-reputation rivals).

In my view, however, the reputational model as applied to law firms is no long particularly robust for three primary reasons. These reasons are as follows.

(1) Improved information technology

First, because of improved information technology, the value of law firms’ reputational advantage in relation to their issuer-clients has declined dramatically. Whereas historically (and particularly prior to the passage of the securities laws) investors would be reassured when issuers whose names and reputations were entirely unknown to them hired iconic corporate law firms whose names and reputations were well known to them. With improved information technology, however, clients have direct access to detailed information about issuers.

(2) The Relevance of the anti-fraud provisions of the securities laws

The second and closely related point is that the passage of the securities laws, particularly the Securities Act of 1933 and the Securities and Exchange Act of 1934, not only could issuers and customers communicate more directly (thereby mitigating the historic asymmetry of information problem that created the need for law firms to serve as informational intermediaries), but issuers could credibly assert for the first time that their various claims they were making about themselves, as well as the financial information
they were reporting, were accurate because the securities laws passed in the wake of the
great stock market crash of 1929 made issuers subject to civil and criminal securities
fraud liability if there claims were untrue, or if they knowingly failed to put in clarifying
information necessary to make any information that was disclosed not misleading.

It is noteworthy that under the Securities Act of 1933, which governs the
disclosure that companies make when they sell securities to the public disclosures outside
of certain formats (i.e. outside of the formal registration statement and its associated
prospectus) are strongly discouraged. In addition, disclosures in any format (oral,
written, communicated to third parties) that are false for any reason legal disclosures,
whether as the result of intentional fraud or mere negligence result in strict liability for
the issuer, with the remedy being rescission. This means that anybody who purchases
securities from an issuer in an public offering that in which there was a misstatement of a
material fact because any person who sees or hears such disclosure and then purchases
securities in the public offering can return them to the issuer and receive the offering
price for them. Because issuers are strictly liable for material misstatements or omissions
in public offerings, without regard to whether these restatements or omissions were made
intentionally or even negligently, this reduced the demand for independent verification by
law firms and other reputational intermediaries because the issuers assertions were more
reliable.

In addition, underwriters, corporate managers, and directors also are liable for
material misstatements or omissions, as well, although they are entitled to the legal
defense known as the “due diligence” defense. The due diligence defense provides a
method for escaping liability for false or misleading statements or from omissions in
disclosure documents. If a non-issuer (recall that the issuer is strictly liable and therefore cannot take refuge in the due diligence defense) can establish that it was appropriately “diligent” in analyzing, verifying and investigating the statements made by the issuer it can avoid liability. In my view the potential liability of underwriters, corporate managers, and directors has reduced the demand for the verification function of lawyers, who charge high prices for providing this service, by imposing the legal requirement that a host of other organizations provide the service. Since customers are forced by the securities laws to pay for these verification services, it stands to reason that many of them will be unwilling to pay law firms again to perform such services.

Moreover, these provisions along with the anti-fraud provisions of the securities laws, particularly SEC Rule 10b-5, which makes it illegal to make a false or misleading statement “in connection with the purchase or sale of securities” reduce the incentives for law firms to invest in reputational capital and improve the competitive positions of firms that have not made such investments. This is because the securities laws make it easier for low reputation firms (firms that have made little or no reputation in developing reputation capital) to claim credibly that they will do a thorough and reliable job of vetting the statements made by potential issuers. The anti-fraud provisions of the securities laws enable low-reputation firms to compete with high-reputation firms because the legal liability created by the securities laws is a substitute for the reputational capital that historically was enjoyed by the venerable law firms of old. After the passage of the securities laws new firms (like the Venture Law Group, Wilson Sonsini and others) could enter the market for the first time by claiming that, even without having invested in

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developing in reputational capital, they could be trusted to refrain from associating themselves with unscrupulous clients, not because of concerns about reductions in the value of their reputational capital, but because of concerns about civil and criminal liability under the securities laws.

