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Item # 07
SEMINAR IN LAW AND ECONOMICS
Professors Louis Kaplow & Steven Shavell

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GATEKEEPERS: THE ROLE OF THE PROFESSIONS IN CORPORATE GOVERNANCE

CHAPTERS 1, 7 & 8

John Coffee

Chapter One: The Failure of the Gatekeepers

A wave of corporate scandals crested in the United States between late 2001 and the end of 2002. Hundreds of public corporations restated their financial statements, scores were sued by the SEC, and some executives were criminally prosecuted. But only two scandals became iconic in character: Enron and WorldCom. Both because they were larger in scale (resulting in the two largest bankruptcies in U.S. history[1]) and because their failures revealed a stunningly complete breakdown in all systems of internal control and external monitoring, their joint collapse within a few months of each other destabilized the capital markets, undercut the credibility of U.S. financial reporting, and provoked swift and punitive political reform.

Unlike other contemporaneous and more traditional corporate scandals – for example, Tyco, HealthSouth or Adelphia – Enron and WorldCom were not simple stories about insiders looting their corporation. Rather, Enron and WorldCom were complex financial frauds in which the primary goal was to maximize the company's stock price. Self-dealing was present, but it was not the underlying motive for misconduct. Instead, driving the principal actors in these two scandals was a fervent desire to maximize the corporation's stock price by any means necessary – sometimes by fabricating earnings, sometimes by deferring expenses, sometimes by hiding liabilities or engaging in bizarre off-balance sheet transactions. Success in this effort depended, however, upon the

[1] The size of a corporate bankruptcy is usually rated in terms of the bankrupt corporation's pre-bankruptcy assets. WorldCom, which filed for bankruptcy in July 2002, had $107 billion in such assets; Enron, which filed in December 2001, had $63 billion in pre-bankruptcy assets. By comparison, the third largest bankruptcy was Texaco in 1987, which listed only $36 billion in such assets. See Simon Romero and Riva D. Atlas, "WorldCom's Collapse: The Overview; WorldCom Files for Bankruptcy; Largest U.S. Case," N.Y. Times, July 22, 2002 at A-1.

assistance, or at least the acquiescence, of the corporation's auditors and its other professional watchdogs. Thus, the key mystery becomes: Why did the watchdogs not bark?

Because they did not, the United States' much-vaunted system of corporate governance was suddenly compromised. Red flags had not simply been missed; rather, the sentries upon whom investors relied appeared to have willfully shut their eyes. Particularly in the case of Enron, it was as if the lookouts on the Titanic had seen the iceberg – and then collectively pretended it was not there. To be sure, this collective failure involved not only the professional monitors – boards of directors, auditors, securities analysts, and credit-rating agencies – but also the most sophisticated institutional investors, who had remained heavily invested in Enron and WorldCom until within weeks of their respective bankruptcies. Much like the adults in the Hans Christian Andersen fairy tale, The Emperor's New Clothes, a tacit conspiracy seems to have arisen not to see the Emperor's nakedness, and this collective blindness continued well after the first skeptics had publicly observed that Enron was a suspect company with impenetrably complex financial statements.

That gatekeepers failed is not by itself surprising. The history of financial frauds reveals many similar failures over the last century. That gatekeepers failed en masse is probably more surprising. But truly startling is the fact that this major outburst of financial fraud in the U.S. was not paralleled by a similar epidemic in Europe over the same 2000 to 2002 period. As will be seen, there were major frauds in Europe (such as Parmalat), but they neither had the same motivation nor peaked over this period. Perplexing as this contrast may seem, it underscores a key point: there are different

characteristic types of failure by gatekeepers. Fraud against shareholders has taken a characteristically different form in Europe and other industrial economies than it has in the United States or the United Kingdom. Indeed, financial statement restatements are uncommon in Europe. If Enron is the iconic U.S. scandal, Parmalat presents the paradigmatic case for Europe, and they are very different – except for the fact that gatekeepers failed in both cases. These differences will be contrasted in Chapter 3, but, for the present, the point is that gatekeepers play different roles in different corporate governance systems.

In the wake of the Enron and WorldCom scandals, Congress re-wrote the federal securities laws, invading an area traditionally reserved for state regulation in order to pass the Sarbanes-Oxley Act in 2002. The principal intent of that legislation was to protect the integrity of financial reporting by redesigning the network of institutions and intermediaries who served investors in order that the capital markets would not be systematically deceived again. Pursuant to Sarbanes-Oxley, audit committees were strengthened, auditors subjected to a new system of quasi-public self-regulation, attorneys commanded to report crimes or fraud up-the-ladder promptly, analysts separated by a new Chinese Wall from underwriters in order to reduce the latter's influence over them, and senior corporate managers required to certify personally the accuracy of their corporation's financial results on a quarterly basis. Whether Congress got it right or wrong, whether it went too far or not far enough, remains subject to heated debate.

But this debate cannot go far until one first resolves what caused Enron, WorldCom, and a host of similar scandals. While almost everyone has a theory, the focus

has generally tended to be on the board of directors. After all, the boards of Enron and WorldCom did strange and reckless things: the Enron board waived its conflict of interest policy so that Andrew Fastow, its chief financial officer, could run special purpose entities that traded extensively with Enron, reaping secret profits running into millions of dollars in the process, and the WorldCom board extended loans and guarantees to its financially strained chief executive totaling $250 million. Reform proposals therefore have tended to concentrate on upgrading the board's independence and processes.

Yet, while board performance can no doubt be upgraded, the board of directors may be the institution least responsible for the eruption of the corporate financial irregularity that broke into the open in 2001 to 2002. Why? Boards of directors have only improved over the last 40 years, becoming gradually more proactive and independent. Because the corporate scandals of 2001-2002 represent a major discontinuity, one cannot explain a discontinuity by attributing it to an actor (i.e., the board of directors) whose performance over the same period actually improved. Rather, a truly causal account must relate a sudden failure in corporate governance to actors whose performance deteriorated over the same period. While boards did not decline in performance during the 1990s, a good case can be made that the performance of gatekeepers over this period did deteriorate.

This initial chapter will recover familiar territory. Others have dissected the collapse of Enron and WorldCom in far more lurid and colorful terms, emphasizing what was bizarre and tawdry in each's failure. This account will disdain any attempt at a journalistic expose and instead focus on the role of the gatekeepers. Why was it in each case that the board did not understand what was happening – until it was too late? This

approach does not seek to exculpate either board, but does suggest that the failure of gatekeepers, along with the active misconduct of the management in each company, better explains these two monumental failures and also similar irregularities at a host of other public U.S. companies over this period. Such a demonstration is intended to set the stage for an analysis of how gatekeepers can best be rehabilitated. The premise here should be made explicit: corporate governance does not work, nor can management be held accountable, in the absence of a system that makes gatekeepers reasonably faithful to the interests of investors.

A. The Enron House of Cards

1. Enron in Overview. Enron filed for bankruptcy on December 2, 2001 in what was then the largest bankruptcy in U.S. history. At the time of its December 2001 collapse, Enron ranked as the seventh largest company in the U.S. with over $100 billion in gross revenues and 20,000 employees worldwide.[2] Indeed, as of early 2001, Enron was by virtually any measure the most successful U.S. corporation of the prior decade. On December 31, 2000, Enron's stock was at $83.13 – a figure seventy times its earnings and six times its book value.[3] Even when the dot.com bubble burst in 2000, Enron's stock price continued to escalate, seemingly immune from market volatility and unaffected by the decline of other high-tech stocks. In 1999, Enron's stock price had appreciated 56%, but in 2000, it rose an astounding 87%, while the market index as a whole declined 10%

[2] See the Role of the Board of Directors in Enron's Collapse: Report Prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, 107th Congress, 2nd Session, Report 107-70 (July 8, 2002) (hereinafter, "The Role of the Board of Directors in Enron's Collapse") at p. 7.

[3] See Paul M. Healy and Krishna G. Palepu, The Fall of Enron, 17 J. Econ. Perspectives 3 (Spring 2003) (hereinafter, "The Fall of Enron").

for that year.[4] Contemporaneously, Enron was winning every conceivable award. For six years in a row, it was voted the "Most Innovative" corporation in America on Fortune's annual list of "Most Admired" corporations, and in February, 2001, Fortune also ranked Enron second in "quality of management" among all U.S. corporations.[5]

By the end of 2001, however, Enron had been disgraced, bankrupted and effectively shut down. Surprisingly, no exogenously caused crisis overtook Enron during 2001 – no business reversal, no regional economic downturn or panic, no huge tort liability crisis or criminal proceeding, not even any revelation that affected the public's perception of the quality of Enron's goods or services. Instead, the market simply learned that Enron incurred more liabilities and earned less profits than it had believed. These revelations placed Enron in default of its loan and debt covenants, in part because Enron was required to preserve an "investment grade" credit rating. Once it became clear that Enron could not hope to preserve that "investment grade" rating and would be in default without it, Enron's only hope lay in a hastily arranged merger with Dynergy, a much smaller competitor in its field. Although Dynergy did enter into a merger agreement with Enron on November 9, 2001, it retained the right to conduct a "due diligence" investigation of Enron. During the course of that investigation, it quickly learned enough to call off the deal on November 28, 2001. Immediately, on the same day, the major credit rating agencies responded by downgrading Enron's debt to below investment grade (or "junk bond") status. Days later, Enron filed for bankruptcy on December 2, 2001.

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[4] Id. at 3. Fortune computed Enron's 2000 performance at an 89% return. See Bethany McLean, "Is Enron Overpriced?", Fortune, March 5, 2003 at 122.

[5] See Scott Sherman, "Enron: Uncovering the Uncovered Story," Columbia Journalism Review, March-April 2002 at 22. This article recites the various awards that Enron won and the uncritical, adoring praise that it received from the business and financial press. Fortune was not alone in its idolization of Enron. Business Week listed Ken Lay, Enron's CEO, on its 2001 list of "25 Top Managers." Id.

Somehow, the credit rating agencies could not discover (or at least reveal) what Dynergy quickly found: that Enron was a house of cards.

Ultimately, Enron's gatekeepers did hold the critical power over its access to the capital markets, because Enron was able to borrow the money only so long as it maintained an "investment grade" rating. But the gatekeepers who should have discovered Enron's fatal flaws never acknowledged any awareness of Enron's problems until after Enron was forced to restate its financial statements in October, 2002. Even then, they responded only equivocally. Yet, on a fairly brief inspection, Dynergy was able to detect serious financial problems and a debt to equity ratio much higher than had been publicly disclosed, which discovery caused it to back out of the merger.[6] The difference was that Dynergy was motivated by its own self-interest to look for fraud, while Enron's gatekeepers were motivated by their own self-interest not to question too skeptically. As will be seen, this pattern persists across a host of examples.

Viewed historically, Enron's ability to exploit and manipulate accounting conventions was to a considerable degree a product of deregulation and the rapid pace of change within its industry. Founded in 1985 as the product of a merger of two natural gas pipeline companies – Houston Natural Gas and Internorth – Enron owned from its outset the largest interstate network of pipelines. As late as 1990, it remained primarily in the pipeline business. But deregulation profoundly changed that business. Deregulation of gas prices led to increased use of spot market transactions[7] and naturally produced greater volatility in gas prices. Based on the advice of Jeff Skilling, then a McKinsey consultant and later Enron's chief operating officer and briefly in 2001 its chief executive officer,

[6] See Kurt Eichenwald, CONSPIRACY OF FOOLS (2005) at 623-625.
[7] By 1990, 75 percent of gas sales between pipelines and their utility customers were conducted on a spot market basis. See The Fall of Enron at 5.

Enron decided that it could exploit this volatility because of its superior knowledge of market conditions gained as the owner of the nation's largest gas pipeline. Skilling's advice was that Enron should create a natural gas "bank" that would intermediate between suppliers and buyers of natural gas. Based on his vision of Enron as an online energy trading company, Enron began to offer utilities and other major customers long-term fixed price contracts for natural gas; it then protected itself by using financial derivatives – chiefly, swaps contracts – to hedge this risk.

This aspect of Enron's business model largely worked. It could profit from trading in the natural gas market where it had superior information. By 1992, Enron had become the largest seller of natural gas in North America, and its trading activities were the second largest contributor to its overall income.[8] Then, extending his original proposal that Enron become a trading company, Skilling proposed in the late 1990s that Enron should transform itself further by adopting what he termed an "asset light" policy. Because it received too little return on the ownership of "heavy assets" – such as pipelines or production facilities – Skilling recommended that Enron dispose of them, except to the extent that they generated useful information that informed its trading activities. His basic premise, spelled out in an October 2000 presentation to the Enron Finance Committee, was that Enron had "[l]imited cash flow to service additional debt" and "[l]imited earnings to cover dilution of additional equity."[9] Therefore, it needed to shed high-cost, low-return fixed assets in order to give Enron a less leveraged balance sheet and thereby enable it to borrow more money to pursue its online energy trading business activities.

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[8] Id. at 7.
[9] See The Role of the Board of Directors in Enron's Collapse at 7.

But there was one problem in this strategy. To shed its fixed assets, Enron had to find buyers, and many of Enron's larger fixed assets were either overvalued or otherwise unattractive to strategic buyers. Enron's solution to this problem was ultimately the cause of its downfall. If third parties could not be found to buy its assets, Enron perfected the alternative of selling those assets to itself – or, more accurately, to controlled affiliates in non-transparent transactions. As a result of an obscure accounting convention, Enron found that it could transfer its "heavy assets" off its own balance sheet by selling them to "unconsolidated affiliates," at least so long as independent financial buyers held a minimum stake (equal to at 3% of the affiliate's total debt and equity) in the "unconsolidated affiliate." As a practical matter, this meant that Enron only had to find someone to take 3% (with Enron still holding the remaining 97%) in order to camouflage its ownership. By late 2000, Enron owned and controlled for all practical purposes a total of $60 billion in assets, of which $27 billion (or 45%) were held in Enron's "unconsolidated affiliates."[10] Thus, Enron had become "asset lite," but its loss of "weight" was illusory, because it remained liable on the debt incurred to finance these "heavy assets," which debt had also been transferred (at least nominally) to the books of the "unconsolidated affiliate."

By the late 1990s, Enron had come to believe – recklessly, as it turned out – that it could profit by trading in a variety of volatile markets: energy, electricity, broadband communications, etc. Although Enron had expertise in natural gas, it proved clueless about the technical complexities of broadband where its grandiose plans never truly could be implemented (the "last mile" between the network and the consumer frustrated it and most other entrepreneurs). Thus, whatever the information advantages that Enron had

[10] Id. at 8.

with respect to energy prices, Enron appears to have known no more than other sophisticated traders in these other volatile markets. Fundamentally, its business model was flawed, and its management collectively suffered from hubris in believing that it could generalize its success in energy trading, broadly extending it to unrelated markets. Nonetheless, Enron disguised its lack of success in these other markets and postponed disaster by exploiting accounting rules and conventions, particularly in two areas where accounting rules were in transition and had never been authoritatively resolved. Using extremely aggressive interpretations of these rules, Enron was able to present only an opaque picture of its operations that hid much and revealed little.

The first of these two areas involved the accounting for long-term contracts, which contracts were the staple of Enron's trading businesses. At its simplest, Enron would enter into a long-term contract to supply a large customer with energy at a fixed price and would receive at the outset a sizable cash "prepay" or down payment. To determine Enron's profit, accounting rules required Enron to "present value" such long-term contracts – or, more specifically, to use "mark-to-market" accounting. This approach required management to forecast often speculative variables – such as energy prices or interest rates – far into the future.

Enron took to this task like a duck to water. It enthusiastically valued 20 year contracts, always estimating their net future cash flows to produce a large profit for Enron. Probably the most extreme example was a 20 year contract, entered into in July, 2000, with Blockbuster Video to develop a system of entertainment-on-demand services across a range of U.S. cities by year-end. Enron's role was to store and broadcast the entertainment on its still undeveloped broadband network. Based on only a few pilot

projects in three cities, Enron recognized profits of $110 million from the Blockbuster deal, even though it had not yet solved such technical problems as delivering broadband over the "last mile" to the consumer or gauging the level of market demand. Similarly, Enron marked to market a 15 year contract to supply electricity to Eli Lilly's Indianapolis plant, valuing the contract at over $500 million. Yet, because Enron had to estimate the present value of the costs of servicing this contract in order to book a profit and because Indiana had not yet deregulated electricity, this forced Enron to predict when, over the 15 year period, Indiana would deregulate electricity prices and what the impact would be on the costs of servicing the contract. At this point, once predictions this speculative can determine a company's current earnings, anything goes, and those inclined toward wishful thinking can report higher income than those inclined towards more conservative financial reporting.

Although the use of "mark-to-market" accounting inflated Enron's results, this practice was not the one that most misled investors or that was most responsible for Enron's downfall. That honor falls to Enron's extraordinarily aggressive use of "special purpose entities" (or "SPEs") to hide liabilities that it had incurred. SPEs are shell firms to which a parent corporation may transfers both assets and associated liabilities in order to avoid showing them on its own balance sheet. In "structured financings," SPEs are legitimately used because some of the parent's assets can be contributed to the SPE so that they are isolated from the parent's liabilities. This gives the SPE a superior credit to that of its parent and thus makes the SPE the better obligor, because, based on its superior creditworthiness, it would pay a lower interest rate. But the key attraction of SPEs to Enron had little to do with economizing on interest costs. Instead, Enron's fascination

with SPEs derived from their utility in permitting Enron to inflate its financial reporting. Because accounting rules permitted (or at least were read by Enron and its accountants to permit) a parent corporation to treat the SPE as an "unconsolidated affiliate" so long as some minimum equity investment was made by unaffiliated investors and the unaffiliated investors controlled the SPE's operations, Enron found that it could use SPEs to implement Skilling's "asset light" strategy, even though Enron could not shed its heavy assets by selling them in arm's length transactions to independent third parties.

By transferring a pipeline or a production facility to an SPE, Enron took an expensive asset off its balance sheet, along with the equally (or more) expensive debt that had financed its acquisition. Fundamentally, this enabled Enron to preserve its "investment grade" credit rating. Moreover, if the asset transfer was only to a shell firm (i.e., an SPE) that was nominally independent but still was effectively controlled by Enron, then Enron got the best of both worlds: a slimmed down balance sheet, which enabled it to borrow new funds and at a potentially lower interest rate, <u>and</u> the informational advantages about the trading conditions in the relevant market that came from its <u>de</u> <u>facto</u> control of the asset. Additionally, if the asset had deteriorated in value (as some of Enron's disastrous foreign investments had certainly done), such a transfer to an SPE was attractive for still another reason: the liabilities so transferred to the SPE exceeded the current value of the asset. To be sure, Enron remained contingently liable on these debts, because the creditors had not released Enron, but the primary obligor became the SPE.

All these transfers would have meant little if Enron had been required to consolidate its SPEs with its own financial results. In fact, neither the Securities and

Exchange Commission ("SEC") nor the Financial Accounting Standards Board ("FASB"), the two primary bodies that promulgate accounting rules in the United States, had ever definitively ruled what the minimum stakes were that the outside investors must hold in an SPE in order to justify its nonconsolidation on the parent corporation's consolidated financial statements. Instead, an advisory arm of the FASB, known as the Emerging Issues Task Force, which was largely controlled by the major accounting firms, had indicated that an investment equal to at least three percent of the SPE's total debt and equity should normally be sufficient to justify nonconsolidation. Accounting firms and the corporate bar eagerly seized on this advice and read it as a firm "3% rule."

Enron stretched these rules regarding SPEs to their limit – and beyond. Overall, it had created hundreds of SPEs by 2000, and the aggregate capital invested in these off-balance sheet SPEs appears to have been between $15 and $20 billion.[11] Extraordinarily favorable as the 3% rule was, Enron did not even comply with it, but instead violated it in a variety of ways. Even under the most liberal interpretations of these rules, independent parties had to both own a minimum 3% interest in the SPE <u>and</u> control the SPE. Yet, Enron used its own employees to run some SPEs, and sometimes the independent owners were neither truly independent nor invested the minimum three percent.

Once Enron discovered SPEs, it found that it could engage in still other transactions with these invisible affiliates. As a trading company that was active in volatile markets, Enron needed to hedge. But hedging is costly and sometimes infeasible. Thus, Enron again found an innovative solution that was strikingly short-sighted: it would hedge with itself by using its own SPEs as its hedging counterparties. To give even a colorable legitimacy to these hedges, Enron capitalized its SPEs with large blocks of

[11] See The Role of the Board of Directors in Enron's Collapse at 8.

Enron stock. But the result was an illusory hedge, because if energy prices moved adversely to Enron, it would take more and more Enron stock to provide sufficient collateral to enable the Enron SPE to fulfill its obligation to hedge Enron's risk. These transactions were known, at least in their broader outlines, to Enron's audit committee and its outside auditors, but neither appears to have expressed any serious concerns before Enron's final days.

When these irregularities were finally discovered, Enron was forced in October 2001 to disclose that it had overstated its earnings for 1996 to 2000 by some $613 million (or 23% of reported profits over this period).[12] In addition, Enron was required to restate its December 31, 2000 balance sheet so as to increase liabilities by $628 million (or about 5.5% of reported equity): similarly, it reduced equity by $1.2 billion (or roughly 10% of reported equity). This restatement was the beginning of the end for Enron.

In truth, this outcome was ironic. Enron had tripped over a technical aspect of a highly technical rule and so was placed in default on billions of dollars. If Enron had simply observed the 3% rule properly, it might have been able to continue for some indefinite further period to conceal the true extent of its liabilities. The greater fraud was not that Enron cheated on the 3% rule, but that Enron and its gatekeepers collectively rationalized that the 3% rule entitled Enron to blind its own investors to some $15 to $20 billion in off-balance sheet financings for which Enron was liable.

2. Assessing Responsibility: Who Deserves the Blame?

Crimes may have been committed at Enron, but the greater social problem lay in the stupidity it revealed. Why didn't the Enron board realize that management had

[12] See The Fall of Enron at 11.

engaged in far too many risky transactions? Why didn't Enron's auditors place some limits on its use of structured finance and SPEs to hide some $15 to $20 billion off Enron's balance sheet? Were Enron's gatekeepers – its auditors, securities analysts, and the credit-rating agencies – simply asleep? Or were they compromised by conflicts of interest?

A good starting point is to begin with the motives of Enron's management. Looking at Enron's 2001 proxy statement, one finds that within sixty days of its February 15, 2001 date, stock options covering some 12,611,385 of Enron's shares were to become exercisable by its officers and directors, including 5,285,542 by Ken Lay, its then CEO, and 824,038 by Jeff Skilling, who was soon to become its CEO.[13] All told, as of December 31, 2000, Enron had 96 million shares outstanding under stock option plans – or nearly 13 percent of all its common shares outstanding.[14] None of these options appear to have placed restrictions on the subsequent resale of the stock.

