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THE DEMISE OF THE REPUTATIONAL MODEL IN CAPITAL MARKETS:
THE PROBLEM OF THE "LAST PERIOD PARASITES"

Jonathan Macey†

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 dependent on open and functional markets for products, services, and capital. These markets, in turn, depend on the ability of people to trade (contract) with one another with a reasonable degree of confidence. 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 counterparts, including customers, suppliers, employees and other constituents.

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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.\(^1\) Fukuyama observes that the United States, 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 to easily enter into contractual relationships and make business deals because they can trust each other.\(^2\)

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 is a great catalyst to economic growth.\(^3\) As Weber observed, these ethical and ascetic religious precepts led to growth by dramatically expanding the number of people who could transact with one another by paving the way for cooperative economic activity to occur beyond one’s immediate kinship group.\(^4\) Fukuyama further observes that in recent years, trust in the United States, as well as in Japan and Germany, has been rapidly eroding.\(^5\) 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.\(^6\) 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.\(^7\)

Working within the general framework, I wish to make two

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2. Id. at 26-31.
3. Id. at 37.
5. Fukuyama, supra note 1, at 23-32
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. Corporate finance and capital markets rely heavily on the ability of companies and other firms to develop what is known as reputational capital. This is true both in theory as well as in practice. For the industries on which I focus, credit rating agencies, law firms, investment banks, stock exchanges and accounting firms, reputational capital historically has been 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, at least in heavily regulated countries like the United States that increasingly rely on regulation rather than reputation to protect market participants from fraud and other forms of abuse. 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, at least in the U.S.

To a large extent we have moved from a reputational paradigm to what might best be described as 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. Additionally, when they would deal with companies with weak or non-existent reputations, they would proceed, if at all, with great caution and skepticism. Now, 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 three 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 Part II, 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. Part III examines the empirical implications and support for the theory presented here. One empirical implication is that we should expect firms in the financial services industry to have weak reputations relative to firms in other, less regulated industries. A second empirical implication is that financial firms in countries like the United States, which have systematic and pervasive laws and regulations for the financial services industry, locally domiciled will have weak incentives to invest in developing and maintaining their reputations. The evidence discussed in Part III of this Article is consistent with the hypothesis developed in the Article.

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 \( t \) find it rational (profitable) to make investments in reputational capital, and then, in time period \( t+1 \) it turns out that it is no longer 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 prices, 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 Wilhelm observe, in these types of businesses, customers can only “observe the quality of [a business’s] 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.”

In my view, however, analysis of this sort, while historically accurate, has become dated. Specifically, while it used to be the case that “[l]oss 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

9. Id.
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." This statement by the Fed, however, fails to recognize that 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 does not 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 analyze the standard historical assumption that investments in reputation are necessary for success in businesses that are characterized by products and services involving what Morrison and Wilhelm describe as "the human capital-intensive production of experience goods." Where a business provides services or produces products that are capital-intensive experience goods, then firm reputation providing such products or services is critical to the success, indeed to the survival of the firm. Moreover, in such cases, the ability of customers to rely on the reputation of the companies with which they are dealing 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

11. Morrison & Wilhelm, supra note 8, at 1683.
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 reputation does not play the central role in the contracting process in capital markets that it once did.

A. Credit Rating Agencies

Credit ratings from credit rating agencies such as Moody’s and Standard & Poor’s 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 firm’s bankruptcy, when the company’s share price had plunged to a paltry sixty-one cents.


14. Id. at 2 (“Numerous academic studies have shown that ratings changes lag the market . . . .”); see also Rating Agencies and the Use of Credit Ratings Under the Securities Laws, 68 Fed. Reg. 35,258 (concept release June 12, 2003).
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.15

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.16 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.17

16. In 1975, the SEC developed the concept of the “nationally 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 Uniform Net Capital Rule and an Alternative Capital Requirement for Certain Brokers and Dealers, 40 Fed. Reg. 29795 (proposed July 16, 1975) (to be codified at 17 C.F.R pt. 240).
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. Banking and other 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.

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 misguided the SEC designation. This designation has, over time, caused an artificial demand for ratings, despite their lack of usefulness to investors.

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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." 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 do not trust a particular issuer, have heard of and are willing to trust that issuer's highly reputed law firm. Therefore, high reputation law firms (and accounting firms and investment banks) "rent" their reputations to issuers.