(3) Lawyers’ Specialization Functions

Another factor in the decline of law firms’ incentives to invest in reputation is the dramatic increase in the sophistication of client’s in-house counsels and the concomitant increase specialization of lawyers’ functions. It used to be the case, in decades past, that law firms would handle all or virtually all of the legal work for their corporate clients. The big firms would advise on banking law, corporate law, securities law, intellectual property, antitrust, commercial law, international business transactions, franchising law, employment and labor relations, contracts, torts. And of course these firms also would litigate as well as do the corporate work on behalf of their big clients. Nowadays, in-house lawyers are much more sophisticated in their selection of outside counsel. In-house lawyers develop detailed, highly textured information about individual lawyers rather than firms nowadays. This means that corporate clients no longer choose law firms so much as they choose individual lawyers to represent them in particular matters. This, in turn, means two things.

First it means that investments in law firm reputations are not as valuable as they used to be because it is the reputation of individual lawyers within firms (or perhaps departments of lawyers within firms) and not the law firms themselves that attract clients. Second, it means that, to the extent that there is still a payoff to law firms in the form of increased client demand from investing in reputation, this payoff has been reduced
because the client demand is likely to be only for the particular lawyer or legal group within the firm that has developed the reputation.

Now that the reputation of individual lawyers has replaced the reputation of law firms, the incentive for lawyers to invest in the own reputations is on the rise, and the incentive of lawyers to invest in their firms’ reputation is on the wane. Individual lawyers change firms far more often than they used to. Lawyers’ incentives to monitor their colleagues has diminished, not only because lawyers no longer have the expertise to monitor other lawyers in the firm with different specializations; but also because lawyers no longer have the incentive to do this. And of course this incentive has been reduced even further by the replacement of the general partnership which provided strong incentives for lawyers accountants and other professionals to monitor their colleagues, with the professional corporation and the limited liability partnership, which eliminate those incentives by removing the risk that lawyers who fail to monitor their colleagues will face liability.

C. The Organized stock exchanges

Organized stock exchanges, particularly the New York Stock Exchange, used to play an important role in U.S. corporate governance. To some extent the exchanges provided secondary market liquidity for the equity of companies with publicly traded securities. But as technology developed, over-the-counter trading, particularly electronic trading, became a superior, low-cost substitute for costly exchange listing. But exchanges, particularly the NYSE continued to thrive as reputational intermediaries, at least until fairly recently.
The role of the stock exchanges is easy to describe: in days gone-by when a public corporation listed on a stock exchange, that corporation was making a credible commitment to abide by a set of corporate governance rules designed to maximize shareholder wealth. The commitment was made credible by the threat of delisting, which, historically, had draconian effects on companies because of the lack of alternative trading venues for shares in public companies. Over time, however, advances in technology and the development of markets have weakened the primacy of the traditional exchanges. A whole host of competitors for the traditional stock exchanges have emerged.

Two decades ago it would have been unimaginable for companies that were eligible for listing on the New York Stock Exchange to choose a competing venue, but it is common for companies to do so today. For example, prominent companies such as Automatic Data Processing (ADP), Amazon.com, Amgen, Apple, Dell, Fifth Third Bancorp, Intel, Microsoft, News Corporation, Oracle, and Sun Microsystems, all of which easily meet the NYSE’s listing requirements, opt out of listing on the NYSE in favor of being traded on the Nasdaq stock market. There does not appear to be any reputational cost associated with this choice.

Traditionally firms moved from one trading venue to another (i.e. from the Nasdaq to the NYSE) because they had grown and viewed the move as a promotion from the over-the-counter markets which catered to start-up companies to the NYSE, which was the venue of choice for mature, successful companies. Decisions by highly successful companies, such as Google and Microsoft, to remain in the over-the-counter markets, along with the ability of firms such as Hewlett-Packard to be simultaneously
listed on both the NYSE and NASDAQ, illustrate the change in the traditional ordering and the decline of the reputational model.