Enron was not unrepresentative in this regard, and many Silicon Valley "high tech" corporations had even higher percentages of their stock covered by stock options, sometimes as high as 20 to 25% of outstanding shares. The impact of such an option-based system of executive compensation is to focus management on the short-run. Subject to potential "insider trading" liability if the option holder clearly was aware of material non-public information, management can bail out and sell if it believes the firm's stock price is about to decline. In this light, Enron's fervent desire to show immediate earnings growth and to hide problems, liabilities, and money-losing

[13] See The Fall of Enron at 13..
[14] Id.

transactions seems a direct consequence of how its management was compensated. They were incentivized to manage for the short-term, and not surprisingly they did.

But if there is no mystery here, why didn't Enron's board or audit committee, or its auditors, or still other gatekeepers stop them? Here, the analysis becomes subtler, more complex, and more important.

1. The Audit Committee. Viewed from a distance, Enron had an exemplary audit committee with more financial expertise than virtually any contemporaneous audit committees possessed at that time. Its chair, Dr. Robert Jaedicke, was an accounting professor who had been the former Dean of Stanford Business School; other members included a CEO of the State Bank of Rio de Janeiro, the former U.K. Secretary of State of Energy, and the former Chair of the U.S. Commodities Futures Trading Commission. [15] Both the Enron board and its audit committee appear to have functioned harmoniously, held regular meetings, and kept detailed minutes, and they were well paid (indeed, at roughly $350,000 per year Enron directors were paid double the U.S. average for directors).[16]

Viewed more closely, however, there were problems. Some audit committee members had low visibility conflicts of interest. For example, Dr. John H. Mendelsohn, President of the University of Texas's M.D. Andersen Cancer Center, looked to Enron as a major benefactor for medical research. Dr. Wendy Gramm was the wife of the senior Republican Senator from Texas, Phil Gramm, who relied on Enron and its executives for

[15] For a breakdown of the Enron board and their prior backgrounds, see The Role of the Board of Directors in Enron's Collapse at 1-2 and 9.
[16] Id. at 11. The average compensation for an outside director at the top 200 U.S. corporations in 2000 was $138,747. See also Report of the Blue Ribbon Commission of the National Association of Corporate Directors (2001) at V.

campaign contributions. Still, other corporations had similar conflicts, and this does not adequately explain the audit committee's nonperformance.

Other evidence suggests that Enron's Audit Committee did very little. Enron's board normally held five regularly scheduled meetings a year, which typically lasted between one and two hours.[17] On the day of these meetings, the audit committee would also meet and, at one such meeting, in early February 2001, it considered over the course of a ninety minute meeting:

1. a report by Arthur Andersen on Enron's compliance with GAAP and internal controls;
2. a report on the adequacy of reserves and related party transactions (which, of course, covered Ken Fastow's very conflicted position at LJM);
3. a report on disclosures related to litigation risks and contingencies;
4. a report on the 2000 financial statements, which included an update on problems in the broadband division;
5. a review of the Audit and Compliance Committee Charter;
6. a report on executive and director use of the company aircraft;
7. a review of the 2001 Internal Control Audit Plan, which included a review of key business trends and risks; and
8. a review of new SEC Regulation Fair Disclosure and a review of the company's policies for communications with securities analysts in light of it.[18]

All this in less than 90 minutes is fast work indeed – and implies a superficial review.

[17] See the Role of the Board of Directors in Enron's Collapse at 9-10.
[18] See The Fall of Enron at 14.

Even better evidence of the Enron Committee's passivity is supplied by New York Times reporter, Kurt Eichenwald, in his detailed study of Enron.[19] A scandal broke at Enron in the late 1980s, when Enron's internal auditors discovered that two rogue employees, both oil traders, were embezzling funds and had far exceeded their trading limits. They prepared a detailed report, but it never reached the Enron board. Instead, senior management called off their investigation and turned the inquiry over to Arthur Andersen, which prepared a much watered down version of the original report that had not gone to the Audit Committee. This "whitewashed" version caused the Audit Committee to do little more than raise an eyebrow because it seemed to imply that all problems had been satisfactorily solved. In fact, the unauthorized trading continued and Enron later lost $85 million because of trading by these same rogue traders in excess of their authorized limits.

Such an example fits a broader pattern: the Audit Committee was regularly blinded by its professional advisers who fed it only the information that senior management wanted it to receive. In this case, Ken Lay, Enron's CEO, did not want to lose the services of two previously very profitable oil traders and so had the information reaching the committee carefully censored – and later he bluntly instructed the audit committee to essentially drop the matter.[20]

Nor was there much reason for the Audit Committee to upset this equilibrium and insist on greater rigor or more intense review. Until late in 2001, Enron appeared healthy even to its insiders. Management had been uniquely successful, and the directors faced only a remote threat of personal liability even if something did go seriously wrong. As

[19] See Kurt Eichenwald, supra note 6, at 34-37.
[20] Id. at 36-37. Lay did demote one of the officers but saved his job despite clear evidence of embezzlement and fraud.

discussed in the next Chapter, personal liability for directors and gatekeepers had largely been eliminated by the 1990s. Hence, if nothing seemed broke, the Enron Audit Committee had no incentive to fix it.

2. The Auditors: Arthur Andersen. If one cannot expect part-time outside directors, who had other pressing business responsibilities, to be skeptical in the face of unbroken success or to investigate diligently their friends and colleagues, the same cannot be said for the auditors. By definition, their job was to be skeptical. Why did they then detect so little?

In addressing this question, it is important to locate Arthur Andersen, both within the accounting profession and in terms of its own rapid transition. Today, after its indictment and dissolution, the name "Arthur Andersen" has become synonymous with accounting chicanery.[21] But as of even 2000, Andersen was near the top of its profession. Its founder, Arthur Andersen, had carefully cultivated a reputation for unbending integrity. His successor, Leonard Spacek, who took over the firm's management in the late 1940s, became the outspoken conscience of the profession for several decades and frequently criticized lax accounting standards.[22] In short, at least during an earlier era, the Andersen firm had grown and prospered by marketing itself as tougher than its peers. For example, in 1986, Andersen dropped a major, but overly aggressive, client, Lincoln Savings & Loan, because Andersen had lost confidence in the client's honesty.[23] Lincoln Savings and Loan hired then another major firm, Arthur Young, which suffered major

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[21] See Christine Earley, Kate Odabashian & Michael Willenborg, SYMPOSIUM: CRISIS IN CONFIDENCE: Corporate Governance and Professional Ethics Post-Enron: Some Thoughts on the Audit Failure at Enron, the Demise of Andersen and the Ethical Climate of Public Accounting Firms, 35 Conn. L. Rev. 1013, 1029 (2003).

[22] Id; see also Gary John Previts and Barbara Dubis Merino, A HISTORY OF ACCOUNTANCY IN THE UNTITED STATES: The Cultural Significance of Accounting (1998) at 310-311.

[23] Earley, Odabashian, & Willengborg, supra note 21, at 1018-1019.

losses when Lincoln Savings failed and Charles Keating, its CEO, became the best known symbol of the S&L meltdown of the 1980s.

Nonetheless, a transition was at work within Andersen. It was the first major auditing firm to enter into the consulting business. Beginning with work it did for General Electric in the mid-1950s, which enabled G.E. to computerize its plant payroll, Andersen developed an expertise, first, in software and computer applications, and, then, more generally, in a host of other consulting specialties.[24] By as early as 1984, well before its peers, consulting revenues had come to exceed auditing revenues at Andersen.[25] With this development, auditing firms, and Andersen in particular, refashioned their business strategy. Auditing became the portal of entry into the large client, through which the firm could market more its lucrative consulting services. The audit partner was to be retrained to become the auditor/salesman, who would be incentivized through compensation formulas that paid as much for cross-selling as for skill at auditing. While this transition affected all the major U.S. accounting firms, Andersen was the extreme example, with the largest consulting revenues on both an absolute and percentage share basis.[26] Consulting income already represented one-half of Andersen's U.S. revenues in 1990, but by 1994 it had climbed to two-thirds.[27]

The rapidness of this transition caused tensions and produced organizational strains within Andersen. As consulting became more profitable than auditing, the consultants first assumed greater authority within the firm and then objected to

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[24] Id. at 1014; see also Stephen A. Zeff, How the U.S. Accounting Profession Got Where It Is Today?: Part I, 17 Accounting Horizons 189, 194 (Sept. 2003).
[25] See John A. Byrne, "Fall From Grace," Business Week, August 12, 2002, at 53.
[26] Id.
[27] See Flynn McRoberts, et. al., "A Final Accounting: The Fall of Andersen: Greed Tarnished Golden Reputation," Chicago Tribune, September 1, 2002 at §1, p.1, 17.

subsidizing the less profitable audit operations. Only a decade or so earlier, in 1979, then Andersen CEO Harvey Kapnick had proposed that Andersen spin off consulting to avoid conflicts of interest, but he was forced to resign when the firm's partners rejected his proposal. In 1989, however, the firm gave in to the demands of its consultants and formally split accounting and consulting into separate businesses.[28] Possibly in response to the consultants' objections, Andersen cut back and fired an estimated ten percent of its partners in the United States in 1992, [29] thereby demonstrating beyond any doubt that a business culture had replaced the older professional culture. Then in 1998, Andersen established a guideline under which its audit engagement partner for a client was expected to double revenues from the client by cross-selling non-audit services.[30] To cross-sell to this extent, the audit partner arguably had to be more a salesman than a watchdog.

Despite these efforts, the consultants could not be placated at Andersen; they demanded a divorce, and the dispute ultimately resulted in an arbitrator permitting them to exit Andersen and form a new consulting firm, Accenture, in return for a $1 billion payment to the accounting side of Andersen in 2000 as the buyout price.[31] Even before this buyout, Andersen had begun to grow a new consulting division to replace the old division that had broken away to become Accenture.

The rise of consulting at Andersen may have caused another internal organizational change that directly contributed to the Enron collapse. Within Andersen,

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[28] See Earley, Odabashian and Willenborg, supra note 21, at 1022-1023.
[29] See McRoberts, et. al., supra note 27, at 16. Similar partner layoffs occurred at KPMG and Ernst & Young. See Earley, Odabashian and Willenborg, supra note 21, at 1017.
[30] See Ken Brown & Ianthe Jeanne Dugan, "Sad Account: Andersen's Fall From Grace Is a Tale of Greed and Miscues," Wall St. J., June 7, 2002, at A-1.
[31] See Earley, Odabashian and Willenborg, supra note 21, at 1023.

as in other major firms, centralized control was maintained over accounting policies and practices by an internal watchdog body known at Andersen as the Professional Standards Group. Under the leadership of Andersen's founder and his immediate successors, this group had been particularly powerful, even though it was not a profit center. Its essential role was to protect the firm as a whole from the "capture" of a local Andersen office or audit partner by a powerful client, with the result that risky accounting decisions might be approved that could result in liability being imposed on the firm as a whole. Every major firm knew that this was a danger and had such an office. But within Andersen, as the auditor ethic eroded in the 1990s and the auditor/salesman became the new model, the Professional Standards Group was downgraded in power and status. Andersen changed its policy so that local partners could overrule the national Professional Standards Group.[32] No other major firm appears to have done so. Allegedly, Andersen even marketed on this basis, telling clients that Andersen was unique in that the local partner could make a final decision and did not need the national office's approval.[33]

Andersen's Houston office appears to have ignored or overruled the accounting recommendations of the Professional Standards Group with regard to Enron on at least four occasions.[34] Even more importantly, the local Andersen Professional Standards Group representative, Carl Bass, who monitored the Enron account was re-assigned – at the insistence of Enron's Chief Accounting Officer Rick Causey, who believed Bass might interfere with Enron's use of SPEs.[35] Causey, himself, was a former Andersen

[32] See Byrne, supra note 25, at 54; Tom Fowler & Julie Mason, "Memos: Enron Muffled Auditor; Andersen Urged to Remove Critic," Houston Chronicle, April 3, 2002 at A-1. See also Earley, Odabashian and Willenborg, supra note 21, at 1023.
[33] See Mike McNamee et. al., "Out of Control at Andersen," Business Week, April 8, 2002, at 33.
[34] See Earley, Odabashian and Willenborg, supra note 21, at 1023.
[35] Id. at 1024.

partner, illustrating the revolving door relationship that had developed between auditors and their clients across the industry. Not only was Bass removed because he disapproved of Enron's risky accounting policies, but Andersen's records were falsified, to mask his disapproval. Internal memos at Andersen that described Bass's views on Enron's accounting were revised to downplay his objections and present him as concurring generally with the views of Andersen's Houston office.[36] In fairness, Andersen did resist early pressure from Enron to have Bass removed and Andersen's CEO even called high-ranking Enron officials to protest.[37] But according to New York Times reporter Kurt Eichenwald's detailed account of Enron's fall, the factor that proved decisive and caused Andersen to acquiesce in Bass's removal was not a fear that Enron would drop Andersen as its auditor, but rather the fear that "the deep-pocketed client would shift its consulting business at the drop of a hat, leaving Andersen only the low-paying audit work. That was a risk that the Andersen partners were simply unwilling to take."[38]

Still, causal responsibility for the decline in professional independence at Andersen cannot be exclusively assigned to the rise of consulting services. Andersen had other conflicts as well. In 2000, Andersen earned $25 million in audit fees and $27 million in consulting fees from Enron.[39] Even though the audit fees were less than the consulting fees, they may have meant more to Andersen's Houston office. Enron's audit fees alone accounted for 27 percent of the audit fees of public clients for Andersen's Houston office.[40] Arguably, it was too big a client for that office to lose and survive.

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[36] Id.
[37] K. Eichenwald, supra note 6, at 426.
[38] Id.
[39] See The Fall of Enron at 15.
[40] Id.

Although Enron was a uniquely large client for Andersen, size appears not to have been a necessary precondition to Andersen's acquiescence in dubious accounting policies. Throughout the 1990s, Andersen was involved in a series of notorious accounting scandals: Sunbeam in 1997, Waste Management in 1999, the Baptist Foundation of Arizona in 1999, and later Global Crossing and Qwest – plus, of course, Enron and WorldCom.[41] Just the Waste Management, Sunbeam and Baptist Foundation cases eventually cost Andersen fines and settlements of over $434 million.[42] Collectively, this rapid succession of scandals, each suggesting auditor involvement in fraud, may explain Andersen's eventual indictment for obstruction of justice in the Enron case. Assistant U.S. Attorney General Michael Chertoff, who made that decision to indict, described Andersen as a "recidivist."[43]

But was Andersen really that different than its major competitors? Some think not,[44] and there is evidence that Andersen's competitors in the then Big Five had similar rates of financial statement restatements among their large public clients.[45] Thus, the performance of the other major auditors may have been more or less equivalent, except that Andersen experienced the "mega-failures." Arguably, it could be that Andersen was simply unlucky and got caught more often. Still, the latest quantitative evidence does

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[41] For a list, see Earley, Odabashian and Willenborg, supra note 21, at 1024.

[42] In Waste Management, Andersen paid a total settlement of $107 million, including in June, 2001 a then record $7 million fine to the SEC. See U.S. v. Arthur Andersen, 374 F.3d 281 (5th Cir. 2004). In the Sunbeam case, it paid $110 million in May 2001, and finally in Baptist Foundation case, it settled for $217 million in May 2002. See Earley, Odabashian and Willenborg, supra note 21, at 1014 and n. 3.

[43] Id.

[44] Theodore Eisenberg and Jonathan Macey, Was Arthur Andersen Different? An Empirical Examination of Major Accounting Firm Audits of Large Clients, 1 J. of Empirical Studies 263 (2004).

[45] This author was the first to point out that, compared to its peer firms, Arthur Andersen had a slightly lower rate of financial statement restatements. While it audited 21% of "Big Five" audit clients, its clients experienced only 15% of the restatements experienced by "Big Five" clients between 1997 and 2001. See John Coffee, Understanding Enron: "It's About the Gatekeepers Stupid," 57 Business Lawyer 1403, 1406 n. 16 (2002). Eisenberg and Macey have more fully examined this point and confirmed it. See Eisenberg and Macey, supra note 44.

suggest that Andersen did become a lower quality auditor in the 1990s. Examining the auditees of Andersen and the surviving Big Four auditors, Ross Fuerman found that Andersen's audit clients experienced a significantly higher rate of both private and public securities litigation.[46] If one accepts his premise that more litigation about the client's financial statements suggests a lower quality audit, then Andersen does look much like a firm that deteriorated in quality during the 1990s, as its internal culture changed.

3. Securities Analysts. Even if the auditors were conflicted, one might still expect that securities analysts would warn investors because their professional reputations were dependent on predicting winners and losers in the stock market. Yet, even after Enron announced a major restatement of its financial statements in October, 2001, most analysts continued to give Enron a strong buy rating. As of October 31, 2001, Thomson First Call, which collects and tabulates analyst recommendations, found that the mean analyst recommendation for Enron was 1.9 out of a possible five, where 1 is a "strong buy" and 5 is a "sell."[47] Nor was this pattern simply the result of a sluggish response. After Enron's restatements were announced and at a time when it was desperately seeking a merger with Dynergy to survive, major broker-dealers such as Merrill Lynch and Lehman Brothers issued "buy" or "strong buy" recommendations on Enron.[48]

Again, conflicts of interest seem to explain much of this pattern. Investment banks earned more than $125 million in underwriting fees on Enron offerings over the period from 1998 to 2000.[49] One study has found that analysts working at investment banking

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[46] Ross D. Fuerman, Differentiating Between Arthur Andersen and the Surviving Big Four on the Basis of Auditor Quality: An Empirical Examination of the Decision to Criminally Prosecute Arthur Andersen, (January 2005) (SSRN Working Paper id = 639644).
[47] See The Fall of Enron at 19.
[48] Id.
[49] Id.

firms that engaged in underwriting had significantly higher estimates for Enron's likely stock price appreciation than did the analysts who did not work at investment banks.[50] But there is an anomaly in this story: analysts who worked for investment banks that did not do current business with Enron had even higher price estimates than the analysts who worked for Enron's then current investments banks.[51] Moreover, all analysts surveyed – both independent and affiliated – showed a strongly optimistic bias. Clearly, other forces were at work here besides simply the receipt of current underwriting business.

This persistent optimistic bias may seem surprising because during 2001 the first skeptical studies appeared about Enron, which suggested that its accounting was opaque and its continued earnings growth uncertain. The best known of these studies, written by Bethany McLean for Fortune, appeared in March of 2001 and was bluntly titled, "Is Enron Overpriced?"[52] The author not only suggests that it was overpriced, but quotes a variety of analysts and fund managers conceding that they found Enron's financial statements "virtually impenetrable."

But there is further reason why analysts might not respond to such warning signals. It is shown in its starkest form in the Enron story by Enron's refusal to allow its long-time investment bank, Merrill Lynch, to participate in a major (and highly lucrative) public offering of its stock until it first fired its energy market securities analyst, John

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[50] Id. at 20. Between January, 2001 and October, 2001 (when Enron announced its major restatement), analysts who worked for investment banks expected a 54 percent 12-month appreciation in Enron's stock price, while analysts who did not estimated only a 24 percent appreciation. In short, "conflicted" analysts predicted more than double the price appreciation that "unconflicted" analysts predicted.

[51] The analysts who worked for investment banks that had no current banking relations with Enron actually had higher estimates of its likely 12 month stock price appreciation (62% versus 53%) compared to the analysts who worked for its current investment banks.

[52] Bethany McLean, "Is Enron Overpriced?" Fortune, March 5, 2001, at 122. The subcaption to this article summarized its thesis succinctly: "It's in a bunch of complex businesses. Its financial statements are nearly impenetrable. So why is Enron trading at such a huge multiple?" Id. Enron fought to prevent the publication of this article and met with Fortune's editors but mainly convinced them that they were disingenuous. See Eichenwald, supra note 6, at _ (describing this visit).

Olson, who had downgraded Enron's stock.[53] Eventually, Merrill Lynch gave in and fired Olson. In short, skeptical analysts had to fear retaliation because their employers typically wanted investment banking business. Even if the issuer could not get them fired, they could threaten to exclude a "disloyal" analyst from their conference calls or from the steady stream of non-public material information that was typically leaked during this era to securities analysts.[54]

Still, even if sell-side analysts were slow to recognize that Enron was overvalued because of their multiple conflicts of interest and their fear of retaliation, why didn't the buy-side wake up? After all, the major mutual and pension funds employ their own analysts, or they hire professional money managers who do. One possibility is that some on the buy-side did detect irregularities at Enron and dumped their stock, but because buy-side research is proprietary and seldom publicly released, the buy-side analysts' discovery of fraud at Enron would not alert others. Indeed, the major institution seeking to liquidate a large and hence illiquid block of stock in Enron would be very careful not to set off alarm bells that would panic other investors. In any event, it is clear that most fund managers did not dump Enron stock until the penultimate moment. As late as October 2001, 60 percent of Enron's stock was held by the major mutual funds, including those managed by Fidelity, Vanguard, Merrill Lynch, Morgan Stanley, and Goldman Sachs.[55] These firms certainly knew that sell-side research was conflicted and should have recognized that Enron's financial statements were opaque and its portfolio of businesses very risky. Why they held Enron when it was trading at price/earnings

[53] See Eichenwald, supra note 6, at 182 to 186. His replacement at Merrill Lynch, Donato Eassey, immediately upgraded Enron (no dummy, he). Id. at 194.
[54] In response to this problem, the SEC adopted Regulation FD in late 2000 to preclude selective disclosure to analysts, in part to preserve the independence of the analyst.
[55] See The Fall of Enron at 16.

multiples as high as seventy to one (or more) seems best explained by a recurrent tendency that has been much documented: fund managers tend to herd.[56] In part, this tendency exists because fund managers and analysts find it more damaging to their careers to be individually wrong than collectively wrong. In part also, such a tendency is a corollary of a stock market bubble. That is, even if the fund manager or analyst senses that a company is overvalued based on any traditional method of valuation, it remains possible that a "bubble market" will carry the stock still higher. If the fund manager believes that the "irrational exuberance" of the market will likely carry the stock price of Enron up another 20%, then the fund manager who sells Enron will underperform the market and appear less successful than his or her competitors. As a result, capital will flow out of the fund and into the funds managed by rivals.

These explanations can account for why credible warning signals would be ignored even in the absence of clearcut conflicts of interest. Supporting this interpretation is the fact that as of October 2001, well after Jeff Skilling had resigned and other warning signals had surfaced, sixteen out of the seventeen analysts covering Enron maintained either "buy" or "strong buy" ratings on it.[57] Such a pattern seems strange when others had already determined that Enron was at the least overvalued. But this pattern can be explained on a variety of grounds: conflicts of interest, fear of retaliation, "herding," or the bubble. For any of these reasons, analysts may not give the market their unbiased, best judgment.

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[56] The term "herding" was coined in a well-known 1990 article. See David Scharfstein & Jeremy Stein, Herd Behavior and Investment, 80 Am. Econ. Rev. 465 (1990). This topic is further discussed in Chapter 6 infra.