In my view, however, the reputational model as applied to law firms is no longer 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 with 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 also issuers could credibly assert for the first time that the various claims they were making about themselves, as well as the financial information they were reporting, were accurate. 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 their 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 disclosures 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, whether as the result of intentional fraud or mere negligence, result in strict liability for the issuer, with the remedy being rescission.\(^\text{21}\) This means that anybody who purchases securities from an issuer in a public offering in which there was a misstatement of a material fact can return them to the issuer and receive the offering price for them.\(^\text{22}\) 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, although they are entitled to the legal defense known as the “due diligence” defense.\(^\text{23}\) The due diligence defense provides a method for escaping liability for false or misleading statements or from omissions in disclosure documents.\(^\text{24}\) 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

\[^{21}\text{James Spindler, Is It Time to Wind Up the Securities Act of 1933?, 29 Regulation 48, 50 (Winter 2006) (emphasis in original).}\]
\[^{22}\text{Id.}\]
\[^{23}\text{Id.}\]
\[^{24}\text{Id.}\]
investigating the statements made by the issuer, it can avoid liability.\textsuperscript{25} 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 any security,” reduce the incentives for law firms to invest in reputational capital and improve the competitive positions of firms that have not made such investments.\textsuperscript{26} 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, even without having invested in developing reputational capital, that 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 increased 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

\textsuperscript{25} Id.
\textsuperscript{26} 17 C.F.R. § 240.10b-5 (2009).
business transactions, franchising law, employment and labor relations, contracts, and torts. 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 their own reputations is on the rise, and the incentive of lawyers to invest in their firms’ reputations 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. 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 eliminates 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 NYSE, 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 has emerged.

Two decades ago, it would have been unimaginable for companies that were eligible for listing on the NYSE 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.27

Moreover, the available evidence indicates that 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 that of 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. As the Special Study on Market Structure, Listing Standards and Corporate Governance, pointed out, “the SEC had adopted a practice of encouraging exchanges ‘voluntarily’ 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.” 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.

As I have pointed out before, a powerful example of the reputational demise of the NYSE is the Exchange’s inability to enforce its most powerful rule concerning corporate governance. This was the rule requiring listed firms to limit themselves to having only one class of common stock outstanding, and to providing that class of stock with no less and no more than one vote per share of stock.

At the height of the takeover wave, when corporate managers wanted to insulate themselves from takeover, they violated this rule by

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28. The available evidence here consists largely of series of episodes in which the exchanges failed 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 & Maureen O’Hara, From Markets to Venues: Securities Regulation in an Evolving World, 58 STAN. L. REV. 563, 575, 577-79 (2005) (“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.”).

adopting so-called "dual class" capital structure. The NYSE found that when it threatened to delist major companies who violated this rule from the exchange, the companies, like General Motors and Dow Jones, Inc., responded by agreeing to delist, a result that would have imposed significantly higher costs on the NYSE than on the listed companies, because the NYSE would lose listing fees and trading revenue, while the listed companies would simply move their listings to a rival venue like the NASDAQ Stock Market.

Unable to enforce its own accounting rules, the NYSE lobbied the SEC to prevent these companies from delisting or, barring that, to require the NASDAQ to adopt a one-share-one-vote capital structure in order to eliminate the incentive to delist for companies desiring a dual class voting structure. In other words, as the Exchange began to face competition for listings, it began to lose the ability to enforce its own rules of corporate governance. This, in turn, meant that companies listing on the Exchange could no longer claim that such listing provided a credible commitment to abide by the NYSE's corporate governance rules in the future.

D. Accounting Firms

Likewise, the role of accounting firms in corporate governance has declined over time. Historically, the services of independent accounting firms was demanded by companies to perform audits in order to signal to suppliers of capital (debtors and creditors alike) that the firm was not engaged in financial fraud. Investors who did not feel that they could

30. 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 CAL. L. REV. 1, 4 (1988). Gordon counts over eighty public firms that have "adopted, or proposed to adopt, capital structures with two classes of common stock." Id. In footnote 2, Gordon adds, "[o]ne recent estimate is that since 1985 the number of companies with dual classes of stock has risen from 119 to 306." Id. at n.2; see also Linda Sandler, Class Struggle: Dual Stock Categories Spur Powerful Debate over Stability vs. Gain—Shares With Multiple Votes Annoy Corporate Raiders and Many Investors Too—If You Don’t Like It, Sell, WALL ST. J., May 17, 1988, at 1.