The modern stock exchange is subject to vigorous competition from a variety of sources, including both rival exchanges and alternative trading venues, such as Electronic Communications Networks (ECNs) and Alternative Trading Systems (ATSs). This competition has strained the exchanges’ capacity for self-regulation and undermined their incentives to regulate in the public interest with respect to issues related to the corporate governance of their members. Moreover, the available evidence indicates the organized exchanges do not even act as stand-alone regulators anymore. There is no longer a reputational advantage associated with an exchange listing. Modern technology, the securities fraud rules, and the SEC’s unwillingness to allow exchanges any leeway in the way that different exchanges regulate listing firms all have combined to eviscerate the ability of competing trading venues, particularly the NYSE to compete by serving as a reputational intermediary for listing firms.

Instead, today all trading venues are properly understood as mere conduits for the SEC, which coordinates the corporate governance regulations that ostensibly are promulgated under the exchanges’ authority as self-regulatory organizations.17 As the Special Study on Market Structure, Listing Standards and Corporate Governance pointed out, “the SEC had adopted a practice of encouraging the exchanges ‘voluntarily’

17 The available evidence here consists largely of series of episodes in which the exchanges fail to self-regulate, often followed by a coordinated regulation led by the SEC. Self-regulation by the exchanges is in general dysfunctional in significant part because securities are often traded simultaneously in multiple venues, thus inhibiting the ability of exchanges to unilaterally enforce regulations. See Jonathan R. Macey and Maureen O’Hara, From Markets to Venues: Securities Regulation in an Evolving World, 58 Stan. L. Rev. 563, 575, 577-9 (“As a purely descriptive matter, the available evidence is inconsistent with the assertion that rival trading venues compete to produce corporate law rules. Rather, the accurate depiction of the competitive situation is that the SEC coordinates the regulatory standards of the exchanges and the Nasdaq in order to prevent competition among these trading venues from occurring at all.”).
to adopt given corporate governance listing standards and in the process has urged the exchanges’ listed companies and shareholders to reach consensus on those standards."\(^{18}\)

The SEC now coordinates the regulatory price fixing among the exchanges’ self-regulatory organizations with respect to every facet of the exchanges’ relationships with listed companies. Thus, the SEC has undermined the traditional way that exchanges competed with one another by serving as a reputational intermediary and by providing and enforcing efficient corporate governance rules and to enhance the reputations of listing firms.

A cogent example of this phenomenon is the one-share, one-vote listing requirement. During the 1980s, the managers of several firms listed on the NYSE were concerned about the possibility of a hostile takeover and wanted to adopt a particularly potent defensive strategy, which involved recapitalizing the firm with additional classes of voting stock, to be held by management, which would have significantly greater voting rights than the shares held by other shareholders. The problem with this recapitalization strategy was that it clearly violated a long-standing NYSE rule providing that all shares of common stock of listed companies could have one, and only one, vote.\(^{19}\)

The SEC was deeply concerned that several high-profile listed firms, notably General Motors Corporation and Dow Jones, Inc., wanted to engage in these so-called

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\(^{19}\) See SEC Office Of Chief Economist, Update – The Effects Of Dual-Class Recapitalizations On Shareholder Wealth: Including Evidence From 1986 And 1987, Table 1 (July 16, 1987). See also, Jeffrey N. Gordon, *Ties that bond: Dual class common stock and the problem of shareholder choice*, 76 Calif. L. Rev. 3, at 4 (1988), in which Gordon counts over 80 public firms that have “adopted, or proposed to adopt, capital structures with two classes of common stock.” In footnote 2, Gordon adds, “One recent estimate is that since 1985 the number of companies with dual classes of stock has risen from 119 to 306. *Dual Stock Categories Spur Powerful Debate Over Stability vs. Gain*, Wall Street Journal, May 17, 1988, at p. 1, col. 6."
“dual-class recapitalizations.” The NYSE was alarmed when both of these firms decided to proceed with their plans to offer dual classes of voting stock, in flagrant violation of the NYSE’s rules. For the NYSE, delisting these firms would have caused a significant loss of both prestige and revenue. But for GM and Dow Jones, the consequences would have been negligible. Delisting would have meant that shares in the two firms would have been traded in a competing forum, such as the American Stock Exchange or the NASDAQ, both of which permitted dual-class recapitalizations.