[57] See "The Collapse of Enron: The Role Analysts Played and the Conflicts They Face: Hearings Before the Senate Committee on Governmental Affairs, 107th Congress, 2d Sess. (Feb. 27, 2002) (prepared testimony of Frank Torres, Legislative Counsel, Consumer's Union). The 17th analyst had a "hold" recommendation on Enron.

4. Attorneys. At least a partial cause of Enron's collapse was the lack of disclosure of material information about the company's activities and liabilities. Both Enron's off-balance sheet liabilities and its related-party transactions with entities controlled by Andrew Fastow, its chief financial officer, were hidden from the market. Normally, the responsibility for ensuring compliance with the corporation's disclosures under the federal securities laws falls on the corporation's attorneys.

What happened? Much attention has focused on the role of Enron's principal outside counsel, Vinson & Elkins. But most criticism of Vinson & Elkins has largely been aimed at their investigation of allegations made by Sharon Watkins, the whistleblower who first called Ken Lay's attention to Enron's accounting problems. Whatever one thinks of this investigation, it was largely a sideshow to the main drama in Enron, and Enron's collapse by this late point was probably inevitable. From a causal perspective, the more central question is who or what was responsible for the inadequate disclosures that allowed Enron to deceive the market for years? Here, the Powers Report (which was prepared by the independent directors of Enron after its bankruptcy and is universally recognized as an objective account of Enron's implosion) describes a disclosure process that was fundamentally dysfunctional.[58] Fundamentally, Enron's disclosures, particularly the most sensitive ones about its liabilities and related-party transactions, were prepared in-house and subjected to only minimal outside review by professionals. As the Powers Report concluded with regard to Enron's most suspect transactions:

[58] See William C. Powers, Jr., Raymond S. Troubh, Herbert S. Winokur, Jr., REPORT OF INVESTIGATION by the Special Investigative Committee of the Board of Directors of Enron Corporation (February 1, 2002) at 181-203.

> "[I]t appears that no one outside of Enron Global Finance, the entity principally responsible for the related-party transactions, exercised significant supervision or control over the disclosure process concerning those transactions."[59]

In short, gatekeepers were either removed from the process or given no more than a brief opportunity to comment. For example, in the case of Enron's financial statements, the critical footnotes to the financial statements were drafted within the Financial Reporting Group and circulated to others, including in-house and outside counsel. According to the Powers Report, Vinson and Elkins claimed "that they may not have seen all of the filings in advance."[60] But even when they did review proposed disclosures and objected or otherwise commented, their role was modest. Richard Causey, Enron's Chief Accounting Officer who would later be indicted in the same indictment with Ken Lay and Jeffrey Skilling, "was the final arbiter of unresolved differences among the various contributors to the financial reporting process."[61]

In the case of related-party transactions, the lawyers played a greater role, but still, because of the complexity of these disclosures, the "accountants and the lawyers relied heavily on – and generally deferred to – the officers and employees in Enron Global Finance who were closer to the transaction and actually knew the details."[62] In particular, Enron's General Counsel, James Derrick, "reviewed the final drafts to look for obvious errors, but otherwise had little involvement with the related party proxy statement disclosures."[63]

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[59] Id. at 181.
[60] Id.
[61] Id. at 182.
[62] Id.
[63] Id. at 183.

The basic picture that emerges then is one in which there was no independent gatekeeper with authority to block or even delay Enron's securities filings if the independent reviewer considered them deficient. Rather, the process was so decentralized and fragmented that in the words of the Powers Report:

> "There was no systematic procedure in place for ensuring identification of all transactions with related parties that needed to be disclosed in the financial statement footnotes or proxy statements."[64]

Given the lack of oversight, Enron management found it comparatively easy to "minimize the disclosures about the related-party transactions."[65] Of course, it is not surprising (and indeed it was predictable) that Andrew Fastow did not want to disclose his lucrative compensation in related-party transactions to anyone – not to the market, not to Jeffrey Skilling, his boss, and not to the Enron board. But as the Powers Report found, that Fastow was successful in avoiding such disclosure was attributable to "the fact that the process leading to those disclosures appears to have been driven by the officers and employees in Enron Global Finance, rather than by Senior Management with ultimate responsibility, in-house or outside counsel, or the Audit and Compliance Committee."[66]

In this light, the lack of transparency surrounding Enron seems attributable less to a gatekeeper that failed and more to the absence of any true gatekeeper in the disclosure process with real responsibility or authority. What was needed – and what was largely absent – was an independent professional – whether an attorney or an accountant – in a position to "exercise … independent judgment about the appropriateness of the company's statements."[67] The absence of such a gatekeeper was not accidental (as

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[64] Id.
[65] Id. at 201.
[66] Id. at 201-202.
[67] Id. at 202.

Enron's management did not want close oversight). But that the disclosure process could be structured so that the attorneys were placed on the sidelines, where they could comment but not block or delay an inadequate filing, seems a more structural failure that invited abuse. If there is no watchdog, it cannot bark when the thief comes in the night.

5. Credit-Rating Agencies. Until four days before Enron declared bankruptcy on December 2, 2001, its debt was rated as "investment grade" by the major credit-rating agencies.[68] This same last minute recognition of impending insolvency also characterizes the reaction of the credit-rating agencies to the downward spirals at WorldCom and Parmalat as well.

But what explains this slowness? Again, one can start with conflicts of interest. The major credit-rating agencies are paid their fees by the very companies that they rate. Although this is problematic, the conflict here is not nearly as intense as it is in the case of the auditor, because the credit-rating agency has thousands of clients, none of which pays a fee that is material to the agency. Nor are the individual raters within the rating agency as dependent upon any individual corporate client or as vulnerable to "capture" by the client, as are the audit partners of an accounting firm.

Other factors may better the apparently poor performance of credit-rating agencies – a performance that, in the case of Enron, Senator Joseph Lieberman, Chairman of the Senate Governmental Affairs Committee, characterized after his Committee's investigation of the agencies as "dismally lax."[69] One factor is pressure on the rating agency because of the devastating consequences of a rating downgrading. In early November, 2001, Moody's was approached by highly placed persons to warn it that a

[68] See Claire Hill, Regulating the Rating Agencies, 82 Wash. U. L. Q. 43, 43 (2004).
[69] Id. at 79.

downgrading of Enron below investment grade would plunge Enron into bankruptcy and disrupt the nation's capital markets.[70] This consequence followed from a downgrading because, under Enron's debt covenants, a downgrading below investment grade triggered a default. The risk that one will trigger a major bankruptcy (and possibly be sued for doing so unjustifiably) has to slow anyone down.

A still more important factor is the lack of competition in the market for credit ratings. Effectively, Moody's and Standard & Poor's share a monopoly, with only modest competition from other raters. Both are highly profitable, but may have little incentive to invest in upgrading their services because they are arguably immune from competition. As will be seen, this immunity partly stems in turn from governmental action that precludes other firms from entering this market. Hence, the absence of competition may be a greater problem than conflicts of interest in the case of this watchdog.

6. How Was Enron Discovered? This quick survey has shown that a variety of professionals failed to perform as, in theory, they should have. Conceivably, this failure could be explained by the fact that Enron was a brilliantly conceived, perfectly orchestrated fraud. But it was not. Kurt Eichenwald's account of Enron's collapse bears a simple title that says it all: "Conspiracy of Fools."[71]

Despite a soaring bull market, hero worship by an infatuated media, conflicted stock analysts, and fraudulent financial reporting, Enron's problems were detected by those who self-interest led them to study it more diligently than others. Ironically, the "hero" who discovered Enron's was not a "gatekeeper" with high reputational capital or significant exposure to liability, but instead a much more unlikely champion of the public

[70] Id. at 69 and n. 124. Allegedly, former Secretary of the Treasury Robert Rubin, then Vice Chairman of Citigroup, made such an appeal to the Under-Secretary of the Treasury.
[71] See Eichenwald, supra note 6.

interest: the short sellers. Motivated by self-interest and the expectation of high profits, they deduced that Enron had to be a house of cards and slowly spread this message to others.

Jim Chanos, a professional trader who ran Kynikos Associates, a firm that specialized in short-selling, deserves the historical credit for being the first to recognize Enron's hopelessly exposed position. Analyzing Enron's public financial statements, he decided that the company was a "hedge fund in disguise."[72] More importantly, he determined that it was earning only a very poor return for a high-risk hedge fund – a 7% return on capital.[73] This return could not justify, he realized, Enron's then valuation of six times book value. Add to this picture the hint of fraud and self-dealing created by Enron's voluminous related party transactions, and the stock seemed to him ripe for a fall.

Chanos began to short Enron in November of 2000. Yet, in January, 2001, Enron management began to predict publicly that its success at bandwidth trading would add an additional $35 to Enron's then stock price of $90 – in effect, a prediction of a $125 market price. In February, 2001, Chanos spoke at a national short-sellers' conference – known then as "Bears in Hibernation" – and made Enron one of his two leading picks for a fall. While Chanos sought to educate and convert securities analysts to his position, his real success came when he was able to convince Bethany McLean, a Fortune reporter, that Enron's financial statements raised a host of unanswered questions. Educated to Enron by Chanos, she wrote the now famous Fortune story, "Is Enron Overpriced?" that began to change the public mood towards Enron.[74] Gradually, Enron's price began to fall,

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[72] Jonathan Laing, "The Bear that Roared: How short-seller Jim Chanos helped expose Enron," Barron's, January 28, 2002 at 18.
[73] Id.
[74] See McLean, supra note 52.

and that decline accelerated when Enron's then CEO Jeff Skilling mysteriously resigned without warning in August 2001. Still, at no point was Chanos aware of the full scope of Enron's fraud, including its extraordinary off-balance sheet liabilities.[75]

Was Chanos simply lucky? The growing evidence is to the contrary. Short sellers appear to have been highly successful at predicting accounting restatements. Researchers have concluded that short sellers can often see through accounting manipulations and profit extensively from this skill.[76]

But if they can, why couldn't Arthur Andersen do the same? The critical point here is that Enron's problems were discoverable. Yet, they were not discovered by any of the firm's gatekeepers. Only those whose self-interest led them to search harder – first, the short-sellers and, later, Dynergy – discovered the truth. If the truth was discoverable and if, across the board, the professional gatekeepers did not find it, the problems with gatekeepers seem serious.

B. The WorldCom Smashup

1. Background. Even more than Enron, WorldCom was a skyrocket that soared and then plunged. Whereas Enron was a long-established and indeed dominant natural gas pipeline that sought to "morph" itself into a trading company, WorldCom started from scratch. Found on a shoestring in 1983 as a discount long-distance service provider

[75] The fullest statement of Chanos's investigation of Enron and its dubious financial statements is contained in his testimony before the House Committee on Energy and Commerce. See "Lessons Learned from Enron's Collapse: Auditing the Accounting Industry," Hearings Before the Committee on Energy and Commerce, House of Representatives, 107th Congress, 2nd Session, Serial No. 107-83 (February 6, 2002) at 71-75.

[76] See Jap Efendi, Michael R. Kinney and Edward P. Swanson, "Can Short Sllers Predict Accounting Restatements?," AAA 2005 FARS Meeting Paper, http://ssrn.com/abstract=591361 (2005). These authors used a sample of 565 firms with restatement disclosures, matched them with a control group of firms not announcing a restatement, and compared the level of the short interest. They concluded that the shorts were able to predict and profit from their anticipation of a restatement.

(then known as LDDS – "Long-Distance Discount Service"), it grew rapidly through a series of mergers, culminating in its 1998 $40-billion merger with MCI Communications Corp. Much of the key to WorldCom's success was its apparent efficiency, which baffled its major rivals, AT&T and Sprint. Somehow WorldCom consistently reported a lower ratio of certain key expenses, known as "line costs," to its overall revenues than did any of its competitors.[77] "Line costs" are essentially transmission costs paid to other service providers for the use or the right to use their lines. Line costs were WorldCom's largest single expense and accounted for roughly half of its expenses. They were sufficiently material that they were reported on a separate line of its financial statements.[78] This apparent efficiency impressed Wall Street and kept WorldCom's stock price high, allowing it to acquire seemingly less efficient rivals in a rapidly consolidating industry.

But while impressive, WorldCom's low ratio of line costs to revenues was largely illusory. Ultimately, the key fraud in WorldCom involved the decision of Scott Sullivan, WorldCom's chief financial officer, to cease expensing line costs and instead capitalize them – in order to keep the ratio of line costs to revenues low. But to capitalize a payment made to rival companies for use of their lines and facilities amounts to a mortal sin for accountants. When one capitalizes a payment, one is in effect creating an asset (which will be depreciated at a much slower rate, thereby reducing the current charge to earnings). But no legitimate asset arises out of the payment of such an expense. To see this, imagine an ordinary tenant making a monthly lease payment and seeking to capitalize this payment as if the tenant had acquired an asset by virtue of the payment. In

[77] WorldCom's ratio of line costs to revenues was 43%, whereas AT&T's equivalent ratio appears to have been 46.8% and Sprint's was 53.8%. See In re WorldCom Securities Litig., 2004 U.S. Dist. LEXIS 25155 at *137 n. 47.

[78] These facts are summarized in In re WorldCom Securities Litig., 2004 U.S. Dist. LEXIS 25155 (S.D.N.Y. Dec. 15, 2004) at *19 to *20.

fact, the tenant has acquired nothing and will be forced to move out at the end of the lease. Similarly, WorldCom acquired nothing and was not entitled to capitalize these line costs payments because no colorable asset had been acquired as a result of them.

When WorldCom reported its discovery in June of 2002 that line costs payments had been improperly capitalized, it acknowledged that but for the capitalization of over $3.8 billion in such costs in 2001 and the first quarter of 2002, it would have reported a loss for such periods.[79] Within a month, it was forced into bankruptcy.

Grossly improper as the capitalization of line costs was, it was not the first or the only irregularity in WorldCom's financial statements relating to recognition of expenses. In fact, when a full restatement of WorldCom's financial statements was completed in 2004, some $76 billion in adjustments were recognized, which reduced WorldCom's net equity from approximately $50 billion to approximately minus $20 billion.[80] The point then is that the WorldCom fraud was not a one-shot transaction engaged in by a reckless chief financial officer. Rather, as the federal court hearing the private securities litigation concerning WorldCom has found:

> "Before capitalizing the line costs in 2001, WorldCom had engaged in other strategies to reduce the apparent magnitude of its line costs."[81]

This is important because if the fraud at WorldCom had been limited to a single occasion, it would be hard to fault WorldCom's gatekeepers, and all the blame would fall on its chief financial officer and his staff. But, in fact, as this court further found, WorldCom

[79] Id. at *6.
[80] Id.
[81] Id. at *21.

had cheated earlier, releasing "reserves or accruals that had been set aside to cover anticipated costs, and used them to offset line costs."[82]

In short, in a rapidly consolidating industry, WorldCom was able to acquire rival long-distance service providers, rather than be acquired by them, because it manipulated its reporting of expenses to give it the image of greater efficiency and thereby inflate its stock price.

But why was WorldCom so willing to take these risks and use an accounting treatment that was not even colorably defensible? Here, it is necessary to introduce WorldCom's chief executive, and controlling person, Bernhard Ebbers. Ebbers became WorldCom's chief executive virtually at its outset in 1985 and as a result owned a significant percentage of the company's stock. A true believer in WorldCom, he never diversified his portfolio by selling significant amounts of his WorldCom stock. Rather, most of his wealth remained in WorldCom, and his personal net worth rose and fell with WorldCom's stock price. However, Ebbers did invest heavily in a variety of other private and illiquid enterprises. He did so by pledging all his WorldCom stock to secure loans that he used to acquire private businesses and fund their operations. Most of the loans to Ebbers were made by affiliates of Citicorp and Bank of America, each of whom were also major underwriters.

As a result, when WorldCom's stock price began to fall in 2000, Ebbers faced a personal crisis. Because his WorldCom stock was pledged to secure loans to him, and because the value of this collateral had just shrunk, Ebbers received a margin call from Bank of America in the Fall of 2000. Having no additional shares to pledge, he would be forced to sell his WorldCom stock in significant quantities, which in turn would drive

[82] Id.

WorldCom's price down even further – unless he could obtain financing elsewhere. He solved his predicament (at least temporarily) by convincing the WorldCom board of directors to extend him a $50 million loan in September, 2000. The board's decision has been widely criticized as irresponsible, but the board evidently felt that equivalent sales by Ebbers would cause WorldCom's stock price to crater.

In a sense, they were right. When Ebbers was faced with additional margin calls later in 2000, and when the WorldCom board refused to extend further loans to him, he sold some three million WorldCom shares, and WorldCom's stock price dropped 8 percent on the disclosure of his sales.[83] Following this decline and additional margin calls on Ebbers, the WorldCom board was induced to make additional loans and guarantees to Ebbers, which by May, 2001 had reach a grand total of $250 million.[84]

Thus, throughout 2000 and 2001, Ebbers could simply not afford to have WorldCom fail to make its predicted earnings or to lower substantially its earnings forecasts – for fear that its stock price would decline and trigger additional margin calls. Nor could he sell much WorldCom stock, as the market would perceive that to be a bail-out and would drop the price faster than he could unload his stock. His position was simply desperate.

Small wonder then that WorldCom's financial reporting was manipulated. But if the motive for fraud was clear, the question again arises: where were the gatekeepers? After all, far more than Enron, WorldCom was widely recognized to be a high risk client. Its meteoric rise from obscurity through merger after merger fits exactly the profile of a

[83] Id. at *17.
[84] Id at *18.

company whose financial statements may conceal more than they reveal. And Arthur Andersen so recognized, internally assigning WorldCom its highest risk rating.[85]

B. Assessing Responsibility: Who Deserves the Blame?

Although much less has been written about WorldCom than Enron, some detailed internal studies are available. A special committee of independent directors of WorldCom, assisted by the same outside law firm that drafted the Powers Report for Enron, produced an elaborate study of what had gone wrong,[86] and the WorldCom bankruptcy court appointed, as its Examiner, former U.S. Attorney General and Pennsylvania Governor Richard Thornburgh, who prepared a series of detailed and lengthy reports.[87] To be sure, a bankruptcy examiner is an advocate who typically seeks to frame the case for liability against those who might be induced to contribute to the bankrupt estate. But the facts in the Thornburgh reports tend to speak for themselves.

1. The Investment Banks. Even more than Enron, WorldCom was a money machine for the major investment banks because it made large and more frequent offerings to finance its acquisitions and expansion. Between 1997 and 2002, Salomon Smith Barney ("SSB") was WorldCom's principal investment bank and received more than $116 million in underwriting and investment banking fees as a result of WorldCom

[85] Andersen's audit team gave WorldCom its highest risk rating, recognizing that "there was a 'significant' risk of misstatements in the WorldCom financial statements…." See In re WorldCom Sec. Litig., 2005 U.S. Dist. LEXIS 710, (S.D.N.Y. January 18, 2005).

[86] The committee of independent directors at WorldCom also included a former U.S. Attorney General (Nicholas Katzenbach) and was counseled by Wilmer, Cutler and Pickering (counsel to the Powers Committee) and assisted by PricewaterhouseCoopers. See Dennis R. Beresford, Nicholas deB. Katzenbach and C.B. Rogers, REPORT OF INVESTIGATION By The Special Investigative Committee of the Board of Directors of WorldCom, Inc. (March 31, 2003) (hereinafter, "WorldCom Special Committee Report").

[87] See Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner, January 26, 2004, in In re WorldCom Inc, Chp. 11, Case No. 02-13533 (S.D.N.Y. 2004) (hereinafter, "Bankruptcy Final Report").

transactions.[88] SSB won and held WorldCom's business by a variety of means, some of which look much like commercial bribery. Specifically, from June 1996 to November 1997, SSB allocated over 748,000 shares in initial public offerings to Mr. Ebbers, on which he realized gross profits of about $11 million.[89] This practice – known as "spinning" in the industry – paid off for SSB, as over the same interval, it was engaged by WorldCom on four engagements on which it received fees of roughly $65 million.[90] Mr. Thornburgh, the bankruptcy examiner, concluded that, in view of all the related circumstances surrounding these stock allocations in "hot" offerings, "they were intended to, and did influence, Mr. Ebbers' decision to hire and to continue to hire Salomon … as WorldCom's lead investment banker."[91]

SSB's cozy relationship with Ebbers is important for two distinct reasons. First, as underwriter for WorldCom's offerings, SSB bore statutory liability as a gatekeeper. Under the Securities Act of 1933, the underwriter must conduct a "reasonable investigation" of the statements made by the issuer in its registration statement when the issuer "registers" securities for public sale. Ultimately, SSB and its parent Citigroup would settle its liabilities under these provisions for a near record $2.575 billion settlement – the second largest securities class action settlement.[92] Yet, despite this risk, SSB proved to be a passive gatekeeper who made no more than perfunctory efforts to

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[88] See Final Report at 137-140. The number $116 million is the result of adding the acquisition fees and underwriting fees received by SSB that were listed on these pages. Additional fees of over $37.5 million were scheduled to be paid by WorldCom to SSB, but were forfeited when several large acquisitions were called off because of antitrust problems (e.g. Sprint and Nextel). Thus, on an ongoing basis, SSB had an even greater anticipated interest in WorldCom.
[89] Id. at 140.
[90] Id.
[91] Id. at 141.
[92] See In re WorldCom Sec. Litig., 2004 U.S. Dist. LEXIS 22992 (S.D.N.Y. Nov. 12, 2004).

conduct "due diligence" investigations of WorldCom during the two major debt offerings that it underwrote for WorldCom in 2000 and 2001.[93]

Second, SSB was the market's principal source of information about WorldCom, because SSB employed a securities analyst, Jack Grubman, who had become the recognized guru of the telecommunications industry and who quickly became a fervent cheerleader for WorldCom. Indeed, Grubman went well beyond performing simply as a securities analyst and also served as an investment banker and adviser to WorldCom, attending board meetings and acquiring material, non-public information. In so doing, he became the poster boy for reformers who were indignant at the conflicts of interest surrounding securities research. But Grubman cannot be viewed in isolation; he was the employee of an investment banking firm willing to go to great lengths to land and hold a very lucrative client.

2. The Auditors. Both the Bankruptcy Examiner and the Special Committee of WorldCom directors found that WorldCom's auditor, which once again was Arthur Andersen, committed professional malpractice in performing WorldCom's audit work.[94] Although the examiner (Richard Thornburgh) recognized that WorldCom management had "deceived" Andersen "on a number of occasions," he still concluded that "Andersen failed to incorporate in its audits the needed testing of the areas where the fraud occurred,

[93] See text and notes infra at notes 113 to 121.