31. Interestingly, 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 Rick Antle, Auditor Independence, 22 J. ACCT. RES. 1 (1984); George J. Benston, The Value of the SEC's Accounting Disclosure Requirements, 44 ACCT. REV. 515 (1969); Ronald R. King, Reputation Formation for Reliable Reporting: An Experimental Investigation, 71 ACCT. REV. 375 (1996); Norman B. Macintosh et al., Accounting as Simulacrum and Hyperreality: Perspectives on Income and Capital, 25 ACCT., ORGS. & SOC'Y 13 (2000). Brian W. Mahew, Auditor Reputation Building, 39 J. ACCT. RES. 599 (2001); Brian W.
trust an issuing company felt that they could better trust the information generated by such a company if it committed to procuring audited financial statements.\textsuperscript{32} Auditor reputation is not only central to understanding why accounting firms began conducting audits from an historical perspective. In addition:

\begin{quote}
[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.\textsuperscript{33}
\end{quote}

This historical, “pre-Enron” analysis was used to explain why accounting firms had strong incentives to conduct honest audits, even in situations in which their clients preferred dishonest 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 audit work’ because ‘auditors with strong reputations could command a fee premium, and high fees ‘signaled’ quality in the auditing market.\textsuperscript{34}

In other words, audit firms had incentives to provide high quality audit services because they wanted to protect their reputation for independence and integrity.

In 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.

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\textsuperscript{33} \textit{Id.}

\textsuperscript{34} Macey & Sale, \textit{supra} note 17, at 1168.
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. 35

Thus,

[p]ublic 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. 36

This view of the economics of the accounting industry critically depends on the existence of competition among accounting firms. Accounting firms who compete do so along the vector of quality. When these firms cease to operate in a competitive environment, their incentive to produce high quality results evaporates. 37 In fact, there is no evidence that accounting firms compete on the basis of quality any longer. In this environment, when clients are selecting their accounting firms, price, and, perhaps other, more subjective factors such as personal relationships, or even malleability, will substitute for quality, to the extent that there is any competition at all. The demonstrable lack of quality differentials among accounting firms means that accounting firms no longer serve as effective gate-keepers for issuing companies. Audit firms, like the organized stock exchanges, are, therefore, ineffective corporate governance devices in the modern world. Simply put, one cannot distinguish between large public companies on the basis of the quality of the auditors they have selected. Audits have become more expensive, not because the quality of audits has improved but because competition has decreased and companies are required to purchase ever-increasing quantities of audit services in order to comply with regulatory requirements. 38

In other words, not only has regulation imposed unnecessary observable costs on industry (in the form of higher prices and restricted

35. Eisenberg & Macey, supra note 32, at 267.
38. Id.
output), regulation has also led to unfortunate unobservable costs, which come in the form of the reduced ability of companies to distinguish themselves from their creditors' on the basis of the reputations of their auditors.

III. DATA ON REPUTATION

The theory developed in this Article is that the value to financial institutions of investing in reputation declines to the extent that a regulatory system that people believe is effective is put into place. This is because reputation and regulation, both of which serve the role of providing contracting parties with some reassurance that they won’t be cheated or taken advantage of in the course of financial dealings, are substitutes for one another.

This theory has at least two empirical implications. First, as a general matter, to the extent that a particular industry, such as the financial services industry, is highly regulated, then the individual firms in that industry will have fewer incentives to invest in reputational capital. Thus, we would expect that, in general, firms in the financial services industry will have weaker reputations than firms in less regulated industries.

Second, in a country such as the United States, which has a vast and complete system of financial regulation and securities law as well as a highly vigorous enforcement regime for such laws, locally domiciled financial firms will be relatively less willing to invest in developing their reputations.

The reputation consulting firms conducted over 70,000 online interviews with the general public in thirty-two countries on six continents during the months of January and February 2009. More than 190,000 ratings were used to create what appear to be reliable measures of the corporate reputation of the 1,300 largest companies in the world. These companies represent twenty-five distinct industries.