This episode illustrates the NYSE’s inability to enforce its own corporate governance rules in today’s new world of competing trading venues. Ultimately, the NYSE was forced to relax its listing requirements in order to avoid losing two of its most valuable listings. In order to avoid a recurrence of this embarrassing episode, the NYSE then petitioned the SEC to impose a uniform voting rights standard for all publicly traded firms. Although the SEC granted the NYSE’s request, the SEC’s uniform voting rights standard was ruled invalid as an impermissible extension of the Commission’s regulatory authority into the realm of corporate governance, which traditionally is the domain of the states.

D. Accounting Firms

Accounting information related to the financial condition and financial performance of companies is important for a variety of reasons. As Ted Eisenberg and I have observed previously, in theory at least, companies in the capital markets demand the services of external auditors because investors will not invest unless they can rely on a credible signal that the financial results being reported by the company are accurate.²⁰

This need is particularly acute in light of the strong incentives that managers have to misstate earnings and other indicia of financial performance:21

[A]uditors’ reputations are central to the standard economic theory of auditing. Only auditors with reputations for honesty and integrity are valuable to audit-clients. The idea is that, absent a reputation for honesty and integrity, the auditor’s verification function loses its value. In theory, then, auditors invest heavily in creating and maintaining their reputations for performing honest, high quality audits. High quality audits by independent auditors who have good reputations are assured. The quality assurance is derived from the fact that performing poor-quality audits diminishes the value of the audit firm’s investment in reputation.22

The so-called “pre-Enron” view of the accounting industry, embraced by the law and economics movement,23 predicted that accounting firms compete in a “race-to-the-top” that provides them with incentives to strive to produce high quality audits:

There was a time that the audit function was carried out in a market environment that induced high quality financial reporting. In that era, accounting firms were willing to put their seal of approval on the financial records of a client company only if the company agreed to conform to the high standards imposed by the accounting profession. Investors trusted accountants because investors knew that any accounting firm that was sloppy or corrupt could not stay in business for long. Auditors had significant incentives to ‘do superior work’ because ‘auditors with strong reputations could command a fee premium, and high fees ‘signaled quality in the auditing market.”24

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21 Thus, outside auditors do not perform any services for a company that the company does not already perform for itself. The role of the auditor is not to prepare financial reports for clients (that is the role of the accountant). Rather, the auditor’s role is to provide a reliable verification of the company’s financial reports. See generally Brian W. Mahew, Auditor Reputation Building, 39 J. ACCT. RES. 599 (2001); Brian W. Mahew, et al., The Effect of Accounting Uncertainty and Auditor Reputation on Auditor Objectivity, AUDITING J. PRAC. & THEORY, Sept. 2001 at 31; Ronald R. King, Reputation Formation for Reliable Reporting: An Experimental Investigation, 71 ACCT. REV. 375 (1996); George J. Benston, The Value of the SEC’s Accounting Disclosure Requirements, 44 ACCT. REV. 515 (1969); Ross L. Watts & Jerold L. Zimmerman, Agency Problems, Auditing, and the Theory of the Firm: Some Evidence, 26 J. L. & ECON. 613 (1983); Rick Antle, Auditor Independence, 22 J. ACCT. RES. 1 (1984); Norman Macintosh et al., Accounting as Simulacrum and Hyper-reality: Perspectives on Income and Capital, 25 ACCT., ORGS. & SOC’Y 13 (2000).
22 Eisenberg & Macey, supra note 2, at 266.
23 Id.
Audit firms had incentives to provide high quality audit services because they wanted to protect their reputation for independence and integrity.25 As Ted Eisenberg and I have observed previously, “[i]n a world in which auditors have both invested in developing high quality reputations and in which no single client represents more than a tiny fraction of total billings, high audit quality seems assured. Under these conditions, any potential gain to an auditor from performing a shoddy audit, much less from participating in a client’s fraud, would be vastly outweighed by the diminution in value to the auditor’s reputation.”26