[94] Bankruptcy Final Report at 19 ("The Examiner concludes that Arthur Andersen committed professional malpractice by negligently failing to carry out the kinds of substantive tests that were warranted by the risks of fraud and material misstatements Arthur Andersen identified, as well as by the existence of a number of 'red flags' relating to the company's accounting practices.") The WorldCom Special Committee Report acknowledges that Andersen was deceived by WorldCom personnel but still asserts that Andersen was negligent. See WorldCom Special Committee Report at 25-26.

such as the 'top-side' adjustments directed by former senior Management outside of the Company's normal processes for recording revenues and expenses."[95]

The post-mortem report by the WorldCom Committee of independent directors reached a similar conclusion that "Andersen's audit approach … limited the likelihood it would detect the accounting irregularities."[96] That "approach," in their view

> "focused heavily on identifying risks and assessing whether the Company had adequate controls in place to mitigate those risks, rather than emphasizing the traditional substantive testing of information maintained in accounting records and financial statements."[97]

This approach allowed Andersen to rely on WorldCom's "controls without adequately determining that they were worthy of reliance…."[98] Of course, that is precisely the way that a gatekeeper seeking to ingratiate itself with a lucrative client in order to market other services would be likely to behave. One does not undiplomatically challenge or test the client's assertions. But the irony seems obvious: Anderson internally rated WorldCom as a client of the highest risk, yet felt it unnecessary to test the information in WorldCom's accounting records because Andersen deemed WorldCom's accounting controls adequate.

To be sure, these critical assessments may seem self-interested because they are from those who have an interest in holding Andersen liable to the WorldCom estate. But their basic conclusions have also been echoed by the federal district court hearing the private securities litigation over WorldCom, which Court refused to grant summary

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[95] See Bankruptcy Final Report at 19.
[96] See WorldCom Special Committee Report at 25.
[97] Id. at 26.
[98] Id. In addition, this report specifically found that "Andersen does not appear to have performed adequate testing to justify reliance on WorldCom's controls." Id.

judgment to Andersen given the "red flags" surrounding its audit work.[99] In her January 2005 decision, United States District Judge Denise Cote found that, although WorldCom had concealed its clearly fraudulent decision to capitalize line costs from Andersen, plaintiffs had shown sufficient evidence to justify a trial because "Andersen appreciated at some level the risk of fraud at WorldCom but did not take adequate steps to detect fraud."[100] In particular, Andersen's internal records showed, she found, that its audit team was concerned about "management pressures, specifically [WorldCom's] desire to 'maintain a stock valuation in anticipation of a security offering or a merger.'"[101]

Ironically, in June 2001, just after WorldCom had begun to capitalize its line costs, Andersen's audit team in preparation for its annual audit held a brainstorming session "to create a list of how management, assuming it were corrupt, could intentionally manipulate financial statements and conceal it from Andersen."[102] Their conclusion: WorldCom could use "the improper capitalization of expenses as fixed assets and top-side journal entries" to conceal it.[103] This was prophetic, but Andersen, having figured out how the fraud could be perpetrated, did not audit for the very scenario that it recognized could occur.[104] As the Court concluded:

> "Without performing this analysis, there was no assurance that the financial statements that were being certified came from the books and records that had been audited."[105]

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[99] See In re WorldCom Sec. Litig., 2005 U.S. Dist. LEXIS 710 (S.D.N.Y. January 18, 2005).
[100] Id. at *26.
[101] Id.
[102] Id.
[103] Id. at 27.
[104] "Andersen last checked for top-side adjustments in 1999, and found none, or at least no questionable adjustments." Id. Thereafter, Andersen "simply accepted management's oral representations that no such adjustments had been made." Id.
[105] Id. at *27 to *28.

So why didn't Arthur Andersen look deeper given the potential for fraud that it clearly recognized? Any answer is speculative, but the Bankruptcy Examiner's conclusion deserves at least serious attention. Mr. Thornburgh proposed that

> "a likely reason [for Andersen's failure to detect fraud] was Arthur Andersen's overriding desire to grow its non-audit business relationship with WorldCom. Consistent with such a desire, it would be natural for Arthur Andersen to wish to trust the representations of … management rather than press for an increase in corroborating documentation, which could strain the business relationship by increasing the amount of time and fees that may be incurred for the audit."[106]

In short, no one asserts that Andersen knew of Scott Sullivan's fraud, but in a world in which clients needed to be stroked (and not offended) if they were to expand their non-audit consulting relationships, a skeptical attitude and propensity to look behind management's representations was poor marketing. Indeed, after reviewing the email correspondence between Andersen's principal audit partner and Scott Sullivan, Mr. Thornburgh found that:

> "Much of the email correspondence … appears to relate to potential opportunities for Arthur Andersen to provide consulting services to WorldCom and its subsidiaries."[107]

If the audit partner was focused on marketing, this "may have served," as Thornburgh concluded, "to minimize the importance of … incidents … [that Andersen failed to see were] 'red flags.'"[108]

3. Securities Analysts. As noted earlier, WorldCom's leading analyst was Jack Grubman, SSB's expert on telecommunications and a media star of the late 1990s. The

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[106] Bankruptcy Final Report at 345. Andersen had a specific goal for its non-audit business with WorldCom and the audit team was aware of, and discusses, that goal of achieving net fees (both audit and non-audit) of $18.5 million by 2001. Id. at 346. In fact, Andersen's total fees for audit and non-audit services went from $17,923,000 in 1999 to $26,688,000 in 2000, and then fell to $16,790,000 for 2001, as WorldCom began to encounter difficulties. Id. at 346 n. 320.
[107] Id. at 346.
[108] Id. at 347.

Bankruptcy Examiner found that, until April, 2002 (which was the same month that Ebbers was fired and the ratings agencies downgraded WorldCom), Grubman and SSB

> "repeatedly gave WorldCom's stock its highest ratings, enthusiastically urging investors to purchase WorldCom shares, even at times when Mr. Grubman was privately advising WorldCom Management and the WorldCom Board on business strategy, acquisitions and investor relations."[109]

Although other analysts also gave WorldCom a "strong buy" recommendation, Grubman's reports stood out "in his rhetorical praise of the Company and in his projected Target Price for its stock, where he was consistently higher than others."[110] Grubman maintained a "buy" rating on WorldCom as it slid from $64.50 to $4.00, not downgrading it until one week before the WorldCom board ousted Bernard Ebbers in late April, 2002.[111]

Grubman's behavior with regard to WorldCom was not unique. As the Wall Street Journal has reported, he remained "wildly bullish on many telecommunications company clients of Salomon," including Global Crossing Ltd., and Winstar Communications, as well as WorldCom.[112] Of course, there was a reason for Grubman to remain loyal to SSB's clients: he was paid over $20 million a year for several years at the height of the bubble.[113]

Other securities analysts were paid far less and their employers had much less reason to remain loyal to WorldCom as it declined. But they also moved very slowly to downgrade WorldCom. The Bankruptcy Examiner prepared a schedule of the ratings of

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[109] Id. at 113.
[110] Id. at 128.
[111] See Charles Gasparino, et. al., "Wild Card: Citigroup Now Has A New Worry: What Grubman Will Say," Wall Street Journal, Oct. 10, 2002 at A-1.
[112] See Charles Gasparino, "Salomon Probe Includes Senior Executives," Wall Street Journal, September 3, 2002, at C-1.
[113] Id.

all analysts covering WorldCom, showing how they changed over time. Events went downhill quickly for WorldCom in early 2002. On March 11, 2002, WorldCom received a request from the SEC for information relating to its accounting procedures. As of this point, only one analyst (Jeffries & Co. – a non-underwriting firm) had less than a buy recommendation on WorldCom (it had a hold).[114] Indeed SSB renewed its own "buy" rating on March 12th. On April 3, 2002, WorldCom announced that it was cutting 3,700 jobs in the U.S. or 6 percent of its staff; on April 22, 2002, Standard & Poor's downgraded WorldCom's credit ratings, and Moody's followed the next day. Only at this point did several firms, including SSB, reduce WorldCom to a "hold" rating. Yet other firms still maintained a "buy" rating. On April 30, the WorldCom board fired Ebbers, and on May 9th and 10th, Moody's and Standard & Poor's, respectively, downgraded WorldCom's credit ratings to junk status. On May 13th, Standard & Poor's removed WorldCom from its S&P 500 Index. Yet, on May 22, Robertson Stephens renewed its "Strong Buy" recommendation. The Titanic had sunk, but it still received a "buy" rating from its most loyal analysts.

4. The Attorneys. The role of attorneys in the WorldCom collapse has received little attention, but merits more. While there were no serious acts of commission, a pattern of passive omission characterizes the efforts of the attorneys conducting due diligence in connection with WorldCom's securities offerings. In 2000 and 2001, WorldCom made two enormous bond offerings, first a $5 billion offering in May 2000, and then a February 2001 offering of $11.9 billion in notes, which was "the largest public

[114] See Bankruptcy Final Report, Appendix 7 ("WorldCom Analyst Reports – Ratings") at pp. 1-6.

debt offering in American history."[115] In both offerings, SSB was the lead underwriter, along with J.P. Morgan Chase & Co.

In the case of the 2000 offering, a considerable time period existed during which counsel and the underwriters could have conducted due diligence. WorldCom filed its registration statement on April 12, 2000 and the date of the offering was May 24, 2000; in fact, this period is considerably longer than what is available in most public debt offerings. Thus, although time constraints can often preclude adequate due diligence, time was not a factor in the WorldCom offerings. Instead, the underwriters appear to have decided to take the business risk that the issuer was withholding material information. To be sure, this is the underwriters' choice, because while the Securities Act of 1933 contemplates a due diligence investigation, it does not mandate it.

Nonetheless, the federal district court hearing the WorldCom class action noted (with apparent surprise) how little due diligence was actually performed:

> "The only written record of due diligence performed by the Underwriter Defendants for the 2000 offering is a May 26 memorandum prepared by Cravath, Swaine & Moore ("Cravath"), counsel to the Underwriter Defendants. The memorandum reflects due diligence conducted from May 15 to May 23. It describes a May 17th telephone conversation in which Sullivan [WorldCom's CFO] was asked questions about the Sprint merger, whether WorldCom had experienced problems integrating either SkyTel or MCI, and whether there were any other material issues. In that conversation, Sullivan predicted overall growth for the year 2000 would be about 14%, represented that the proceeds for the 2000 offering would be used to repay 'commercial debt,' reported that WorldCom was experiencing a very competitive environment, but that there were no changes in that environment since 1999, and stated that there were no other material issues than the ones that he described in the call."[116]

That appears to have been it. Effectively, Sullivan handled the attorneys for the underwriters much as he would have handled a conference call with second-rank

[115] See In re WorldCom Inc. Sec. Litig., 2004 U.S. Dist. LEXIS 25155 at *49.
[116] Id. at *42 to *43.

securities analysts – all generalities and few specifics. Yet, a $5 billion bond offering was a very large transaction. The underwriters appear to have relied almost exclusively on the audited financials and the "comfort letter" that they were to receive from Arthur Andersen, which would cover WorldCom's more recent, unaudited financial statements. In the standard "comfort letter," the auditor opines that nothing had come to its attention that would require any material modifications in issuer's unaudited financial statements. No serious attempt was made to inquire deeper, even though the WorldCom court found that a variety of "red flags" were present.

By the time of the 2001 offering, WorldCom's situation had deteriorated; its stock price had fallen, and several of the underwriters who were commercial banks had downgraded their internal credit ratings for WorldCom (on a non-public basis).[117] Standard & Poor's had also publicly lowered WorldCom's rating.[118] Even more revealing, some of the underwriters participating in the bond offering had begun to hedge their own WorldCom positions, as bank lenders, through the use of credit default swaps.[119] In short, the underwriters were marketing the issuer's debt securities, while simultaneously reducing their own exposure to the issuer's debt.

The 2001 $11.5 billion note offering was the largest public debt offering in history, but nothing special was done. Again, Cravath – possibly the preeminent firm in this field – represented the underwriters, and due diligence was conducted from April 19 through May 16, 2001.[120] While this period was shorter than the time period in the 2000 offering, this roughly four week interval still left substantial time for a factual

[117] Id. at *48 to *50 (noting that both Bank of America and J.P. Morgan internally downgraded WorldCom just prior to this offering).
[118] Id. at *50 to *51.
[119] Id. at *53 to *54. J.P. Morgan in particular used this technique.
[120] Id. at *57 to *58.

investigation of the issuer. A written list of questions was given to WorldCom, and telephone calls were held with Sullivan, WorldCom's CFO, on April 30th and May 9th; finally, a separate May 9th telephone call was conducted between the underwriters, their counsel, Andersen and WorldCom. In these calls, Sullivan

> "indicated that WorldCom was comfortable with the current earnings per share, that there were no issues that could affect the company's credit rating, and that the company had nothing material to disclose that had not been discussed with the investment bankers."[121]

Ironically, as of this time, Sullivan had already begun to capitalize WorldCom's line costs.[122] Clearly, the underwriters and attorneys could not have detected this change at this point. But Sullivan was not pressed in any respect in these discussions, despite a variety of recent reversals and S&P's downgrading.

Particularly symptomatic was the response when a problem did surface. Both J.P. Morgan and Cravath noted that Andersen's "comfort letter" to the underwriters in the 2001 offering failed to give the same assurances as Andersen had given the underwriters in the 2000 offering. Although they were concerned, they were counseled by an SSB banker who "advised against getting 'too vocal' about it since 'WorldCom's a bear to deal with on that subject.'"[123] In short, the limited due diligence that was conducted appears to have been constrained by the need not to offend the client; the result was a process more perfunctory and formulaic than searching or investigative. To be sure, the underwriters and the attorneys did not suppress any information nor suspect any fraud, but neither did they search for it intensively. As a result, the federal district court hearing

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[121] Id. at *58.
[122] The capitalization of line costs began on April 20, 2001 when some $771 million was transferred from an expense account to a capital account. Id. at *22. Days later, the first due diligence conference call was held on April 30th. Id. at *59.
[123] Id. at *60.

the WorldCom class action was forced to largely agree with the plaintiffs that "the underwriters did almost no investigation of WorldCom in connection with their underwriting of the bond offerings for the company…."[124]

5. How Was the WorldCom Fraud Discovered? The answer is simple, but surprising: the company's internal auditors detected the fraud. WorldCom's capitalization of line costs began in April of 2001 and continued through the first quarter of 2002.[125] In May, 2002, when WorldCom's internal audit team began its 2002 audit of capital expenditures, it was confused by a new term "prepaid capacity" that WorldCom managers used to explain the differences between two sets of schedules. The internal auditors had never previously heard this term, which referred to the capital account to which line costs were being transferred. In response, one member of the team – Eugene Morris – used a new software tool to determine how this "prepared capacity" account had been created and "was able to uncover the transfer of line costs to capital accounts in a matter of hours."[126] In fact, this discovery must have surprised senior management because the internal audit team had not been given access to the corporation's general ledger (precisely to prevent such detection). Thus, the software tool proved critical. But Morse testified that those having access to the WorldCom general ledger "could also have uncovered the fraud."[127] The bottom line then is that internal auditors quickly discovered what the outside auditors (who did have access to the general ledger) could not find for over a year. Interestingly, this story parallels a similar incident at Enron

[124] Id. at *4. The Court further noted that in other cases in which the underwriters were found to have satisfied their due diligence defense, they and their counsel had held as many as 20 meetings with the issuer's management. Id. at *131.
[125] Id. at *26.
[126] Id. at *27.
[127] Id. at *27 n. 15.

where the internal audit team uncovered unauthorized oil trading, which ultimately cost Enron millions in losses, only to see their investigation handed over to Andersen, which whitewashed the events in question.[128]

In fairness, there is no evidence that Andersen knew of the fraudulent capitalization or that it deliberately avoided knowledge. Nor is there any hard evidence that any other gatekeeper (even Mr. Grubman) was willfully blind. But it is revealing the Scott Sullivan, WorldCom's CFO, was confident that he could deceive his outside auditors, but yet backed away from a proposed merger with Verizon, because he feared that Verizon would conduct serious due diligence efforts that would discover his accounting irregularities.[129] Collectively, the gatekeepers at both Enron and WorldCom missed clues that more motivated actors – short sellers, Dynergy, and possibly Verizon – were able (or would have been able) to find. Their failings involved sins of omission, not commission. When a clear violation was placed before them, they did respond (for example, Andersen did require a restatement at Enron when it was shown that the 3% rule governing special purpose entities had been violated). Yet, even though Andersen could accurately predict how a fraud would most likely occur at WorldCom,[130] it did not see fit to confirm its own hypothesis by inquiring further.

In short, to the extent that Enron and WorldCom are representative, the gatekeepers in these cases appear to have worn blinders. While not active participants in fraud, they were passive watchdogs who conducted largely perfunctory investigations.

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[128] See text and notes supra at notes 19 to 20.

[129] Scott Sullivan has recently testified at the criminal trial of Bernhard Ebbers that he advised Ebbers to call off merger talks with Verizon "because if they proceeded further, WorldCom would have to show Verizon financial documents that could have revealed illegal accounting changes." See Ken Belson, "Key Witness On WorldCom Tells Jury He Broke Law," N.Y. Times, February 18, 2005 at C-3.

[130] See text and notes supra at notes 102 to 105.

Chapter 7: The Ratings Agencies

Introduction

Ratings are a fact of life in modern society where non-specialists want complex information distilled by experts into easy-to-use symbols and rankings. Even outside the financial sector, ratings are a major commercial activity: U.S. News and World Report finds it highly profitable to rank colleges and universities; Underwriters Laboratories has tested and rated consumer appliances for safety since the early 20th Century.[1] Often, these ratings are highly subjective (such as Michelin's restaurant ratings, Robert Parker's wine ratings, or Siskel and Ebert's movie reviews); other times, the rankings are based on the collective preferences of a substantial number of raters (e.g., Hollywood's Oscars or Zagat's restaurant ratings). Informational intermediaries supply ratings to the markets for such information, based either on (1) their superior access to information or expertise in its analysis, or (2) their ability to predict the market's own taste or preferences through the collective judgment of the many raters that they use.

[1] Underwriters Laboratories, Inc. was organized in 1901 by a group of insurance companies to test and generate reliable information about the risks associated with tested products. Underwriters Laboratories applied its label to approved products, and by the 1920s, consumers had learned to appreciate this label as a signal of safety, thereby giving products with this label a marketing advantage. By the 1990s, Underwriters Laboratories had grown to the point that it employed over 3,900 people and applied its distinctive logo to over six billion new products a year. Although Underwriters Laboratories arose and grew as a private body that pledged its reputational capital, it has become – much like credit-rating agencies – entangled in government regulation, as the Occupational Safety and Health Administration ("OSHA") recognizes it as an authorized independent testing and certifying organization for a number of OSHA procedures. See Frank Partnoy, The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit-Rating Agencies, 77 Wash. U. L. Q. 619, 685-687 (hereinafter, "Partnoy"). As Professor Partnoy has incisively suggested, recognized rating agencies in any field predictably become relied upon by government agencies, which piggyback on their ratings, but thereby enable the rating agency to sell a form of regulatory immunity that he terms a "regulatory license."

Within the financial sector, numerous ratings services exist. Morningstar Inc. uses a "star" rating system of from one to five stars to rate mutual funds.[2] Security analysts rank companies within an industry, which assessments are collected and publicly aggregated by Thomson First Call. Analysts are themselves rated each year by several services, with the best known survey being Institutional Investor magazine's "Annual All-America Team."[3]

Unique among ratings organizations, however, are the credit-rating agencies. Their clout is legendary. New York Times columnist Thomas L. Friedman overstated only marginally when he declared:

> "There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful."[4]

Since at least 1909 (when Moody's first published its bond ratings), credit-rating agencies have provided extremely standardized and condensed information about the creditworthiness of bonds, distilled into an alphabetical symbol. This condensation of highly nuanced information into a single symbol makes ratings easily comprehensible to even the dullest user and enables markets to respond quickly and, more or less, uniformly to changes in ratings (e.g., upgrades or downgrades). Although rating terminology varies

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[2] Moringstar Inc. uses a one to five "star" ranking to rate the approximately 8,000 U.S. mutual funds. As of the late 1990s, approximately 100 five star rankings have been awarded. See Charles Gasparino, "Mutual Funds Show Managers the Money," Wall St. J. March 7, 1997 at C1. Under Moringstar's announced system, the top ten percent of funds get five stars, and the next 22.5 percent get four stars. See Partnoy at 708 n. 398.

[3] Institutional Investor conducted its 33rd annual survey of sell-side analysts in 2004, asking money managers to rank securities analysts by industry. See "Lehman analysts rated best; survey asks money managers to list favorites," Houston Chronicle, October 15, 2004 at 2. It is well understood that a high ranking in this survey translates into a high bonus for the manager, and investment banking firms compete to do well in this survey, just as movie studios compete to win Oscars. Institutional Investor has more recently begun to rank buy-side analysts as well.

[4] See Partnoy at 620. Mr. Friedman made this statement in 1996 in an interview on The News Hour with Jim Lehrer.

somewhat with each agency, the ratings agencies in common rate long-term debt from AAA (the highest category) down to D, with ratings below BBB- being deemed "non-investment grade" – a characterization that carries serious legal consequences because it will likely restrict the ability of many institutional investors to buy or hold such a debt security.[5] Even within the universe of investment-grade securities, a rating downgrade or upgrade is likely to dramatically affect the issuer's cost of capital.

The market for credit ratings is distinctive from other markets for information in three critical respects:

1. Concentration. Even the market for auditing services (dominated as it is by the Big Four) looks open and competitive in comparison to the market for credit ratings. Since early in the 20th Century, credit ratings have been dominated by a duopoly – Moody's Investors Services, Inc. ("Moody's") and Standard & Poor's Ratings Services ("Standard & Poor's"). Each is highly profitable, earning a consistently high rate of return that seems incompatible with a competitive market.[6] Only recently has a third firm – Fitch Investor Service, Inc. – been able to develop a toehold in some specialized

[5] The major agencies vary slightly in their terminology. While Standard & Poor's and Fitch use capital letters – e.g., AAA, BBB and so forth – Moody's uses Aaa, Baa and so on. The first two also use "+", no gradation, or "-", to show further refinements, while Moody's may add a 1, 2, or 3 numerical rating to its letter grade (i.e., "Baa1"). See Staff of Senate Comm. on Governmental Affairs, 107th Cong., "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs," S. PRT. No. 107-75 (Comm. Print 2002) (hereinafter "Watchdogs"). The credit-rating agencies also use slightly different terminology for shorter-term debt.

[6] Professor Partnoy estimates that Standard and Poor's had an operating margin of 29 percent in 1999, and Moody's was in his judgment similarly profitable. See Partnoy at 654. Others have estimated that Moody's rate of return was even higher. Because Standard and Poor's is owned by a larger company (McGraw-Hill Companies, Inc.), precise calculation of its profits is not possible. Moody's was similarly owned for many years by Dun & Bradstreet, but was spun off as a public company in 2000. Since then, its profit margins have been estimated as being as high as 50 percent and its return on assets at over 40 percent. See Claire Hill, Regulating the Ratings Agencies, 82 Wash. U. L. Q. 43, 52 (2004) (hereinafter, "Hill"). Professor Hill also notes that after Moody's was spun off by Dun & Bradstreet in 2000, its market capitalization quickly rose to $6 billion. Id. at 48.

submarkets.[7] One recent estimate placed Standard & Poor's market share in 2001 at 41 percent; Moody's at 38 percent; and Fitch at 14 percent.[8] But this may understate the dominance of Moody's and S&P in the U.S. market, because Fitch is most active in some highly specialized and international markets.