40. Id. The data in this section of the Article is taken from surveys performed and analyzed by the Reputation Institute. The list of the world’s most reputable industries and countries is available at the Reputation Institute’s website. Reputation Institute, http://www.reputationinstitute.com (last visited Mar. 18, 2010). Reputation Institute (RI) is a private advisory and research firm headquartered in New York with representation in more than twenty countries around the world. Founded in 1997, RI is a pioneer and global leader in the field of corporate reputation management, with a mission to help companies create value from reputation. 2009 GLOBAL REPUTATION PULSE, supra note 39, at 24. RI connects
Interestingly, counter-intuitively, and consistent with the theory propounded in this Article, as a general matter, companies in emerging countries, particularly those in the so-called BRIC countries (Brazil, Russia, India and China) rank extremely high in terms of their reputations. For example, Corporate India has the best reputed companies. Of the twenty-seven Indian companies ranked among the six hundred largest in the world, almost ninety percent received scores above the global mean, with five ranking among the “Top 50.” Only the United States had more in the “Top 50” (seventeen companies), but of course, the United States has five times the number of companies on the list of large companies than India.

Further, “corporate trust [is] higher in Emerging Markets, [and] Lower in Industrialized [(i.e. relatively highly regulated)] Markets.” More specifically:

\[\text{proportionally, the largest companies in Brazil, Russia, India and China enjoy a stronger emotional connection with consumers than the largest companies in the industrialized world. . . [Moreover], [o]f the 289 companies from the US, Japan, the UK, France and Germany, 45% have reputations below the global average, while only 34% of the 142 companies from Brazil, Russia, India and China have below-average reputations, with Chinese companies dragging down the BRIC average substantially. These results highlight that large companies in emerging countries have greater success in building relevance with the general public. It also points to the challenge of redefining stakeholder interactions that many companies face in more developed markets. For example, despite significant presence on the} \]

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a global network of practitioners and academics working towards this common mission through research, analysis, and consulting. \textit{Id.} In 2009, Reputation Institute’s Global Reputation Pulse project surveyed more than sixty thousand people in thirty-two countries, to measure consumer perceptions of one thousand companies in North America, Latin America, Europe, Asia, Australia, and Africa. \textit{Id.} at 2. RI works with corporate leaders who trust RI to use its cutting-edge knowledge, international network, and experienced advisors to help develop resilient reputing strategies. \textit{Id.} at 24.


42. \textit{2009 GLOBAL REPUTATION PULSE, supra} note 39, at 5.

43. \textit{Id.} at 6.

44. \textit{Id.}

45. \textit{Id.}

46. \textit{Id.} at 5.
list (31 companies), no German company was among the global Top 50.47

With the exception of tobacco, the financial services industry is at the bottom of the list of companies in terms of reputation.48 Here below is a list of industries, ranked in order of their reputation, from highest to lowest. Not only is the financial services industry at the bottom of the list of industries when industries are ranked by reputation, but U.S. financial services firms are at the bottom of the list of firms in the financial services industry when ranked by reputation.49

To summarize the data, there are no financial institutions among the top twenty companies in the world when ranked by reputation. The highest ranked financial institution in the world on the basis of reputation is China Merchants Bank, which is ranked twenty-fourth. The next financial institution on the list is the Russian bank Sberbank, which is ranked twenty-seventh, followed by the State Bank of India at twenty-nine. The highest ranked U.S. financial institution on the list is Warren Buffett's firm, Berkshire Hathaway, which is ranked sixty-sixth. The list of major U.S. financial institutions that did not even make the list of global companies ranked by reputation is rather remarkable.50 Absent from the list are: Bank of America, Citigroup, Goldman Sachs, JP Morgan Chase, Morgan Stanley.51

CONCLUSION

From the perspective of economic theory, companies care if they are trusted in the marketplace because companies whose customers, counter-parties and suppliers trust them will—all else being equal—be 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 customers, counter-parties, and suppliers to trust them. This is because, after having made the costly investment

47. 2009 GLOBAL REPUTATION PULSE, supra note 39, at 5-6.
48. Id. at 10.
49. Id.
51. Id. at 6.
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 is irrational for firms with good reputations that have been costly and time-consuming to develop, because it results in a lower demand for the products and services of such companies, while producing only limited, short-term benefits.

In this Article 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.