In sum, even though companies can (and do) audit themselves, they can justify the expense of hiring outside auditors to enhance their financial reputation and credibility with a wide range of current and prospective claimants on their cash flows, including investors, suppliers, customers, and prospective employees. Under this reputational model, companies need independent audits to attract outside capital, because it is widely believed that an auditing firm that discovers a problem would insist on a correction or, ultimately, fire the client. Being fired by an accounting firm has serious implications for the client.27 In contrast, economic theory supposed that an accounting firm that dismisses an audit client, however, would, at worst, lose only that client.

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25 Independence is measured by the percentage of an audit firm’s billings that are derived from a particular client. For example, Andersen was said to be independent of Enron because Andersen had 2300 other audit clients, and Enron accounted for only about one percent of Andersen’s total revenue from auditing (Andersen’s Enron’s revenues were reported in 2001 as $100 million as compared to $9.34 billion in 2001 audit revenue). Id. at 1176, n.33. Of course, Andersen’s independence as a firm did not extend to the partners responsible for doing the actual audit work for Enron. See id. at 1168.

26 Eisenberg & Macey, supra note 2, at 267.

27 The resignation of an auditor sends a very powerful negative signal to the capital markets and can have dire consequences not only for the firm whose auditor resigns, but also for the managers of the firm. See, e.g., Martin Fackler, Drawing A Line: Unlikely Team Sets Japanese Banking on Road to Reform, WALL ST. J., Aug. 6, 2003, at A1 (describing how auditors’ failure to sign off on financial projections of a large Japanese bank caused a crisis that forced the bank to seek a $17 billion government bailout that put the financial institution under government control).
even this loss probably would likely be offset as the accounting firm might well gain new clients by virtue of the enhancement in the reputation of the accounting firm that followed from firing the client.

Thus, the “law and economics 101” approach to auditing embraced the view that, even though companies can and do impose their own financial controls and audit themselves, they hire outside auditors to capitalize on the audit firm’s reputation for probity. Hiring an auditor, under this theory, allowed the client company to “rent” the reputation of the accounting firm, which rents its reputation for care, honesty and integrity to its clients. As one observer characterized the market for auditors’ services:

> Public accountants knew they had a lot to lose if their clients’ information turned out to be false or misleading. Auditors who did a superior job would reduce the chance of their clients’ issuing unreliable information and so reduce their own risk of being sued by aggrieved investors. Such suits are costly to auditors; even unsuccessful suits damage their valuable reputations.28

Unfortunately, the theory was flawed. The basic problem is that the accounting industry is not characterized by robust competition, and investors do not trust the numbers generated by accounting firms.29 As Ted Eisenberg and I have shown, there are no detectable statistically significant distinctions among the big accounting firms with respect to quality.30 Rather, the accounting firms all perform about the same, and there simply is no way for a company to distinguish itself for probity and honesty in its

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30 Eisenberg & Macey, *supra* note 2.
accounting standards through its selection of auditors, contrary to the assumptions of economic theory.\textsuperscript{31}