This level of concentration might suggest that high natural barriers exist to entry into this market. Logic suggests that there should be a significant barrier, because reputational capital cannot be acquired overnight. Indeed, some view Moody's and S&P as the functional equivalents of the Educational Testing Service, which designs and administers the SATs and similar tests used by college admissions officers and which never has received significant competition – in short, a natural monopoly.[9] Still, an alternative theory may better explain the modern domination of the Moody's and S&P duopoly: as will be seen, the Securities and Exchange Commission has erected a high barrier that has discouraged entry into this market for at least thirty years by entitling selected ratings agencies (but only a few) to confer de facto dispensations to issuers from various regulatory requirements if the issuer receives a high or "investment grade" rating from the ratings agency. While the SEC fears fly-by-night credit-rating agencies and a

[7] Fitch is owned by a French conglomerate, FIMALAC, and is the successor to several smaller agencies that were compelled to merge in order to survive, including Fitch, IBCA, Duff & Phelps, and Thomson BankWatch. See Hill at 47. During the 1990s, Fitch dominated the market for ratings of mortgage-backed securities. See Partnoy at 675. Although it remains a major player in structured finance transactions and has expanded internationally, it is only a weak competitor in the market for rating the debt of publicly held U.S. corporations.

[8] See Aline Van Duyn, "Big Three Learn Lessons from Enron," Financial Times (London) May 27, 2002 at 4.

[9] This analogy to the SATs was first suggested by NYU Economist Lawrence White (who nonetheless appears to think greater competition is possible). See "Rating the Ratings Agencies: The State of Transparency and Competition: Hearing Before the Capital Markets Subcommittee of the House Financial Services Committee," 108 Congress (2003) at 150 (testimony of Lawrence White). Presumably the SATs have no competition because a second exam would only create noise and confusion and interfere with the comparability of students. Although this same claim can be made with respect to credit ratings, S&P and Moody's have long competed and the market apparently wants the re-assurance of their mutual views. In short, the analogy is not exact.

race to the bottom, its attempt to exclude them has arguably resulted in a government-created duopoly – one that may be more an artificial than a natural monopoly. Much depends on whether one views credit-rating agencies as enjoying a natural or an artificial monopoly; indeed, policy prescriptions logically flow from this starting point.

From a public policy perspective, this lack of competition is important, not for the traditional reason that it permits the oligopolists to charge inflated prices to their customers (here, corporate and municipal debt issuers), but for a newer and different reason: it permits these nominal competitors to shirk, engaging in less effort and research than if there were true active competition. Indeed, the principal recent criticism of credit-rating agencies has been that they have been reactive, rather than proactive, belatedly responding to negative information that has been publicly released, but seldom anticipating any serious decline.[10] Surveys show that participants in this market consider ratings changes to be sluggish, often inaccurate, and seldom made to "favor the interests of investors."[11]

Enron and WorldCom both illustrate this sluggish response, as the major agencies downgraded each below investment grade only a few days to a few weeks, respectively, before each's bankruptcy. This pattern in which a ratings downgrade resembles more an obituary than a prophecy again suggests the absence of real competition. Rationally, the

[10] See Hill at 65; Partnoy at 655 to 664. The essence of this claim is that ratings are simply a response to negative information that is already publicly available. Hence, even if ratings correlate closely with bond default rates, correlation does not necessarily imply causation. Surveys of financial professionals reveal that a high percentage of them doubt that changes in ratings are timely; that is, they believe that rating agency decisions to upgrade or downgrade debt are less informed than their original ratings decisions. See Hill at 65 n.110 (citing surveys).

[11] A 2002 survey by the Association for Financial Professionals found that only 40% of professionals who worked for companies with rated debt believed changes in ratings to be "timely"; only 29% found ratings to be accurate, and only 22% believed that ratings "favored the interests of investors." See William H. Beaver, Catherine Shakespeare and Mark Soliman "Differential Properties in the Ratings of Certified vs. Non-Certified Bond Ratings Agencies," (SSRN Working Paper, September 2004) (SSRN id = 596626) at p. 7.

nominal competitors may prefer to enjoy the quiet life and not invest in the personnel or monitoring necessary to detect financial decline before it becomes public knowledge.

But if some evidence fits this profile, other evidence suggests that the credit-ratings agencies are highly sensitive to the danger of reputational damage and have aggressively sought to preserve their reputational capital. In fact, the credit-rating agencies have in recent years vastly expanded their staffs in order to detect credit deterioration.[12] Moreover, even if Moody's and Standard and Poor's share a duopoly in the United States market, they compete aggressively in the global market, where they face numerous competitors and where their position is not nearly as entrenched. Finally, before one concludes that credit-rating agencies have shirked, one must recognize that the scope of operations of a major credit-rating agency vastly exceeds that of the typical securities research department of a brokerage firm (which at most covers a few thousand stocks). In contrast, in 2003, Moody's monitored over 85,000 corporate and governmental issuers.[13] Hence, constant updating of debt ratings on outstanding debt securities may not be as feasible in this larger context.

Nonetheless, after all these points are acknowledged, considerable evidence does support the charge that the principal credit-rating agencies typically respond slowly to signs of financial danger. The reasons for their sluggish pace are complex (for example,

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[12] The number of credit rating agency employees grew by more than ten-fold between 1985 and 1995 and has further increased by over 50 percent over the last decade. In 1980, for example, the S&P Industrials group employed only 30 professionals; in 1985, it employed 40, but by 1995 it had 800 analysts and a total staff 1,200. See Partnoy at 649. As of late 2004, S&P employed over 1,250 ratings analysts worldwide. See www.standardandpoors.com/Aboutus. Much of this growth reflects the international expansion of the credit-rating agencies, and also their new profitability, which has risen dramatically with the growth of structured finance.

[13] In 2003, Moody's provided credit ratings and analysis on 85,000 corporate and governmental securities, 73,000 public finance obligations, 4,300 corporate relationships, and 100 sovereign nations, all totaling over $30 trillion of debt. See Claire Hill, Rating Agencies Behaving Badly: The Case of Enron, 35 Conn. L. Rev. 1145, 1146 n. 8 (2003).

the agency often may fear that a credit downgrade by it will itself cause bankruptcy because of the "trigger" clauses common in many debt instruments that turn a downgrade by a major credit-rating agency into an event of default). But this slow response pattern underscores the questionable social policy inherent in the SEC's long-standing refusal to open up this market to competition. Logically, active competition among credit raters should lead to a quicker response to the signs of credit deterioration.

2. Conflicts of Interest. Michelin and Zagat sell their restaurant ratings to the retail customers who buy their guides; Institutional Investor and U.S. News and World Report profit from their rankings through increased revenues from subscribers and advertisers. Even securities analysts do not generally accept direct payment for their ratings from the issuers that they rate. But credit-rating agencies do. Approximately ninety to ninety-five percent of the credit-rating agencies' annual revenues comes from issuer fees.[14] Obviously, this heavy dependence on issuer fees gives rise to a fundamental conflict that logically could lead to ratings inflation.

Still, credit-rating agencies have long policied this conflict by adopting a number of policies that minimize the incentive to go easy on one's paying clients. For example, the fees paid by the issuer to the agency are usually fixed at two to three basis points of the amount of the bond offering, thereby precluding any low-visibility exchange of above-market fees for inflated ratings.[15] In addition, the market, itself, imposes further important restraints. Issuers do not seek the rating of only one agency, but typically feel

[14] See Partnoy at 652; relying on more recent 2003 data, Professor Hill places the figure at 90 percent in the case of Moody's (estimating 95 percent dependence); See Hill at 50.
[15] Id. (noting that S&P charged 2.5 basis points per issue and Moody's charged $10,000 to $25,000, depending on the issue's size). In more complex deals, however, fees of $90,000 have become common, and thus some reason for bias exists in this context. See House, Rating the Raters, Institutional Investor Oct. 1995 (Int'l Edition) at 53.

compelled to seek the ratings of both Moody's and Standard & Poor's.[16] Because of this well-established norm that two ratings are necessary, issuers cannot play one agency against the other, and the principal two credit-rating agencies probably feel little, if any, pressure to inflate ratings for a client for a fear that it will instead hire their rival. Although this nearly uniform practice eliminates the danger of a race to the bottom, it also reduces active competition between the principal two agencies and instead allows them to enjoy the advantages of the quiet life. Finally, the credit analysts who are employed by the principal credit rating agencies rate many issuers and do not receive incentive-based compensation. Hence, they are less subject to "client capture" than are the audit partners of a major accounting firm who often serve (and are thus dependent upon) only a single client.[17]

Even if the conflicts inherent in having the issuer pay for its rating have been adequately monitored to date, this issue remains open for the future. Much like accounting firms, the credit-rating agencies began to receive significant additional revenue from issuers for ancilliary or consulting services beginning in the 1990s.[18] With such revenues comes the possibility that the issuer can increase or decrease its fees to the extent that it is satisfied or dissatisfied with its rating.

3. The Multiple Functions of Ratings. In a simple world, the role of ratings is just to provide information. But the real world is more complex. Although creditors and trading partners certainly need information about the creditworthiness of prospective

[16] The evidence is clear that the market reacts more favorably to debt with Moody's and S&P's ratings than it reacts to debt with only one of these two ratings. See Hill at 66; see also Richard Cantor and Frank Packer, "Multiple Ratings and Credit Standards: Differences of Opinion in the Credit Rating Industry" in 12 FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS (1996).
[17] See Beaver, Shakespeare and Soliman, supra note 11, at 7.
[18] See Securities and Exchange Commission, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS (January 2003) at 23-24.

borrowers and counterparties, rating agencies may do much more than provide information. Sometimes, ratings create value for their customers and users. For example, the value of the Michelin "three star" rating may be to convey a cachet to both the restaurant owner and its customers that they could not gain in the absence of a ranking. Alternatively, a rating may protect the manufacturer of the rated product from tort liability (this was a major reason why Underwriter Laboratories' ratings of consumer appliances became popular). Or, a rating may immunize from liability the fiduciaries who make investment decisions if an investment later sours (this was an early impact of the "investment grade" rating given by credit-rating agencies). In these cases, the informational role of ratings may become secondary to their legal impact, which is to insulate users from liability and reduce their regulatory costs.

Ratings agencies may also specialize. Some may focus on bond default risk, while others may be more interested in current valuation. As a result, the latter may be more timely in their ratings changes, while the former may better predict insolvency.[19] The multiple roles played by credit-rating agencies thus need to be distinguished. Initially, the credit-rating agency profits from specialization. By concentrating on, and developing expertise in, the gathering and analysis of credit information, it economizes on the duplicative and wasteful efforts that less well-trained individuals and firms would otherwise expend in gathering information. Secondly, by pledging its reputational capital, it assures investors of the credibility of its statements. Thirdly, it may enable the issuer to signal information about itself without disclosing proprietary information to its competitors.[20] In this respect, credit-rating agencies arguably create value by minimizing

[19] See Beaver, Shakespeare and Soliman, supra note 11, at 2-3.
[20] See Partnoy at 631-633.

the informational asymmetry that exists in financial markets between sellers and buyers. In debt markets, the seller of debt securities (i.e., the issuer) inherently knows more about the reliability of its promise to repay and fulfill its debt contract than does the buyer of its debt (i.e., the investor), but its statements about itself are not necessarily credible. Given this asymmetry in information, the rational buyer would price the commodity purchased in terms of its historic average quality (that is, the buyer would look to the mean rate of defaults on similar debt securities in pricing the security).[21] Such average pricing, based on the default rates for all issuers, works to the advantage of issuers with below-average quality and to the disadvantage of issuers with above-average quality. The latter bear the cost of informational asymmetry because they must pay a higher interest rate than they have paid in a world in which all parties had perfect information.

To minimize this cost, the debt issuer has an incentive to disclose information that shows the superior quality of its debt securities. It can do this by sharing confidential information that may be proprietary and non-public with a third party (the credit-rating agency) who can evaluate and verify its disclosures without revealing non-public information to the world (or, most importantly, to the firm's competitors). From this perspective, bond ratings are a signal that spares above-average quality issuers from having either to bear inefficiently the cost of "average quality pricing" or to disclose proprietary information that they wished to keep non-public. Partly for this reason, credit-ratings agencies are exempted from Regulation FD, which bars selective disclosure.[22]

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[21] This description is very condensed summary of the well-known "market for lemons" thesis. See George A. Akerlof, The Market For Lemons: Qualitative Uncertainty and the Market Mechanism, 84 Q.J. Econ. 488 (1970). Such a market and inefficient average cost pricing arise when the individual competitor cannot credibly distinguish its product from the herd of similar products.

[22] See 17 C.F.R. 243.100 (b)(2) (exempting from Regulation FD "an entity whose primary business is the issuance of credit ratings, provided the information is disclosed for the purpose of developing a credit rating and the entity's ratings are publicly available;").

Thus, issuers can disclose information and forecasts in confidence to credit-ratings agencies that they cannot selectively disclose to securities analysts.

Of course, disclosure by the issuer to the third party works only if the third party is trusted by investors, which in turn requires that the third party have sufficient reputational capital pledged behind its rating that it would not rationally misrepresent the significance of the information that it learns. But the key point here is that the issuer uses the reputational intermediary to send a credible signal that its securities are of above average quality in order that it can pay a below average interest rate.

While the foregoing "reputational intermediary" model has long been the dominant and orthodox view of the credit-rating process, it is increasingly being contested by an alternative model of the role played by such agencies. This alternative model focuses on the regulatory consequences of ratings and the non-informational needs of both investors and issuers. These non-informational benefits of a credit rating enable the rating agency to confer a "regulatory license" on its customers either because: (1) a rating enables issuers to escape costly regulatory burdens or prohibitions to which they would otherwise be subject;[23] or (2) portfolio managers and institutional investors gain legal protection by virtue of such a credit-rating, because it insulates them from potential claims that they breached their fiduciary duties to investors in buying or holding the security (if the investment later sours or defaults).

The key idea behind this alternative "regulatory license" model is that regulation imposes costs which a favorable rating can reduce. To the extent that a rating reduces the issuer's costs or the costs of financial intermediaries, then rating agencies can sell

[23] The fullest and best account of this "regulatory license" model has been provided by Professor Frank Partnoy. See Partnoy at 681-703.

"regulatory licenses" to enable such persons to avoid these costs. Such sales of regulatory licenses need not be based on trust or reliance on the rating agency (as the "reputational intermediary" model assumes), but only on the short-term cost savings realizable. As a result, the rating agency has less need to invest in or protect its reputational capital – at least so long as it does not jeopardize its ability to issue regulatory licenses.

A prerequisite to the "regulatory license" model's applicability is that the Government vary the level of regulation based on the credit rating applicable to the securities being sold. In the early days of credit ratings, regulators did not do this, and indeed they paid little attention to them. But this began to change in the 1930s. The first regulator to take notice of credit ratings was the Federal Reserve System, which, beginning in 1930, implemented a system for evaluating a bank's entire portfolio based on the credit ratings on the bonds in that portfolio.[24] In 1931, the United States Treasury Department accepted credit ratings as the best measure of the quality of a national bank's bond portfolio.[25] Specifically, bonds below a specified investment grade were required to be written down on the balance sheet of a national bank, but bonds with a higher rating could be carried at cost. New Deal banking legislation later limited the ability of national banks to buy bonds that did not comply with criteria promulgated by the Controller of the Currency,[26] and in 1936 the Comptroller required that bonds purchased by national banks be rated as of investment grade "by not less than two ratings manuals."[27] At a stroke, this regulatory action arguably granted Moody's and Standard and Poor's a license to coin

[24] See Partnoy at 686-87.
[25] Id. at 687. The Comptroller of the Currency ruled in 1931 that bonds rated BBB or higher could be carried at cost, but lower rated bonds had to be written down on the bank's balance sheet.
[26] Id. at 688. Section 308 of the National Banking Act of 1935 limited national banks to purchasing only securities that satisfied the definition of "investment securities" promulgated by the Comptroller of the Currency.
[27] Partnoy at 688 (summarizing Comptroller of the Currency's regulations).

money, because banks had to use both of them, thereby reducing their need to compete. State banking regulators soon adopted similar rules. As a result, banks needed ratings on their bonds, not for information or investment decision-making, but to satisfy regulators.

The next major use of credit ratings by regulators came in 1973, when the SEC revised Rule 15c3-1, its "net capital" rule for broker dealers, to explicitly incorporate credit ratings – but only those ratings promulgated by what it defined as "Nationally Recognized Statistical Ratings Organizations" (or "NRSROs").[28] Much like earlier federal banking regulation, the SEC's "net capital" rule required mandatory write-downs (or "haircuts" in the parlance) on the broker's balance sheet for securities that it owned which were deemed risky or speculative. Rather than elaborately define the various levels of risk and the criteria that determined them, the SEC instead found it much simpler (and probably more accurate) to rely on the credit ratings on the debt securities held by the broker-dealers. By mandating that the higher the credit rating, the less the writedown that the broker-dealer had to place on the bond, Rule 15c3-1 strongly encouraged broker-dealers to invest in rated bonds.

Still, the SEC realized that if it stopped at this point and only required a credit rating from some recognized rater, new raters would come out of the woodwork overnight. Fearing the proverbial "race to the bottom," the SEC decided to recognize only the credit ratings issued by the major credit-rating agencies that pre-existed its new rule. To this end, it defined the term "Nationally Recognized Statistical Ratings Organizations" (or "NRSROs") so as deliberately to exclude start-ups and fly-by-night small firms that lacked reputational capital. Only credit-rating agencies that long had

[28] See Sec. Exch. Act. Rel. No. 34-10,525 (Nov. 29, 1973). Rule 15c3-1 remains in force to this date. See 17 C.F.R. 240.15c3-1.

been recognized were permitted to give the now required ratings. But in so providing, the SEC effectively gave Moody's and Standard and Poor's a monopoly on the issuance of "regulatory licenses" to broker dealers.

Once the concept of NRSRO became established, it was quickly adopted for a variety of other regulatory purposes. For example, in the early 1980s, the SEC began to regulate the new field of money market funds, and it modified Rule 2a-7 under the Investment Company Act of 1940.[29] That rule limited money market funds to investments in "Eligible Securities," which term was defined to mean securities rated by at least two NRSRO (or by the only NRSRO that rated the security) and that had received one of the two highest short-term rating categories from these rating agencies. In 1991, the SEC further revised this rule to provide that a money market fund could invest no more than five percent of its assets in "second-tier" paper (and no more than one percent in any single "second-tier" issuer of commercial paper).[30] Because money market funds invested heavily in commercial paper, they were forced to redirect their investments to the commercial paper of issuers who had NRSRO ratings – thereby reinforcing the duopoly of Moody's and Standard and Poor's.

Not only institutional investors were directly affected, but issuers as well. In the early 1980s, the SEC introduced an important deregulatory system known as "shelf-registration," which permitted qualified corporate issuers to register significant amounts of securities in advance of any specific contemplated offering.[31] This liberalization

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[29] Rule 2a-7 exempts money market funds from the requirement, applicable to most mutual funds, that they mark to market on a daily basis the value of portfolio securities, provided that the money market fund observe certain risk-limiting conditions. See 17 CFR 270. 2a-7.

[30] See Securities Act Release No. 33-6882 (Feb. 20, 1991).

[31] The adoption of Rule 415, which authorized shelf-registration for large public corporations, provoked a major confrontation between the SEC and the investment banking community that did not want the increased competition for underwriting business that the new faster rule encouraged. The Commission,

conferred significant cost savings on those issuers who qualified for shelf registration, because it gave these issuers control over the timing of public securities offerings. No longer did they have to wait out an uncertain period until the SEC declared the registration statement covering their securities "effective." This deregulation not only speeded up the securities issuance process, but enabled the issuer to exploit what it perceived as favorable "market windows." Eligibility to use shelf registration was limited by the SEC to only issuers of high-quality debt. In determining what debt securities qualified for shelf registration, the SEC predictably followed the course of least resistance and made eligible any issuer that had obtained an "investment grade" credit rating from an NRSRO credit-rating agency.

The insurance industry has similarly piggybacked on the NRSRO concept. The National Association of Insurance Commissioners ("NAIC") maintains a Securities Valuation Office ("SVO"), which monitors the financial condition of insurers, principally by reviewing the credit quality of their investments.[32] The NAIC relies heavily on NRSRO credit ratings and thus effectively penalizes insurance companies that invest in low-rated or –even worse – unrated debt.[33]

Small wonder then that NRSRO designation has become critical. Whatever the category of institutional investor – federal or state bank, mutual fund, broker-dealer, or insurance company – its capital structure is understandably regulated to assure financial solvency. But across a broad range of contexts, state and federal regulators have found it simpler to delegate the task of risk assessment to the NRSRO credit-rating agencies.

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itself, divided over this rule. See Securities Act Release No. 6491 (November 17, 1983) (adopting Rule 415).

[32] State insurance regulators created the NAIC in 1871, and the Committee on Valuation of Securities, the forerunner of the SVO, was formed within it in 1907. See Partnoy at 700.

[33] Id. at 701.

Moreover, on the global level, international bank regulators appear have followed this same well-traveled path at least part way, as the new Basel accords for regulating bank solvency place considerable weight on the credit ratings applicable to the bank's investments.[34] Potentially, credit-rating agencies may thus acquire a worldwide license to reduce the regulatory costs of banks.

Obviously, this common policy made it very attractive to become an NRSRO agency. Over the years, a number of small and start-up credit-rating agencies have applied to the SEC for admission to this exclusive club, but only a few gained admission. Unsuccessful applicants described the process as ensnaring them in a "Catch-22" dilemma: they could not get the NRSRO designation until they were "nationally recognized," and they could not become "nationally recognized" until they received the NRSRO designation that gave legal effect to their ratings.[35] One unsuccessful applicant for NRSRO status reported that throughout its failed effort it was contacted only twice by the SEC: once in 1992 to acknowledge receipt of its application, and again in 2000 to reject it.[36] Lace Financial has been seeking to gain admission for thirteen years, and Egan-Jones Ratings Co. since 1998.[37]

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[34] The Basle Committee on Banking Supervision promulgates "voluntary" global standards governing the adequacy of capital for international banks. Its regulatory approach relies in part on credit ratings in preference to heavier-handed regulation. For a criticism of this approach, see Frank Partnoy, Why Markets Crash and What the Law Can Do About It, 61 U.P.H. L. Rev. 741, 788-82 (2000).

[35] See Leslie Wayne, "Credit Raters Get Scrutiny and Possibly a Competitor," New York Times, Apr. 23, 2002, at C1 (describing unsuccessful experience of Egan-Jones Ratings).

[36] See Hill, at 55 n. 61 (discussing application by LACE Financial for NRSRO status); see also Jenny Wiggins, "A Chance to Step Into the Light: Credit Rating Agencies: The Failure of S&P and Moody's to Detect Problems at Enron Has Spurred Regulators to Consider Opening Up the Market," Financial Times, Dec. 9, 2002, 2002 WL 103396934.

[37] See Robert Schroeder, "Credit Ratings Agencies Could Face More Regulation," CBS MarketWatch, September 14, 2004.

All told, the SEC did grant NRSRO status to four applicants between 1980 and 2000 – only to see each of them quickly acquired by the original three NRSROs.[38] As a result, in 2003 when the Sarbanes-Oxley Act required the SEC to report to Congress on the responsibility of credit rating agencies for Enron and similar financial debacles, the SEC had to face the hard truth that only the original three NRSROs remained.[39] Faced with growing criticism from both academics and practitioners about its parsimonious attitude toward recognizing NRSROs, the SEC responded by granting NRSRO status later in 2003 to Dominion Bond Rating Service Ltd., a Canadian firm.[40] But little else changed: the level of concentration in the credit agency market continues to imply oligopoly.

Did the SEC cause this de facto oligopoly in the credit-rating market? Or, was it inevitable? On this issue, even the U.S. Government has divided. In 1997, when the SEC proposed a more formalized rule to govern the recognition of NRSROs, the U.S. Department of Justice objected to the SEC's proposed rule, because it continued to rely on the NRSRO designation.[41] In Justice's view, the SEC's proposed requirement that a credit rating agency must have achieved "national recognition" before its ratings would qualify to trigger any of the exemptions under the SEC's rules created a "nearly insurmountable barrier to new entry into the market for NRSRO services."[42] In the face

[38] The four successful applicants were Duff and Phelps, Inc. (in 1982); McCarthy Crisanti & Maffei, Inc. (in 1983), IBCA Limited (in 1990), and Thomson Bank Watch, Inc. (in 1999). See U.S. Securities and Exchange Commission, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS (Jan. 2003) at p. 9. (hereinafter, "SEC Report on Role and Function of Credit Rating Agencies").
[39] Id.
[40] See Kathleen Day, "SEC Backs 4th Credit Agency," Washington Post, February 25, 2003, at E2.
[41] See SEC REPORT ON ROLE AND FUNCTION OF CREDIT RATING AGENCIES at 37.
[42] Id.

of this and other criticism, the SEC never adopted its proposed rule – but it still persisted in using the same informal practice that put primary emphasis on "national recognition."

Probably the most telling evidence that the extremely concentrated character of the credit-rating market in the United States is not the product of a natural monopoly is the existence, outside the United States, of as many as 130 to 150 rating agencies, all currently operating.[43] That a sufficient demand exists in the world market for credit information to support this large a number of producers undermines the claim that a natural monopoly exists. One reason for this diversity of firms is that they may cater to different investor needs. For example, one team of researchers has recently concluded that non-NRSRO research primarily seeks to inform the valuation process, while the ratings of NRSRO credit agencies are almost exclusively focused on the risk of future default.[44] Similarly, the persistence of a "two ratings" norm, both domestically and internationally, indicates that users want more than simply a "regulatory license." After all, an issuer seeking a "regulatory license" would be content with a single rating; thus, only the "reputational intermediary" model can account for this insistence on two ratings by credit information users. Potentially, these two models can co-exist, but the key policy question is whether the government should keep the barriers to entry into this market high in order to preclude fly-by-night credit raters or instead open up the field to competition

[43] Id. The Basel Committee on Banking Supervision estimated that some 130 rating agencies were active worldwide in 1999, and an official of the U.K.'s Financial Services Authority placed the number at 150 in 2002. Id. NYU Professor Lawrence J. White, an economic expert on banking, places the number of active ratings agencies in the world-wide market somewhat lower at between thirty-five to forty (plus Moody's and S&P). See Lawrence J. White, "The Credit Rating Industry: An Industrial Organization Analysis 7-8 (2001) (available on SSRN).

[44] See Beaver, Shakespeare and Soliman, supra note 11, at 27. The non-NRSRO agency (Egan Jones) was found to be much more timely in its ratings changes and more responsive to the needs of investors (who after all paid its fees), whereas the NRSRO agency (Moody's) performed more of a "quasi-regulatory function" and had a more "conservative bias," but did better predict bond defaults.

by relaxing the criteria for an "NRSRO" designation. And this issue turns on what one thinks competition would produce.

I. History: The Rise and Record of Credit-Rating Agencies

Historically, the modern credit-rating agency can be traced back to earlier mercantile credit agencies that principally served suppliers and other business and trade creditors. The earliest of these in the United States, The Mercantile Agency, was formed in 1841, following a market crash in 1837 that had shown businessmen the need for better credit information.[45] Other firms followed in its wake, including R.G. Dun and Company, which was organized in 1859 to promote the Dun rating book, which contained some 20,000 listings.[46] Eventually, it merged with its leading competitor to form Dun and Bradstreet, Inc., long the dominant mercantile credit firm, which until 2001 owned Moody's. These early firms corresponded with merchants and businesspeople to acquire opinions about the reputations and standing of business owners across the country.[47] Such information may have been anecdotal and speculative, but merchants eagerly bought these services because it was the best information available.

In 1860, Henry Varnum Poor published the first edition of his History of Railroads and Canals of the United States. Unlike the mercantile credit agencies, his focus was on the leading issuers of debt securities: railroads and canals. His business model was also different: to sell data to book purchasers, thereby making his information public, rather than advising commercial clients on a confidential basis. In due course, competitors arose, and one of these, the Standard Statistics Bureau was formed in 1906,

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[45] See Richard Cantor & Frank Packer, The Credit Rating Industry, Federal Reserve Board N.Y.Q. Rev. 1 (Summer-Fall 1994); see also Partnoy at 636-637.
[46] Cantor & Packer at 1-2; Partnoy at 637 n. 74.
[47] See J. Wilson Newman, "Dun & Bradstreet: For the Promotion and Protection of Trade", in REPUTATION: Studies in the Voluntary Elicitation of Good Conduct 85, 86 (Daniel Klein ed., 1997).

also to publish financial data that had previously been unavailable or confidential. Eventually, in 1941, Poor's Publishing Company and the Standard Statistics Bureau merged to form Standard & Poor's Corporation, which in 1966 was in turn acquired by The McGraw-Hill Companies, Inc., also a major publisher specializing in business publications.[48]

During the late 19th Century, these two industries – the mercantile credit agencies and the manual publishers – co-existed, never quite converging, each serving a different client base. The next major innovation came from a relative outsider, John Moody, who first published his Moody's Manual of Industrial and Miscellaneous Securities in 1900. By 1903, it had become the dominant publication in its field, but Moody's firm failed to survive the stock market crash in 1907. Still, in 1909, John Moody returned to Wall Street with a new and improved product: Moody's Analysis of Railroad Investments. First published in that year, this volume not only collected data, but also analyzed railroad securities, using a consistent methodology, and then condensed that analysis into a single rating symbol. Such letter grades had earlier been used by the mercantile agencies, but they had not been previously applied to outstanding debt securities.[49]

Simplicity sold, and Moody's rating system was an instant hit with investors. Moody quickly expanded his scope of operations to include industrial corporations in 1913 and municipal bonds in 1914. By 1924, Moody's ratings were available with respect to nearly every publicly traded bond in the U.S. bond market.

Success attracted competition, and soon Standard Statistics and later Poor's Publishing, the two precursors of S&P, also began to give debt ratings to corporate bonds.

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[48] Much of this information is set forth on Standard & Poor's website. See www.standardandpoors.com.
[49] Most of these facts are set forth on Moody's website. See www.moodys.com/aboutmoody's.

By 1940, Standard Statistics also was rating municipal bonds. The third significant entrant into this market, The Fitch Publishing Company, began publishing ratings in 1924.[50] Only one other significant entrant, Duff and Phelps Credit Rating Co., entered this field, and it confined itself to public utility companies from 1932 until 1982 (when it expanded its coverage to include other public companies). Never a significant player in the broader public markets, Duff and Phelps eventually merged into Fitch. Ultimately, Fitch became the buyer of resort for several new entrants that tried and failed to crack the Moody's/S&P duopoly.[51]

Despite these failures, it is difficult to believe that there were high barriers to entry into the credit-rating market during the first half of the 20th Century. Over this period, the paucity of competitors may have been more the product of the common perception that the market was simply too small to justify the start-up costs incident to covering the large universe of publicly held bonds. In their early years, the bond rating agencies drew their revenue exclusively from subscribers, not from issuers. Not only did issuers not pay them, but some resisted the rating process regarding it as an "intrusion." Ultimately, however, resistance proved futile. In response to a low rating, the issuer had no practical recourse other than to cooperate and provide additional data to the rating agency in the hopes that it would lead the agency to upgrade its rating.

The reliance placed on bond ratings varied with the client. During the 1920s, large banks, having their own internal credit analysts, seem to have made only marginal use of them, but smaller banks and trust companies depended on them.[52] In part, this was because judicial decisions, dating back to 1897, had protected trustees and other

[50] See Partnoy at 639.
[51] See Hill at 47; see also, www.fitchratings.com/corporate/aboutfitch.
[52] See Partnoy at 644.

fiduciaries who had purchased bonds recommended by established bond manuals, such as Poor's Manual.[53] These cases essentially found that fiduciaries who consulted the recognized bond manuals (Poor's or Moody's) and purchased investment-grade, non-speculative securities were not liable to their beneficiaries for a lack of due care if the bonds later defaulted. As a result, to trustees and other fiduciaries, ratings not only carried valuable information, but they also conveyed a degree of insurance. By the 1920s, trust indentures sometimes explicitly limited the trustees' investment discretion so that they could only purchase bonds rated as of "investment grade."

Traders also came to value ratings, because they began to observe that any change in a rating implied a subsequent price change in the value of the bond rated.[54] In effect, even if the rating agency lacked any non-public information, its upgrade or downgrade became a self-fulfilling prophecy which traders could not ignore in a market where little public information existed.

The value and prestige associated with a high bond rating probably peaked in the 1930s, when an escalating series of bond defaults during the Depression forced investment managers to become preoccupied with the risk of default. In contrast, during the 1940s and 1950s, this pattern reversed itself. The economy prospered, bond defaults decreased, and overall bond volatility also declined. Correspondingly, however, as volatility declined, the utility of bond ratings to investment managers similarly fell. In

[53] For the early decisions, see In re Bartol, 38 A. 527 (Pa. 1897); In re Detre's Estate, 117 A. 54 (Pa. 1922). This line of cases continues to this date. See Glennie v. Abitibi-Price Corp., 912 F. Supp. 993 (W.D. Mich. 1996) (finding that fiduciary exercised due diligence where it consulted Moody's and S&P's ratings and found that ratings remained "investment grade," despite the fact that the issuer had encountered a variety of financial problems that had been publicized).
[54] See Partnoy at 644-45.

consequence, the bond-rating agencies experienced a period of contraction during the Post-War era.

Although bond volatility increased again during the 1970s, the relevance of bond ratings had by now come under attack. Institutional investors and other buy-side investors grew exponentially in size during the 1970s, and, as they did so, they began to internalize their own credit analysis staffs. These staffs typically produced more sophisticated research than a simple bond rating. Academic studies also challenged whether bond ratings (and particularly changes in bond ratings) provided new information of material value. One such study, covering corporate bond rating changes between 1950 and 1972, concluded that such changes merely reflected information that had already been incorporated into the stock market prices of the same issuers.[55] Indeed, it found a lag time of approximately one-and-one-half years between the public release of the information and the rating change. So viewed, the ratings provided by the credit-rating agencies had little informational value (and were purchased mainly for the legal protection they gave banks and trustees).

What explains this quick reversal between the high prestige of bond ratings in the 1920s and 1930s and their reduced prestige in the 1970s? The most plausible explanation is that the passage of the federal securities laws in the 1930s greatly deepened the informational resources available to the market about the creditworthiness of bonds. By the 1970s, the credit analyst at a bank, insurance company or other institutional investor had available to him or her the same information that in the 1920s had been made available only privately to the credit-rating agency. As a result, the agency's rating

[55] See George Pinches & J. Clay Singleton, The Adjustment of Stock Prices to Bond Rating Changes, 33 J. Fin. 29 (1978); see also Frank J. Reilly & Michael Joehnk, The Association Between Market-Dominated Risk Measures for Bonds and Bond Ratings, 31 J. Fin. 1387 (1976).

largely duplicated what a more sophisticated market already knew. Not surprisingly then, rating agencies during the 1960s and 1970s entered a period of austerity and experienced little growth.

Probably in response, in the 1970s, the ratings agencies collectively changed their basic business model. Instead of relying exclusively on revenue from subscribers (as they had in the past), they began to charge issuers for rating their debt securities. Although this change gave rise to an obvious conflict of interest problem, it made sound economic sense, because it solved the "free rider" problem that the industry long had faced. Information (including ratings) has the character of a public good; inevitably, information leaks from the subscriber who has paid for it to others who have not. The inability to tax these latter "free riders" implies that the bond rating agency cannot compel all who benefited from its services to pay for the value conferred on them. But, by requiring the issuer to pay for its rating, the industry could effectively tax all users of its ratings, because the issuer could pass on the cost of the rating to the bond purchasers in the form of a slightly lower interest rate. Thus, the free rider was at last taxed its fair share of the rating agency's cost.

This transition did, however, force the bond rating industry to face the claim that increased public regulation and oversight were necessary in view of these new conflicts of interest. In response, the industry made two valid points: (1) because its members typically charged fees based on a formula (for example, two or three hundreds of a percent of the debt issue rated), they had little incentive to inflate their fees for so modest amount (at least when their reputational capital was also at stake); and (2) because most issuers faced great pressure from investors to obtain ratings from both Moody's and S&P,

there was little likelihood of any race to the bottom under which one agency succeeded in inflating its rating in return for a higher fee. That is, if the market wanted the ratings of both firms, neither would be excluded if the other underbid them.

These two arguments are generally valid, but they still overlook some conflict problems that have in fact arisen. For example, on very large debt offerings, even a two or three basis point fee can be significant and thus the rating agency might be tempted to inflate its rating (at least if it feared being excluded from the ratings process).[56] Another problematic practice that developed was the use of unsolicited ratings. Critics have charged that Moody's used the practice of giving unsolicited ratings to issuers to coerce them into hiring it.[57] That is, if Moody's gave a deliberately low rating to an issuer that had not hired it, that issuer might reconsider its decision to forego a Moody's rating – particularly if it sensed that by hiring Moody's, it would obtain a higher rating.

More recently, Standard and Poor's has followed Moody's lead and in its own words "as a matter of policy … publishes ratings for all public corporate debt issues over $50 million – with or without a request from the issuer."[58] Fitch also now gives unsolicited ratings on a case-by-case basis, without following any general policy. Yet, stung by criticism, Moody's has largely retreated from this practice and now gives unsolicited ratings only in the case of high-yield junk bonds.[59] Again, this suggests that, for all their oligopolistic power, credit-rating agencies remain very sensitive to any loss

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[56] For example, on a very large offering of $1 billion in debt, two basis points comes to $200,000. Also, higher fees may be charged for complex offerings, such as asset securitization transactions. This is, of course, exactly the profile of some Enron offerings.

[57] See "Credit-Rating Agencies. AAArgh!," Economist, Apr. 6, 1996 at 80; see also Frank A. Bottini, Jr., An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies, 30 San Diego L. Rev. 579, 598-600 (1993); "Now It's Moody's Turn for a Review," Bus. Wk., April 8, 1996 at 116.

[58] See Hill, Regulating the Rating Agencies, supra note 6, at 51 (quoting S&P policy statements).

[59] Id. at 52.

of reputational capital. Because only Moody's suffered any reputational loss from giving unsolicited ratings, it is not surprising that only it has abandoned the practice.

While credit-rating agencies stagnated or contracted in the 1960s and 1970s, they rebounded dramatically in the 1980s and 1990s, doubling and tripling their staffs over this period. A major reason for this expansion was the growth of structured finance. These new transactions – basically asset securitizations – were ratings driven; that is, their architects aimed to achieve a high rating for the special purpose entity created to issue the debt. As a practical matter, such transactions did not go forward unless the desired high rating was achieved.[60] Because they were complex transactions, the ratings agencies' fees on them were also typically higher.

The idea that these transactions require a specified rating before they can be accomplished (i.e., that they are "ratings-driven") has offended some critics who see this as a sign that the ratings are contrived.[61] But the real, underlying issue here is the accuracy of these ratings. Critics point to a series of well-known crises in which the rating agencies failed to predict insolvency, beginning with the bankruptcy of Penn Central in 1970, and extending to the insolvency of Orange County in the 1980s, the Asian financial crisis that crested in 1997, and finally the Enron, WorldCom and related bankruptcies in 2001-2002. In response to this criticism, the industry asserts that few investment-grade rated bonds ever default: Moody's in fact has not experienced such a default since Johns Manville, a single-A rated company, filed for bankruptcy in 1982, and S&P has had only one such default on its investment grade debt over the same period (in

[60] Id. at 49.
[61] See Partnoy at 664-670. For a rebuttal, see Hill, Regulating the Ratings Agencies, supra note 6, at 49-50.

1989).[62] But this response will satisfy only the truly naïve, because it ignores the tendency (as in Enron) for ratings agencies to downgrade an issuer's debt to below investment-grade status only days before a default occurs. It is as if a doctor claimed that none of his patients had ever died, without disclosing that he usually resigned when they became seriously ill. Default statistics are thus as cooked as Enron's books.

A better measure of ratings accuracy may be ratings' stability. Here, Standard & Poor's asserts, based on an analysis of 9,169 companies whose debt it has rated, that its ratings are highly stable. For example, all "A" rated companies at the beginning of a given year have a 87.94 percent likelihood of maintaining that same rating at year's end.[63] Again, however, a methodological problem lurks here. That ratings are stable may be the problem, not the answer, in a volatile world. The standard criticism of rating agencies is that rating changes tend to lag well behind public disclosures that indicate credit deterioration. If so, demonstrating that ratings are stable does not demonstrate that they are accurate or timely.

As an alternative, some critics argue that the better measure of relative creditworthiness is credit spreads, not credit ratings.[64] In particular, Professor Frank Partnoy argues that NRSRO rating requirements in federal banking and securities regulation should be junked, and instead creditworthiness tests should be framed in terms of credit spreads. But, while provocative, his trenchant views have not yet attracted any consensus of support, and many academics believe that investment grade ratings for

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[62] See Steven L. Schwarcz, Private Ordering of Public Markets: The Ratings Agency Paradox, 2002 U. Ill. L. Rev. 1, 13-14.
[63] Id. at 14.
[64] See Partnoy at 704-707.

corporate securities remain reliable.[65] The question of whether other measures can outperform ratings has only a marginal relevance to the public policy debate, because literally no one has suggested that ratings agencies should be prohibited from publishing ratings. Still, if other measures of risk, such as credit spreads, work better than the credit agencies' subjective ratings, that probably is a reason to drop or relax the NRSRO requirement and encourage greater competition. In any event, the critical public policy question, discussed below, is what government-initiated reforms will produce more timely updating of credit ratings. What levers can the government pull?

II. Scenarios for Reform: What Might Work?

Basically, four basic policy options seem plausible: (1) public policy could rely on increased competition (and thus the SEC could either abandon or liberalize its now highly exclusive "NRSRO" designation); (2) public policy could seek to impose greater liability on the credit-rating agencies, hoping thereby to cause them to update their ratings more quickly in the face of new information; (3) the SEC could treat the credit-rating agencies as a regulated industry, imposing higher training and monitoring standards and, itself, disciplining poor performance, much as it does in the case of broker-dealers; or (4) the SEC could seek to restore the original principal/agent relationship that once existed by requiring rating agencies to be paid by the users of their information, not the issuer corporations who today pay them.

This third option of close administrative regulation makes sense if one believes that the dominant ratings agencies possess a natural monopoly and so should be supervised like public utilities. Conversely, if one doubts that rating agencies are a

[65] See Charles Adams et. al., International Capital Markets Developments, Prospects, and Key Policy Issues at 137-139, 203 (International Monetary Fund survey, Sept. 1999). The agencies' ratings on sovereign and municipal debt were, however, found to be less reliable.

natural monopoly, the first option of enhanced competition logically should be preferred, while the second option of increased liability could make sense under either of these premises.

Each of these options merits a brief review:

A. Can the Principal/Agent Relationship Be Restored? The fourth option is particularly promising, but faces a basic problem in terms of its economic feasibility. Although public policy could seek to restore credit-rating agencies to their former position as the agents of their subscribers (for example, by prohibiting credit-rating agencies from receiving fees from the issuers of the securities that they rate), such a policy may be confounded by the free-rider problem and the rapid flow of information. The credit-rating agency is different from the security analyst precisely to the extent that the credit-rating agency condenses its information into a ratings symbol – i.e., AAA to DDD.[66] This condensed information can instantly be leaked in the age of the Internet to non-paying users by any subscriber. Thus, only a fraction of the users of this information might pay for it, and the producer of this information would not be able to capture its full value because of the non-excludability of non-paying users. Arguably, this might be why the major rating agencies instead charge the issuer.

This objection is not, however, as compelling as it first appears. Some non-NRSRO rating agencies (most notably Egan Jones Rating Company) do charge their subscribers (and not the issuer). Perhaps as a result, they appear to change their ratings

[66] This is not to assume that the securities analyst is not also subject to this same "public goods" problem. After all, it also is not paid (in most cases) by subscribers or by traders who explicitly rely on its recommendations, but by broker-dealers firms who find that securities research (predictably, to be sure, optimistic such research) increases trading volume.

twice as frequently as the typical NRSRO agency,[67] thereby satisfying the constituency that pays them with more timely ratings. Still, Egan Jones does not attempt to meet with or consult the issuer or receive access to its non-public information (as it is permitted by law to do). This may be because it cannot undertake a costly investigation based on the modest fees it receives.

Even if the Egan Jones business model were revised so that it did consult with the issuer, its incentive would still be to keep its research and ratings confidential and proprietary, informing only its subscribers of ratings changes. But such a policy essentially permits its subscribers to profit from material, non-public information. Thus, to the extent that the ratings agency receives non-public information from the issuer in the course of its credit review and passes that information along only to its subscribers (rather than the public generally), this system can be viewed as institutionalizing a de facto system of selective disclosure. As a result, some (possibly including the SEC) may prefer to let the issuer pay for its rating, thereby collectivizing its cost among its shareholders, but require immediate public disclosure by the issuer of the rating. If the issuer pays for the rating, the research is likely to reach to public market quickly.

B. Can Competition Improve Rating Agency Performance? Here, two distinct questions must be evaluated: (1) Will competition produce a "race to the bottom," as low-cost, substandard rating agencies enter the field in order to sell cheap "regulatory licenses"; and (2) Can new competitors break into the market and raise the overall level of performance?

[67] See Beaver, Shakespeare and Soliman, supra note 11, at 3 (finding that Egan Jones changes its ratings twice as frequently as Moody's).