There are many explanations for the decline in audit quality. These range from a decline in civil liability and changes in organizational form, which resulted in a diminution in incentives for accounting firms to monitor themselves,\textsuperscript{32} to changes in the complexity of financial transactions, which made financial reporting more difficult.\textsuperscript{33} Somewhat more controversially, the provision of consulting services by accounting firms upset the traditional balance of power between issuers and auditors, and contributed to the capture of accounting firms by their clients.\textsuperscript{34}

\begin{footnotesize}
\begin{enumerate}
\item Eisenberg & Macey, \textit{supra} note 2.
\item The shift of organizational form from the general partnership form to the Limited Liability Partnership form reduced the threat of liability faced by audit firm partners not directly involved in auditing a particular client. This, in turn, may have resulted in a diminution in the incentives of accounting firm partners to monitor the performance of their colleagues. The removal of aider and abettor liability risk reduced auditors’ incentives to monitor one another. Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (holding that Section 10(b) and SEC Rule 10b-5 prohibit only “the making of a material misstatement (or omission) or the commission of a manipulative act” and do not prohibit the aiding and abetting of such acts). This decision was thought to have alleviated substantially the legal risks to outside advisors such as auditors and lawyers. This reduction in incentives was exacerbated in 1995 by passage of the Public Securities Litigation Reform Act (PSLRA), Pub. L. No. 104-67 (codified at 15 U.S.C. § 78 (1998)). The PSLRA established new rules of pleading that require plaintiffs’ complaints to “state with particularity all facts giving rise to a strong inference that the defendant acted with the required state of mind” when making a misstatement or omission in financial reporting. The PSLRA also delayed the beginning of discovery until after a court has decided whether to allow the case to go forward on the basis of the heightened pleading standards. Prior to passage of the PSLRA, plaintiffs’ attorneys could begin to gather documents and interview witnesses as soon as their complaint was filed. PSLRA also sharply limited the doctrine of “joint and several liability,” which insures that victims can recover full damages even if one or more of the parties to the fraud cannot pay. Under PSLRA, those whose reckless misconduct contributes to the fraud can be held responsible for only their proportionate share of victims’ losses. As a result, when the primary perpetrator of the fraud is bankrupt, investors cannot fully recover their losses from other entities, such as accounting firms.
\item Auditing became more complex as new and more sophisticated methods of financing proliferated, and as the audit rules themselves became more technical and complex. As a consequence, audit firms that were engaged by large public companies found that the “audit engagement teams” they assigned to perform audits had to spend increasingly large percentages of their time performing audit services for that client. Where accounting firms also provide consulting services, accounting firms might be tempted to use auditing work either as a loss leader or “as a mechanism for ‘opening the door’ with a client for the purpose of pitching their (higher margin) consulting services.” Macey & Sale, \textit{supra} note 6, at 1178. Providing consulting services further erodes auditor independence by shifting the balance of power away from the auditor and in the direction of the audit client when auditors are discussing audit work and retention issues. Worse, consulting services provide a means by which audit clients can reward auditors for succumbing to the client’s wishes about what accounting treatment
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The point here is not simply that accounting firms have failed to distinguish themselves in their role as gate-keepers. This is well known. Rather, consistent with the theory advanced in this article, the point is that the political response to the dismal performance of auditors was not what it should have been. The political response should have been to address the real problems of capture cartelization that plagued, and continue to plague, the accounting industry. However, the response in Sarbanes-Oxley avoided addressing the real problems in the accounting industry and did nothing to improve competitive conditions or to facilitate entry into the accounting profession.

Instead, the legislation dramatically increased demand for the audit services of the four surviving, incumbent accounting firms, thereby imposing massive costs on investors without any clear concomitant benefits. A survey by the Financial Executives International (FEI), an association of top financial executives, reported in *The Economist*, found that companies paid an average of $2.4 million more for their audits in the year 2004 than they had anticipated prior to the passage of the Act (and far more than the