The first scenario of a race to the bottom has obviously long troubled the SEC. Some evidence does support it. Less established competitors, such as Fitch, have at times been perceived as more generous in their ratings than S&P or Moody's.[68] Logically, a new competitor needs to offer something, either a price concession or a more attractive rating, to induce an issuer to drop one of its established raters and turn to them. Not surprisingly, one empirical study has found that Fitch on average gave higher ratings than did its two larger, more established rivals.[69] But even if this tendency for ratings inflation exists, it does not follow that inflated ratings are taken seriously by the market. Rather, the norm that issuers must secure two ratings seems a protection mandated by the market to guard against the danger of ratings inflation.

The market for credit ratings is also a uniquely sophisticated market, because the vast majority of corporate debt securities are held by institutional investors that have their own credit analysts and probably as a result place only partial reliance on the agency's rating. But, if so, why is there then a demand for inflated ratings if the market does not believe them? One answer takes us back to the concept of the "regulatory license": the issuer wants the inflated rating less for its impact on the market than for its ability to reduce its regulatory costs. The market protects itself from inflated ratings by insisting on the two ratings norm, thus restricting the issuer's ability to purchase its ratings from less than independent raters. But the issuer may still have an incentive to "buy" an investment grade rating from a lower-quality rater in order to achieve some specific regulatory goal

[68] Professor Hill notes that the "perception" long existed that Fitch "was in the business only of giving inflated ratings to a company after Moody's or Standard & Poor's refused to give an issuer the rating it desired." Hill at 51-52.

[69] See Richard Cantor and Frank Packer, Multiple Ratings and Credit Standards: Differences of Opinion in the Credit Rating Industry, in 12 FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS 3, 27 (1996).

or immunity. In this light, the NRSRO system creates an incentive to find a lax ratings agency, which incentive in turn leads the SEC to keep the pool of NRSRO raters very small. That this problem is circular seems to have escaped the SEC's attention.

Another perspective on the "race to the bottom" scenario emerges from research that suggests that new raters appear in the market not to sell inflated ratings, but to meet other unmet investor needs. From this perspective, non-NRSRO agencies do different things than NRSRO agencies. For example, a recent study of Moody's Investor Services versus a non-NRSRO credit-rating agency (Egan-Jones Ratings Company) found that the younger non-NRSRO agency (Egan-Jones) was more timely in its ratings and that its ratings more closely paralleled market changes.[70] Typically, the non-NRSRO agency would lead Moody's in its ratings changes by up to six months, but it was less accurate in predicting bond defaults. Essentially, it appears to be servicing customers who want more timely information than Moody's is giving them.

On this basis, the dangers from encouraging competition seem modest and worth the risk. If the SEC were to relax the eligibility criteria for its NRSRO designation, some small firms might well enter the market in order to sell "regulatory licenses," and some ratings inflation might occur. But major institutional investors seem likely to pay little attention to lesser known ratings agencies (or might only consult them to determine current valuations). More importantly, the SEC has an obvious answer available to it to deal with this danger of regulatory licenses: admit only new entrants to NRSRO status that earn their revenues from subscribers, not issuers. Such firms have little incentive to

[70] See Beavers, Shakespeare and Soliman, supra note 11, at 3, 27. Egan Jones was found to make twice as many ratings changes as Moody's. Id. at 3.

issue lax ratings because they profit only by convincing subscribers of their independence and integrity.

Still, if new competition able to challenge the duopoly of Moody's and Standard & Poor's ever appears, it will likely surface not as an across-the-board challenge to their dominance, but through localized challenges in industries where the new entrant already enjoys a reputation for greater expertise. For example, A.M. Best Co. has long rated the insurance industry in terms of the ability of insurers to meet insurance claims. Thus, it was positioned to rate the bonds of insurance companies, a field that it has now entered aggressively.[71] Other investment advisory firms or firms of independent securities analysts might also have special expertise with regard to, say, bank stocks or public utilities. Hence, the most plausible scenario for increased competition is not the overnight appearance of a major new competitor, but rather creeping competition around the edges, as new entrants compete for a specialized segment of the market (as Fitch, itself, has successfully done). That such firms have not in fact entered the credit-rating field may reflect their estimate of the low profit potential, not the high barriers to entry. Nonetheless, the SEC should be especially prepared to relax its NRSRO barrier and admit a firm like Egan Jones, even if it lacks "national recognition," where it does have expertise in some specialized area.

The factor that may be keeping these existing highly specialized firms out of a lucrative market is that they use highly paid, highly-educated employees, while the credit-rating agencies have long paid their credit analysts only a fraction of what

[71] Press reports suggest that A.M. Best Co. will be the next firm to receive the coveted "NRSRO" designation. See Alec Klein, "SEC Prepares to Change Rules for Credit Raters," Washington Post, February 25, 2005 at E-2.

securities analysts and young investment bankers make.[72] Thus, these potential entrants may be higher cost competitors who would have to charge more than Moody's and S&P to provide the same service (although they might provide it in greater depth). To be sure, other new entrants might have lower costs and could seek to compete by offering lower prices or a cheaper product, but such lower-cost entrants would do little to improve overall industry performance.

If there is a consensus to the contemporary criticism of the credit-rating industry, it is that the established firms have made only a limited effort to update credit ratings in the light of new information (while the newer firms do better). Constant monitoring of issuers is expensive, and the costs so incurred will not necessarily be recouped from the issuer (which today pays the ratings agency only when it issues debt). Because the major ratings agencies have learned that they may wait years between debt issuances, they may economize on the potentially unreimbursed costs of ongoing monitoring and ratings changes. Precisely because it is costly to follow current developments at thousands of companies, one cannot expect that new entrants with smaller capitalizations and budgets will seek to compete on an across-the-board basis. What they will do, however, is focus on the needs of the constituency that pays them, and if they are paid by their subscribers, not the issuer, they will provide more timely ratings changes.

From this perspective, the SEC should admit new ratings agencies into the hallowed halls of NRSRO-dom, but only new entrants willing to commit more capital and invest more heavily in ongoing monitoring than the existing credit-rating agencies

[72] See Partnoy at 72; Hill at 72. Hill agrees that rating agency personnel "may not be as sophisticated, or … as highly motivated, as the (mostly institutional) investors supposedly being informed by the ratings" (id), but argues that such personnel "need not be exceedingly skilled to provide" valuable information. Id. at 73. That comment, however, misses the point if we want the ratings agency to dig deeper and uncover the information that they missed in Enron and other cases.

have been willing to do. Ratings agencies paid by subscribers seem likely to be quicker and more timely in meeting the needs of subscribers, but they may be unable to make more than a toehold entrance into a limited sector of the ratings market. Today, the SEC's use of its NRSRO rating probably discourages such a piecemeal entry.

C. Can Litigation Induce Reform? If credit-rating agencies move slowly to update their ratings, in effect following the market, rather than leading it, one potential answer is to increase the deterrent threat facing them. Today, the ratings agencies enjoy a virtual immunity from private litigation. This may seem surprising because, after all, bonds and publicly traded notes are "securities," and statements made by any person "in connection with the purchase or sale of a security" are potentially within the reach of SEC Rule 10b-5.[73] Thus, a particular rating (or its upgrade or downgrade) could constitute a material misstatement and be actionable under Rule 10b-5; similarly, the failure to update ratings in light of new information could be a material omission. Of course, these misstatements and omissions would be actionable only if the ratings agency acted with scienter, but under current law "recklessness" – meaning a conscious recognition that a statement might be false or an indifference to its truth or accuracy – suffices to satisfy the scienter standard under Rule 10b-5.

Nonetheless, the reported cases, while few in number have been extraordinarily protective of ratings agencies (far more so than the judicial decisions on security analysts). One judicial response has been to deem credit-agency ratings to be mere

[73] The general standard is that a public statement, such as a press release, that will forseeably impact the market will be deemed to have been made "in connection with a purchase or sale of a security" (which language appears both in Rule 10b-5 and Section 10b of the Securities Exchange Act of 1934) and so can violate Rule 10b-5 if made with the requisite intent. Thus, for purposes of the reach of Rule 10b-5, a credit rating is not conceptually different from a securities analyst's "buy" recommendation or an auditor's opinion that the issuer's financial statements comply with GAAP.

opinions and therefore protected speech under the First Amendment.[74] An alternative approach has been to protect the ratings agency by finding the plaintiff's reliance on its rating to have been "unreasonable."[75] This latter approach is particularly ironic because for over a century institutional investors have been found by courts to satisfy their due diligence obligation as fiduciaries by relying on "investment grade" ratings from the ratings agencies. Yet, when they attempt to sue over an allegedly flawed rating, they are told that their reliance on the rating was "unreasonable." At the least, judicial treatment of credit ratings has been inconsistent.

The relevance of a meaningful litigation remedy seems obvious. The standard critique of the dominant ratings agencies is that they have not made a sufficient investment in research and tend to slight ongoing research after initially assigning a rating.[76] Even the agencies, themselves, concede that "they do not purport to go beyond what company officials tell them."[77] Senator Joseph Lieberman contended that S&P's analysts had not even read Enron's proxy statement.[78] Holding ratings agencies to the same antifraud standard that securities analysts and auditors are held to should motivate them to research more thoroughly and update more regularly.

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[74] See, e.g., Jefferson County Sch. Dist. v. Moody's Investor Services, Inc., 988 F. Supp. 2d 1341, 1348 (D. Colo. 1997), aff'd, 175 F.3d 848 (11th Cir. 1999); Compuware Corp. v. Moody's Investors Servs., 324 F. Supp. 2d 860 (E.D. Mich. 2004) (Moody's qualified for reporter's privilege under New York statute). These two cases involved, however, actions by the issuer brought against the rating agency where the issuer claimed that the agency had given it too low a rating. The more relevant litigation remedy is that available to the investor who relies upon an "investment grade" rating, and this is the context in which Rule 10b-5 applies. Some commentators have argued that there should be no or little liability in this context. See Gregory Husisian, What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability, 75 Cornell L. Rev. 411 (1996). But this view of ratings as editorials (or as political speech) seems increasingly dated.

[75] See Quinn v. McGraw Hill, 168 F.3d 331 (7th Cir. 1999).

[76] See Hill at 81.

[77] Id. at 79.

[78] Id. at 70-71.

Still, there is a potential downside to holding ratings agencies to a more liberal standard of liability. First, the price of their services would increase, as they would be forced to invest more heavily in ongoing monitoring. Second, they might begin to exhibit a self-protective conservative bias in their ratings. That is, the more conservative the rating, the less the litigation risk. Third, at some point, the market could collapse. In the case of the rating agencies, the disproportion between the fee from the client/issuer and the astronomic potential liability to investors is even greater than in the case of the auditor. In contrast to the auditor who today may charge a fee in the tens of millions for auditing a large, public corporation, the credit-rating agency's fee is typically only two or three basis points of the amount of the debt issuance.

Realistically, however, a number of factors suggest that credit-rating agencies will not face astronomic liabilities for a flawed rating, even if its issuer client becomes insolvent. First, as a result of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), securities law defendants typically face only proportionate liability, not joint and several liability. This means that the total investor losses found by the court to have been caused by a securities fraud must be allocated among all defendants in terms of their relative culpability. In the case of a credit-rating agency, even if it were found to have committed securities fraud, its proportionate share of the total liability would be modest in percentage terms, because it typically will be far less culpable than its issuer/client. Second, the PSLRA further shelters credit-rating agencies from liability by mandating special pleading rules that require the plaintiff at the outset of its case to plead "with particularity" facts giving rise to a strong inference of fraud. Absent such pleadings, the plaintiff cannot obtain discovery against the defendant. In practice, this rule means that

few actions are generally brought against secondary defendants (such as a rating agency) because the plaintiff faces a "Catch 22"-like dilemma: it is unable to plead fraud with respect to a secondary defendant without first obtaining substantial discovery from it, and it cannot get that discovery until it first pleads fraud with particularity. In truth, these pleading rules may be the principal reason why, even in major credit disasters, little liability has been imposed on the rating agencies.[79]

What then could be done on the practical level to create an adequate deterrent threat without risking market failure? One possibility would be for the SEC to promulgate a "safe harbor" rule that would define the nature of the review that the rating-agency should make on an going basis. Such a rule might require, for example, periodic review of all public SEC filings by the issuer and direct contacts with the issuer before the ratings agency published a rating; further contacts and investigation would be necessary if the credit-rating agency maintained the rating for longer than a specified period. Procedurally, such a safe harbor rule would provide that compliance with these due diligence standards immunized the credit-rating agency from any claim that its rating was fraudulent (at least for purposes of the federal securities laws), but in substance the rule would imply (without itself creating liability) that a failure to comply with these standards could amount to "reckless" conduct that was actionable under Rule 10b-5. The practical impact of such a rule would be to advise courts that a credit-rating agency that grossly failed to investigate an issuer (or that left its rating recklessly outstanding without periodic review) could be liable under Rule 10b-5.

[79] Following its bankruptcy in 1995, Orange County sued many of its advisers and underwriters for professional negligence, breach of contract, and breach of fiduciary duty. Overall, it recovered $860.7 million from all of them, but only $140,000 from S&P, which was sued by Orange County on each of these theories. See Partnoy at 641 n. 97 and 710-711.

D. SEC Monitoring: What Can It Achieve? The SEC actively monitors broker-dealers and investment advisers and specifies a variety of standards with which they must constantly comply. Should they do the same for credit-ratings agencies? A critical difference is that broker-dealers and investment advisers manage "other peoples' money," while credit-rating agencies do not. In addition, broker-dealer firms are fiduciaries to a retail clientele, which likely contains the proverbial "widows and orphans," but credit-ratings agencies serve an almost exclusively institutional clientele. Further, in contrast to auditing firms, credit-rating agencies have less serious conflicts of interest and generally have not awarded comparable incentive compensation or stock options.[80] Hence, the credit-rating analyst faces less pressure than the securities analyst to upgrade its opinion in order to please the client and also has less incentive than the auditor to do so. Put more simply, credit-rating agencies cover thousands of corporate clients, none of whom pay fees approaching the same order of magnitude as the annual multi-million dollar fee paid by Enron to Arthur Andersen. Nor is any credit-rating analyst tied to a single major client the way an audit partner of an accounting firm often is.[81] In short, the SEC has less reason to worry about the independence of the credit analyst than that of either the auditor or the securities analyst.

But if the SEC has less reason to worry about independence, it has as much or more reason to worry about rating agency performance. This is because the major competitors operate on a low-cost business model that may protect them from new

[80] See Hill at 91-92.

[81] Typically, a credit-ratings covers up to thirty-five companies. See Frank Partnoy, "The Paradox of Credit Ratings" in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM at 72 (Richard M. Levich, et. al. eds., 2002). Credit analyst compensation, which is modest in comparison to the other gatekeeping professions, also does not seem dependent on the fees paid by any individual client, particularly because such fees are generally fixed by a formula. See Hill at 76.

entrants and increased competition. Yet, because the major credit-ratings agencies are today all registered investment advisers, the SEC arguably has authority to regulate them. How should it seek to improve performance? In 2003, the SEC published a concept release in which it proposed possible approaches for closer regulation in light of criticism of the rating agencies for their failure to detect approaching corporate insolvencies.[82] Specifically, it asked whether it should condition NRSRO recognition "on a rating agency developing and implementing procedures reasonably designed to ensure credible, reliable and current ratings?"[83] It suggested that each NRSRO could be required to "ensure that a similar analysis is conducted for similar companies and that current information is used in the rating's agency's analysis." In addition, it pondered whether it should "establish minimum due diligence procedures for ratings agencies."[84] Other questions posed by the SEC for public comment included (1) whether it should limit the number of companies assigned to an analyst;[85] (2) whether it should adopt "minimum standards for the training and qualifications of credit analysts";[86] and (3) whether it should supervise "the extent of contacts with the management of issuers (including access to senior level management of issuers)."[87]

Incorporating these criteria into the process for recognizing NRSROs would address the recent lackluster performance of credit-rating agencies in failing to detect financial deterioration at rated companies, but it would also involve the Commission deeply and intrusively in the business practices of rating agencies. It will not be simple

[82] See Securities Act Release 33-8236 (June 12, 2003).
[83] Id. at Question 13. 68 FR35258 at 35261.
[84] Id.
[85] Id. at Question 17.
[86] Id. at Question 16.
[87] Id. at Question 14.

for the Commission to develop "minimum due diligence" procedures for ratings agencies or any profession. In so doing, it might also raise the barriers to entry for potential new entrants. In this light, encouraging rating agencies to obtain their fees from subscribers, rather than issuers, may do more than governmental monitoring to make agencies responsive to the needs of investors.

Sensible compromises are also possible. One such proposal, advanced by Fidelity and the Investment Company Institute, would be to make the NRSRO designation periodically renewable, much as broadcast licenses are periodically renewed.[88] This would permit liberalization of the recognition criteria for NRSROs in order to encourage new entrants, but also condition recognition on a periodic backward look to weed out those firms that had failed or proven to be fly-by-night operators selling "regulatory licenses." At such a periodic review, regulators could also look at the accuracy of the issuer's ratings, thereby focusing on outputs, rather than inputs.[89]

Another route to this same end could be the creation of a "self-regulatory organization" (or "SRO") for credit-rating agencies, much like the NASD or the PCAOB. This would allow the industry to propose self-regulatory standards; the problem, however, is that the industry today is an oligopoly.

E. Summary.

All these approaches offer some promise: increased competition could work to bring in some specialized competitors with greater expertise who would be willing to make a greater investment in monitoring their chosen segment of the market; an

[88] See Hill at 88. Professor Hill notes, however, that the threat not to renew a broadcast license has never been credible. Hence the threat not to renew a Moody's or a S&P would seem similarly hollow.
[89] This has been a criticism long made by Professor Lawrence J. White of New York University: i.e., that regulators unwisely focus on "inputs," rather than "outputs" – i.e., the agency's actual record as a predictor. See Hill at 86.

enhanced litigation remedy should encourage greater due diligence and investment in research. SEC standards could also work – modestly and marginally at least – to require greater investment and to allow the Commission to review actual performance periodically.[90] Finally, the Commission could encourage the growth of subscriber-funded ratings agencies by offering them easier admission to the coveted NRSRO-status. This option probably makes the greatest sense, because it is difficult to understand why subscriber-funded ratings agencies would lead the race to the bottom that the SEC evidently fears. Their market lies instead in convincing their subscribers that they can provide more timely information.

[90] The most recent press reports suggest that the SEC is concerned about its statutory authority to regulate credit-rating agencies and will not aggressively pursue this option. See Deborah Solomon, "SEC Says It Can't Police Credit-Ratings Firms" The Wall Street Journal, February 25, 2005 at C-4.

Chapter 8: What Might Work?: A Preliminary Assessment

Gatekeepers differ. One size clearly does not fit all. But even if their differences overshadow their similarities, one generalization does emerge from the foregoing tour: namely, that investors, as principals, have relatively weak controls over the professional agents who in theory serve them. In comparison to the mechanisms of accountability that shareholders have vis-à-vis corporate officers and directors, the relationship between gatekeepers and investors is one in which investors have significantly less legal rights or controls and only an implicit, rather than an actual, principal/agent relationship.

The gatekeeper's fidelity to the investor is only weakly enforced by either market or legal incentives. Only the auditor faces liability based on well-established legal principles, while the others – analysts, attorneys, and credit-rating agencies – have almost never been able liable to investors. As discussed earlier in Chapter 2, those legal remedies that investors did enjoy were seriously weakened in the 1990s, particularly by the abolition of "aiding and abetting" liability and the passage of the PSLRA. But this still leaves a major question. Even if legal rights were eroded, why wasn't the gatekeeper's interest in preserving its reputational capital sufficient to protect investors? Every gatekeeper asserts that its reputational capital is critical to it, but their collective behavior during the 1990s seemingly belies this claim. Few took serious precautions to protect their reputations (and many relaxed controls that had previously been in place). Thus, the central mystery becomes: Why did gatekeepers risk or even sacrifice reputational capital that they had earlier worked diligently to amass and protect?

Tentative answers to this question are best grouped under three broad headings: (1) Competitive Environment; (2) Gatekeeper Capture and Conflicts of Interest; and (3) The Role of Reputational Capital.

1. Competitive Environment. The starkest, most basic fact about the four gatekeepers just examined is that two of these gatekeeping markets – law and securities research – are characterized by active competition, while the other two – auditing and credit-rating services – are not. Not surprisingly, the markets that are the least competitive are those in which the role of reputational capital looms the largest. Auditors and credit-rating agencies need to possess significant reputational capital in order for investors to perceive them as resolute and unlikely to defer to corporate managements. This capital must be at risk in order to assure investors that any economic gain that the corporate client could confer on the gatekeeper for acquiescing would be exceeded by the cost of long-term reputational loss. As a result, the need for pre-existing reputational capital creates a barrier to entry that may preclude new entrants.

The impact of competition on gatekeepers is debatable and probably involves a tradeoff. If the gatekeeper enjoys a near monopoly, it can better resist pressure from the client. But its willingness to resist pressure will still depend on whether it also faces either exposure to litigation from investors or the potential loss of its reputational capital. On the other side of the equation, in a truly monopolistic market, the gatekeeper has little reason to invest in new technology or controls – or, more simply, to improve its product or service. Instead, there will be organizational slack (as many believe exists in the contemporary credit-rating agency market).

Competition should spur the gatekeeper to improve its product or service, but it may also leave the gatekeeper more vulnerable to client pressure. The legal profession seemingly provides a clear example, but again additional institutional detail complicates the picture. Unlike auditors and credit-rating agencies, corporate attorneys are only part-time gatekeepers. They thus have only weak incentives to play a gatekeeping role. In truth, corporate attorneys are probably more prized for their ability to outmaneuver regulators, exploit loopholes, and generally economize on regulatory costs. Certainly, this is what their corporate employers expect, and if investors have a different preference or expectation, the attorney, except under special circumstances, will more likely conform to the corporate client's expectations than to the investor's.

Nor do attorneys depend as heavily on reputational capital. Law firms compete on the basis of price and quality of service much more than on the basis of their reputation for integrity. This is why new start-up firms can (and do) enter the market and compete successfully. Also, because the corporate client's general counsel is the actual purchaser of legal services and can conduct a sophisticated search, law firms can prosper even though their identities are unknown to the general public. In contrast, corporations hiring independent auditors are necessarily more concerned with reassuring investors and so need to find an auditor with an instantly recognizable identity. To sum up, although a highly competitive market may have inhibited law firms from playing a gatekeeping role, it was probably only a secondary factor. The larger problem involves the weakness of the incentives motivating the corporate attorney to play a gatekeeping role in the first place.

Securities analysts present a more intriguing case because active competition and clear sensitivity to reputational concerns did not cause analysts to resist pressures during

the 1990s to inflate their recommendations. In overview, the performance of securities analysts and credit-rating agencies differed sharply during the 1990s for reasons that are not self-evident. Although both perform functionally similar services, their two markets are polar opposites, with securities analysts, unlike the ratings agencies, inhabiting a highly competitive market.