should be used to report novel or complex transactions and business practices. *Id.* Where auditors only offer clients audit services, the client’s only option is to fire the auditor if the client does not think that the auditor is being sufficiently aggressive or compliant. But when the accountants also are peddling consulting services, the client can employ a “carrot and stick” strategy that rewards the accounting firm for being compliant and punishes the firm for being inflexible. This pressure is particularly acute in an environment in which the firm is the only client of the engagement partner from the accounting firm that is performing the audit, since a partner’s inability to procure lucrative consulting work would be reflected in the salary, promotion, and bonuses of the partner. As John Coffee has observed, it is difficult for an audit client to fire its auditor because such dismissals invite “potential public embarrassment, public disclosure of the reason for the auditor’s dismissal or resignation, and potential SEC intervention.” John C. Coffee, Jr., *Understanding Enron: It’s About the Gatekeepers, Stupid*, 57 BUS. LAW. 1403, 1411-12 (2002). Where a company is both an audit client as well as a consulting client of a particular accounting firm, “the client can easily terminate the auditor as a consultant or reduce its use of the firm’s consulting services, in retaliation for the auditor’s intransigence.” Macey & Sale, *supra* note 6, at 1178. When the client terminates the high margin consulting services provided by the accounting firm and retains only the low margin auditing services, there is no need to make any public disclosure. This means that there is no risk that firing the auditor from a consulting engagement will provoke heightened scrutiny from investors, the SEC, or plaintiffs’ class action law firms.
statute’s designers had envisaged).\textsuperscript{35} As \textit{The Economist} observed, the statute has “provided a bonanza for accountants and auditors—a profession thought to be much at fault in the scandals that inspired the law, and which the statute sought to rein in and supervise.”\textsuperscript{36}

As the General Accounting Office (GAO) has observed, the accounting industry is not competitive, and the elimination of Arthur Andersen dramatically increased the amount of concentration in the industry.\textsuperscript{37} The GAO also noted that smaller accounting firms face “significant barriers to entry” and that “market forces are not likely to result in” new entry.\textsuperscript{38} \textit{The Economist} also observed that the four largest accounting firms (Ernst & Young, Deloitte, PricewaterhouseCoopers (PwC), and KPMG) audit 97% of all large companies in America, and that the American Electronics Association (AeA), which represents 2,500 companies and is an outspoken critic of the law, maintains that lack of competition “is significantly increasing the costs of section 404 certification.”\textsuperscript{39}

Not surprisingly, the large accounting firms are proponents of Sarbanes-Oxley, just as any firm would support legislation that allowed them to increase prices and reduce output. The chief executive of PwC has been called “an enthusiastic advocate of the new law.”\textsuperscript{40} The head of KPMG’s U.S. business unit recognizes the increase in costs associated with the statute, but asserts that such costs will fall in the future.\textsuperscript{41}

Turning to the substance of Sarbanes-Oxley, the basic problem with the relationship between auditors and their clients is that the individual auditors who

\textsuperscript{36} \textit{Id.}
\textsuperscript{37} \textit{Id.}
\textsuperscript{38} \textit{Id.}
\textsuperscript{39} \textit{Id.}
\textsuperscript{40} \textit{Id.}
\textsuperscript{41} \textit{Id.}
comprise the audit engagement teams that actually conduct the audits of public companies are highly susceptible to capture. They typically spend 100 percent of their time engaged in auditing a single firm. This problem of capture, coupled with reduced incentives to audit, was exactly what generated the problems that Arthur Andersen had in servicing its Enron account.\footnote{Macey & Sale, \textit{supra} note 6, at 1169.} Accounting is a service business, and client satisfaction is as important in accounting as it is in all service businesses. Auditors’ careers increasingly have come to depend entirely on the “care and feeding” of their solitary client. Sarbanes-Oxley did nothing to address this problem of client “capture” of their auditors. Although the legislation could possibly have solved the capture problem by requiring public companies to change the accounting firms that audit them periodically, this rather radical change was not implemented. Instead, as a sort of “compromise,” Sarbanes-Oxley requires rotation every five years of the individuals within the accounting firms actually performing the audits of large companies.\footnote{Harry S. Davis & Megan Elizabeth Murray, \textit{Corporate Responsibility and Accounting Reform}, Banking & Fin. Services Policy Report, Nov. 2002, at 1.}

This auditor rotation provision is likely to be both extremely costly and highly ineffectual. The provision will be costly because each new auditor will incur substantial billable start-up costs when she begins her new engagement every five years. The provision will be ineffectual because it will not reduce the tendency of auditors to be captured by their clients and may, in fact, exacerbate those tendencies. A new auditor that is “rotated” onto the account of an accounting firm’s client certainly will not want to receive lower ratings for client satisfaction than her predecessor. In other words, the new auditor rotation provisions may trigger a destructive “race to the bottom” among auditors of reporting companies that want to be aggressive about reporting their financial results.
Those auditors willing to use the most creative accounting techniques will receive the highest ratings for customer satisfaction.

In sum, the provisions of Sarbanes-Oxley provided demonstrable benefits for a very discrete interest group – the largest accounting firms. The benefits that the biggest accounting firms provide to investors is not at all clear, given the unreliable nature of the certifications of financial results that they provide. Nevertheless, demand for the services provided by the accounting firms remains strong, not because of market forces, but because of regulation.

The SEC’s regulations have effectively cartelized the accounting industry by requiring that large, publicly held corporations be audited by accounting firms that obtain only a small proportion of their revenues from any one client. This, in turn, means that large public companies can only be audited by very large accounting firms. In my view, this is what led to the massive consolidation that the accounting industry has experienced in recent decades. Sarbanes-Oxley has further entrenched the largest accounting firm’s regulatory cartel, without doing anything to improve the quality of the financial reporting that is of vital importance to investors and capital markets.

Using event study methodology, Ivy Xiyiing Zhang has estimated that the net private cost of Sarbanes-Oxley is $1.4 trillion,44 or about $460 for every person in the U.S. This figure, which The Economist has characterized as “astonishing,” is an econometric estimate of the loss in shareholder wealth from the statute. In other words, Professor Zhang’s study measures the direct costs of the statute to investors. Some of

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these losses undoubtedly simply are dead-weight social losses associated with the highly inefficient statute. Another significant portion of the losses, however, reflect wealth transfers from widely dispersed, politically weak shareholders to well-organized, highly concentrated interest groups, like the biggest accounting firms.

In other words, Sarbanes-Oxley, as it relates to accounting firms, appears to provide a straightforward application of George Stigler’s important insight that narrow interest groups tend to dominate the political process. Interest groups and their lobbyists and other agents interact with government officials in markets for political support. To survive in these political markets, regulators and politicians are constrained to generate results (in the form of statutes, regulations, and administrative agency action) that tend to benefit highly concentrated groups able to overcome the collective action problems of free-riding and rational ignorance, and in this way harm (through higher prices and restricted output) less well-organized groups, such as consumers, and, of course, private investors.

Conclusion

From the perspective of economic theory, the reason that companies care if they are trusted in the marketplace is because companies whose customers, counterparties, customers and suppliers trust them will, all else being equal, more profitable than companies whose constituents don’t trust them. But developing trust is not free. It’s not even particularly cheap. Rather developing trust requires a costly investment in reputational capital. In environments in which reputation matters, firms will invest in their reputations because such investments cause rational constituents, particularly

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customers, counter-parties, customers and suppliers to trust them. This is because, after having made the costly investment required to develop a good reputation, a company’s constituents know that it will be irrational for the company making such a reputation to cheat or to otherwise be dishonorable, since doing so will be irrational. Cheating for firms with good reputations that have been costly and time-consuming to develop is irrational because it results in a lower demand for the products and services of such companies, while producing only limited, short-term.

In this paper I have argued that a variety of exogenous developments, particularly the promulgation of the securities laws, but also the rise of more efficient capital markets and improved technology, are making it less rational for certain companies, particularly credit rating agencies, law firms, investment banks, stock exchanges and accounting firms to invest in (or to maintain their investments in) developing strong reputations for integrity and honesty. Rather, such organizations are likely to monetize the value of their reputations by participating in one-shot frauds and declining to invest in the external and internal controls necessary to maintain their reputations.