Why are the two markets so different when their services are so similar? The answer may lie in whose reputation is at stake. Typically, the individual securities analyst advances based on his or her own personal reputation, while in contrast investors never even learn the identity of the credit analyst who conducts Moody's or S&P's assessment of an issuer. Investors want a creative vision from the securities analyst, but only a standardized (and highly condensed) comparative rating from the credit-rating agency. In addition, only an institution – and not an individual – can generate comparative rankings on thousands of issuers prepared on a consistent basis. Arguably, creativity tends to be personal, and thus securities research spawns a market with many competitors and low barriers to entry. In contrast, investors want something very different in the case of credit ratings: namely, a consistent methodology that is objectively and evenly applied to all rated firms, which requirement necessitates that an institution, not an individual, be the rater. Given this need for greater scope and scale, it is not surprising that the market for credit ratings is more concentrated and the barriers to entry are higher.

Still, the relevant policy issue is less why some markets are competitive and others not than whether encouraging competition would enhance or erode gatekeeper influence and reliability. Conceivably, competition could do more harm than good. The credit-rating agencies, which have historically faced little or no competition, appear to

have remained largely uncaptured by their corporate clients – even if they were slow to respond to new information. Thus, the SEC has long feared that new entrants would lower standards.[1] In contrast, securities analysts during the 1990s probably were the most "captured" gatekeeper, despite intense competition. The case of attorneys also reinforces this generalization, as increased competition in the market for corporate legal service appears to have coincided with the arguable decline of the lawyer/statesman. Today, corporate lawyers largely compete as technocrats in a short-term, spot market, where they are hired by a general counsel who has every reason to want specialized expertise more than broad, free-ranging judgment.

Yet, enhanced competition could well increase auditor independence and incline firms to resist the demands of a client more resolutely. Why? Today, in a highly concentrated market, the Big Four can all assume that both their firm and their rivals will take a certain number of reputational "hits" – that is, all will be predictably involved in some messy scandals. Because it is a cost of doing business, no firm with a substantial market share can expect to remain unscathed. Although spectacular failures (such as Arthur Andersen's in the Enron implosion) will attract attention and destroy a firm's reputational capital, investors cannot meaningfully discriminate among shades of gray; thus, they cannot distinguish Ernst & Young from a Deloitte. Each has had its share of embarrassing moments, and investor memory may be short. As a result, reputations become noisy, and investors can only recognize the outliers. This absence of reputational competition may be just what the competitors want because it enhances their

[1] As discussed in Chapter 7, this attitude seems myopic. Particularly if new entrants into this market were dependent upon subscribers for their revenues, they could lead a race to the top.

discretionary ability to cooperate with corporate managements, knowing that none of their rivals will seek to embarrass them or distinguish themselves.

But suppose instead that the market for auditing services had a dozen or more large auditing firms, each logistically capable of providing global services to a large corporate client. In such a market, all firms would not face the inevitability of reputational injury, and a few firms might distinguish themselves for being "tougher" on the client. Such a stance might not please all, or even most, large corporate clients, but it would be attractive to clients seeking to bond themselves with investors. Interestingly, Arthur Andersen adopted such a profile back in the 1950s, when its leaders repeatedly criticized generally accepted accounting principles for being too soft and permissive.[2] At that time, the accounting industry was less concentrated, and Andersen was a relatively young and smaller firm. During this era, the stock market was far less frothy than during the 1990s; stocks declined as often as they rose, with the result that investors may have been more interested in the auditor's reputation. Andersen's strategy seemed to work, and given similar circumstances, it might work again. But Andersen abandoned this policy once it became more lucrative to expand one's business with existing clients through consulting than to attract new auditing clients. Thus, competition will work to induce desired behavior only to the extent that some firms want to compete based on their reputations. And this is not inevitable.

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[2] Leonard Spacek, the managing partner of Andersen who took over as the firm's leader in 1947 on the death of Arthur Andersen, was known within the profession as the profession's conscience. He not only preached the need for high integrity but organized Andersen around a strong system of internal controls and second partner review, and he was outspoken in his criticism of some generally accepted accounting principles as too lax. Many of his contemporaries at other firms disliked his lecturing of the profession, which they saw as marketing, but at the time it seems to have attracted business for Andersen. See Christine Earley, Kate Odabashian and Michael Willenborg, Enron, the Demise of Andersen and the Ethical Climate of Accounting, 35 Conn. L. Rev. 1013, 1028 (2003); Previts & Merino at 310-311.

Enhancing competition will work as a reform strategy only if the costs of entry into the market are not prohibitive. Today, the auditing market has become global, and the new entrant seeking to provide global auditing services to major corporations faces much higher minimum capital requirements incident to attaining global scale. Still, in 2003 and 2004 alone, over 10% of all publicly held corporations changed their auditors, and in this process, the Big Four lost a net total of over 400 corporate clients.[3] Increased competition seems then a safe prediction.

The impact of enhanced competition on securities analysts and credit-rating agencies is more speculative. The market for securities research is already highly competitive. The real problem is that the analyst generates little or no direct revenue, and recent reforms have restricted the indirect revenues (i.e., underwriting income) that securities research once generated. As a result, broker-dealers have cut back on research coverage and have reduced incentives to invest in research. Although analyst research still does attract brokerage commissions, securities research is likely to remain a "loss leader" for most broker-dealer firms, in which they will make only modest investments. Only if securities research generated ascertainable revenues and became a profit center for broker-dealers would a strategy of encouraging competition likely work within this market.

Credit-rating agencies present an even more debatable case. Although today the Moody's/S&P duopoly has long dominated this industry, competition might be encouraged either from (i) specialized firms that already possess expertise with respect to

[3] See Chapter 4 at [note 282]. In 2004, the Big Four resigned from 210 public companies; in 2003, from 152; in 2002, from 78. By dropping higher risk clients, the Big Four is opening the door to real competition. See Lynnley Browning, "Sorry, the Auditor Said, But We Want a Divorce," N.Y. Times, February 6, 2005, Section 3, p. 5. Most of these changes were, of course, because the Big Four has decided to drop smaller, higher-risk clients, but the result is still to make the market less concentrated.

a particular industry (for example, insurance or banking, where such expert firms clearly exist), or (ii) professional services firms that enjoy high reputational capital. For example, if a PriceWaterhouseCoopers began to offer credit-rating services for non-audit clients, investors would likely consider their ratings credible – on the assumption that such a firm would take considerable safeguards to avoid reputational injury.

The principal credit-rating agencies have long behaved as "quasi-regulatory" bodies, content to receive high rents and disinclined to provide more timely monitoring of their issuer clients. This reluctance is unfortunate but rational. Because the rating agency bills the issuer client on an upfront basis, it has less incentive to invest in continuing research after it has been paid. Much as with securities research, rating agencies need to be incentivized (or threatened) into making a greater investment in ongoing research. But the typical new entrant will have far less capital to invest than the two established oligarchs, Moody's and S&P. Hence, the new entrant who may most affect their behavior is the new entrant who is paid by its subscribers, not by issuers, because it will be more likely to provide timely updates to satisfy its subscribers (and thus will challenge the dominant, but slow-moving, oligarchs).

To sum up, although competition is not a panacea, it can motivate firms to invest in their reputational capital. Unfortunately, as in the market for legal services, competition may also tend to erode professional values. It is thus, by itself, less than a complete or optimal solution.

2. Gatekeeper Capture and Conflicts of Interest. Across all markets for gatekeeping services, much evidence suggests that gatekeepers lost leverage vis-à-vis their clients over recent decades. The clearest example is the legal marketplace. Although

it is debatable whether the arguably mythical lawyer/statesmen ever truly existed in significant numbers, reliance on a single outside attorney – one who exercises judgment as well as expertise – has clearly decreased in response to the rise of the in-house general counsel.

Within the auditing marketplace, a debate continues as to whether the desire to cross-market more lucrative consulting services compromised auditor independence during the 1990s. The participant observers have largely reported that the climate within auditing firms changed as auditors were retrained to become salesmen and cross-sell consulting services. Still, the regression studies disagree as to whether a high ratio of non-audit services to audit services actually correlates with a higher probability of a financial statement restatement or with greater earnings management. At best, these studies are inconclusive, and at worst they seem to undercut the hypothesis that the rise of consulting services compromised auditing.

But these studies miss a key point. In a highly concentrated industry, the major auditing firms all wanted to attract lucrative consulting income from their clients, even if they had not yet achieved that goal. Each knew more or less what its rivals were doing. During the 1990s, they collectively changed their business models in order to use auditing as a portal of entry through which they could market consulting services to audit clients, because consulting revenues, unlike auditing revenues, could grow exponentially. Thus, even if the auditor was currently receiving little consulting income from a particular client, it might still be as deferential to that client as it was to another audit client from which it was receiving substantial consulting income – so long as the prospect of future consulting income existed. Once the audit partner was converted into a salesman,

both current consulting income and the potential for such income gave rise to nearly equivalent conflicts, and hence regression studies showed little difference in the behavior of firms in terms of the amount of consulting revenues that they paid their auditors. The sharp and pervasive rise in accounting restatements in the late 1990s provides the strongest evidence that auditors did acquiesce in dubious accounting policies. Clients that actually paid high consulting income did not stand apart or show a higher rate of irregularities, because the audit firm had already positioned itself to market for consulting income from all its clients and so was more or less equally inclined to acquiesce.

In general, a conscious parallelism of action often characterizes the behavior of the competitors in a concentrated industry. Observing that their competitors deferred to their auditing clients, each individual firm might see little to gain and much to lose from acquiring a reputation for intransigence. Finally, in a stock market bubble, investors worried less about auditing, but corporate managers cared greatly about maximizing share prices.

The impact of conflicts of interest is even clearer in the case of securities analysts. The 1990s saw an extraordinary growth in IPO and underwriting activity, which created strong incentives for broker-dealers to organize their research departments as marketing agents for their underwriting clients. But again, as in the case of auditors, the empirical studies show conflicting results. Some studies find that the market discounted the recommendations of "conflicted" analysts employed by the corporation's underwriters, but other studies do not.[4] But again, these studies attempt to answer the wrong question.

[4] Compare Daniel Bradley, Bradford Johnson and Jay Ritter, "Analyst Behavior Following IPOs: The 'Bubble Period'" (Working Paper October, 2004) (studying 7,400 analyst recommendations and finding little evidence that the market discounted the views of affiliated analysts in comparison to unaffiliated analysts) with Xia Chen, "Analyst Affiliation, Ranking and the Market Reaction to Stock

That wrong question is whether the market considered analysts working for the issuer's underwriter to be more conflicted than analysts working for other broker dealers. In fact, all broker-dealer firms were conflicted. Not only were firms that did underwriting conflicted by the need to appease their underwriting clients, but so were firms that either wanted to be underwriters or, even in the absence of any such interest, still wanted to please the institutional investors who were their largest brokerage clients. Both the corporate client and the institutional client disliked "sell" recommendations that were publicly communicated. Finally, all corporate issuers, including even non-clients, possessed a formidable weapon by which to threaten or punish analysts who published negative research: they could cut such analysts off from the further flow of selective disclosures, thereby virtually driving such an analyst out of the market.[5]

Alone among the gatekeepers, the major credit-rating agencies were not "captured" by their clients during the 1990s. This was both because they approached the status of a natural monopoly and because they had the least dependence on individual large clients. Still, even these firms had earlier modified their relationship with their clients in a manner that made them less independent. Until the mid-1970s, credit-rating agencies received their revenues from subscribing investors, but thereafter, following a period of relative austerity, the major rating agencies changed they business model so that their revenue stream came from corporate issuers that paid for their own ratings. While rating agencies did not experiment with any of the forms of incentive compensation and cross-marketing that compromised auditors, they still had little incentive to scrutinize a

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Recommendations for IPOs" (Working Paper October, 2004) (studying 7,354 stock recommendations relating to 1,666 IPOs in 1996-2000 and finding such a discount for the positive recommendations of analysts employed by a lead or co-lead underwriter).

[5] This conflict has been at least partially mitigated by the adoption of Regulation FD in late 2000, which prohibits selective disclosure to analysts.

corporate client on an on-going basis after they issued a rating. Facing no prospect of liability and no real competitive threat (particularly given the "two ratings" norm), they could (and did) enjoy the pleasures of the quiet life. In this light, to the extent that one views the prospect of competition in this market as remote,[6] then one is forced to recognize that only the prospect of enhanced liability can significantly change behavior in this market.

3. Reputational Capital. In theory, gatekeepers should not risk the reputational capital built up over decades to maximize the earnings from a single client. For example, even in the case of Arthur Andersen, which saw Enron as a $100 million a year potential client, the firm's total earnings in its last year exceeded $9 billion. Hence, because in the absence of Enron (and later WorldCom), Andersen would probably still be alive today, its deference to Enron's dubious demands looks irrational in hindsight. But what really proved wrong with the logical premise that "rational" gatekeepers would protect their reputational capital?

Several different answers can be given to this important question. An obvious explanation is that litigation risk declined, and with that decline came a reduced risk of reputational injury because litigation attracts publicity and produces reputational damage. Although this may account for much of the change in the 1990s, other independent explanations also explain the willingness of professional firms to risk or even sacrifice reputational capital:

A. An Inability to Monitor Agents. While it was irrational for Arthur Andersen to defer as it did to Enron, it was not irrational for the audit partners at Arthur Andersen handling the Enron account to do so. Their career interests were arguably more closely

[6] There is in fact some real prospect of new competition in this market. See Chapter 7 at notes # to #.

aligned with their corporate client than with their audit firm. This explanation is simple but incomplete. Why didn't the firm take precautions to better control its agents? "Agent capture" is a problem in internal controls that a sophisticated accounting firm should have anticipated. Arguably, if Andersen had truly wished to curtail audit partners from identifying excessively with the client's interests, Andersen had only to adopt prophylactic measures (such as a limit on consulting income from an audit client or a mandatory rotation policy under which the audit partner would rotate every two or three years). Extreme as such measures may seem (for example, clients would obviously not like the constant replacement of their audit partners), auditing firms could have minimized the risks associated with this conflict of interest.

Because controlling conflicts of interest is costly, however, some level of agency costs had to be accepted. Andersen's failure to use more aggressive measures to protect its agents from client capture suggests that it placed the need to market its services above the need to protect its integrity. Given the climate of the 1990s, this was not a surprising choice.

B. Reputational Schizophrenia. Protecting its reputational capital is not the only goal that a professional firm has in terms of marketing its image. Law firms present a special case. Uniquely, the law firm may wish to promote inconsistent images of itself to different persons. To the corporate general counsel, it is the tough, relentless advocate, the hard-driving negotiator and the skillful planner who is able to exploit whatever loopholes the law offers. To investors and the public generally, it is the wise statesmen with an impeccable reputation for integrity whose opinions can be relied upon. These competing self-definitions can blur, or the law firm may vacillate between them, playing

sometimes the advocate and sometimes the gatekeeper. The underlying policy point here is that it may be necessary to insist that a law firm choose a single role that it is to play for the corporate client, and this may restrict the law firm's ability to provide inconsistent services.

C. Regulatory Licenses? Another explanation for gatekeeper failure is that gatekeepers saw more profit in selling "regulatory licenses," than in protecting their reputational capital. This theory applies with some plausibility to the credit-rating agencies where the SEC has uniquely privileged those rating agencies that have obtained the SEC's elusive NRSRO rating, which enables them to reduce significantly their clients' regulatory costs. But outside this narrow context of the credit-ratings market, where real competition is lacking, this theory seems overextended. Some would apply this theory to auditors as well. Their view is that the federal securities laws similarly gave a regulatory license to auditors by mandating an independent audit for publicly traded companies.[7] But this interpretation overstates the "regulatory license" theory's logic. Legislation that mandates an audit may increase a public corporation's regulatory costs, but it does not enable a gatekeeper to reduce those regulatory costs in return for its fee (as the NRSRO designation does). Federal law that mandates use of a gatekeeper may create a market that would not have otherwise existed, but it does not enable the gatekeeper to sell immunity from otherwise applicable regulatory requirements.

D. Implicit Collusion? In a concentrated market, the competitors can decide whether not to compete or whether to compete only on a certain bases. Actual collusion is not necessary, as implicit signals can be exchanged. Over the last twenty-odd years,

[7] See Sean O'Connor, Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence, 46 B.C. L. Rev. 741 (2004).

auditing firms have not competed in terms of relative integrity or commitment to accurate financial reporting. Not only would such a competition invite destructive retaliation from their rivals, but the competitors knew that this was an ineffective strategy by which to win clients. Cooperation and flexibility won clients. Senior managers at clients wanted auditors who would assist them in maximizing the firm's stock price by using any accounting principle or convention not clearly and strictly prohibited. While reputational injury and litigation risk always placed some limitations on what the auditor could accept, both of these constraints were relaxed significantly during the 1990s. Even price competition became less important, as auditors found it more profitable to develop their existing client base and exploit the opportunities for more lucrative consulting income than to compete for the clients of other auditors. They had found that competition over existing clients resulted, more often than not, in a zero-sum game in which the auditor won one client only to lose another. Accordingly, they chose to focus more on exploiting the opportunities for cross-selling non-audit services to audit clients than on stealing clients from rivals.

This tendency toward a closed-ranks solidarity may also characterize other professions. After all, doctors do not describe their rivals to the press as "quacks"; nor do lawyers typically denounce their adversaries in public as "shysters" or "ambulance-chasers." But as others have noted,[8] throughout the intense criticism that the accounting profession attracted during and after the collapse of Enron and the passage of the Sarbanes-Oxley Act, the principal audit firms and their partners remained steadfastly silent. No accounting professional in private practice called for reform of the profession.

[8] See William W. Bratton, Rules, Principles, and the Accounting Crisis in the United States, 5 European Business Organization Law Review, 7, 27 (2004).

This was in marked contrast to the often public and nasty debates within the more competitive securities brokerage industry.

Post-Enron, as the litigation risks have risen and as the possibility of crippling reputational injury is much more evident, the major audit firms have taken action to unload their riskiest clients, usually passing them along to smaller audit firms not in the Big Four. But prior to Enron and the new reforms, such resignations were rare. Clients were too valuable to be surrendered, because, even if audit fees were relatively stable, the non-audit fees from such clients could be projected to grow exponentially.

In contrast to the closed ranks solidarity of the auditors, a very different pattern characterized the market for securities research. That analysts often disagree about individual companies is not surprising (in part because some analysts work for firms that have client relationships with the subject corporation and others do not). But it is more instructive to compare how brokerage firms responded to the adverse publicity that began with Attorney General Eliot Spitzer's investigation of Merrill Lynch's securities analysts. In response, some major firms quickly and voluntarily adopted strict new conflict of interest policies (for example, Merrill Lynch prohibited its analysts from covering stocks that they personally owned), but others did not. Still other firms (most notably, Charles Schwab & Co.) aggressively and publicly criticized their rivals in widely televised commercials attacking their conflicts of interest.[9] This level of combat occurs only in a truly competitive market (and the brokerage industry has long been fiercely competitive),

[9] In 2002, Charles Schwab ran a series of satirically barbed T.V. commercials in which hypothetical sales managers at rival firms pushed their brokers and analysts to deceive their clients by saying "Let's put some lipstick on this pig." See Neil Weinberg, "Holier than Whom?: Lipstick on the Schwab Pig," Forbes June, 2003 at p. 71. Perhaps because Charles Schwab was not an underwriter, it was freer to attack the conflicts and tainted research of its rivals.

and it contrasts sharply with the solidarity shown by the nominal rivals in the accounting industry.

E. Noisy Reputations. Another reason that audit firms did not take more aggressive steps to protect their reputational capital prior to Enron may be that they realized their reputations had largely blurred and investors could not distinguish clearly among them. Once, a decade or so earlier, a clear hierarchy was discernible within the accounting industry, with Price Waterhouse and Arthur Andersen being regarded as the "Tiffany" firms within the profession. But then came a wave of mergers among accounting, and reputations blurred, as firms with the best reputations often acquired firms with mediocre reputations.

In overview, that these mergers occurred shows that senior managements at the acquiring firms believed size and scale were more important to their future than prestige. Reputational capital was in this sense deliberately diluted in order to gain scale and clients in an increasingly global marketplace.

This willingness to accept dilution of their firm's reputational capital expressed itself in other ways as well. Some empirical evidence suggests that a high level of non-audit fees at a particular audit client alarmed investors and made them question the reliability of the corporation's earnings.[10] Although these studies did not show that auditor independence was in fact impaired, they did indicate that apparent conflicts attributable to a high level of non-audit fees caused the market to discount the corporation's earnings. In effect, investors questioned the auditor's independence and thus reduced the stock price. Despite this reaction, prior to Enron, investor anxieties do

[10] See J.R. Francis and B. Ke, "Disclosure of Fees Paid to Auditors and the Market Valuation of Earnings Surprises," (working paper on SSRN at id=487463) (high non-audit fees leads to a 17 percent reduction on average in the market valuation of quarterly earnings surprises).

not appear to have slowed auditors in their race to maximize consulting revenues from audit clients. Even placing a ceiling on such consulting revenues was too high a price to pay for protecting their reputational capital.

F. The Impact of the Bubble. A final explanation for the apparent willingness of auditors to risk their reputational capital was that a market bubble increasingly made investors less concerned with backward-looking financial information and more focused on forward-looking disclosures. Under this alternative view, the gatekeepers' reputations were less noisy than irrelevant. If investors had lost their natural skepticism because of a decade of constantly increasing earnings and stock prices, then investors might have been no more concerned about the identity and reputation of their auditor than are the tenants of a skyscraper about the identity of their elevator inspector. Like elevator failure, audit failure was discounted as a trivial risk. But if these risks seemed remote, then issuers would come to perceive that the costs of rigorous gatekeeping exceeded their benefits. More generally, during the 1990s, investors came to rely more on securities analysts than on auditors.

To the extent that this scenario has validity, auditors may have sensed that investors in an exuberant market were becoming indifferent to the auditor's relative professional reputation. Arguably, the corporate client merely needed some minimally reputable auditor to certify its financial statements in order to satisfy the SEC. Although auditors were necessary for legal reasons, they did not create value for their clients, and hence they had reduced leverage. From this perspective, if your client places little value on your services, your best strategy for holding a lucrative client is to become very

compliant. To be sure, this theory may seem overbroad and too cynical as applied to all clients, but it could easily apply to some.

The common denominator to all these accounts is that reputational capital can be risked or sacrificed, either because its value had declined in a market that viewed the gatekeeper as an old-fashioned, non-essential service provider or because the gatekeeper could not profit from its "excess" reputational capital. By the end of the 1990s, the auditor arguably needed only to have a qualifying level of reputational capital, and it did not need to expend resources to protect any "excess" level of such capital, particularly if it interfered with its ability to market other more lucrative services.

4. The Post-Scandal Markets. In the wake of scandals and the reforms of the Sarbanes-Oxley Act, much has changed. As noted earlier, auditors are shedding their riskier clients and observing (for the time at least) a norm imposed by institutional investors that non-audit revenues from any audit client stay below its audit revenues. Conflicts of interest are thus reduced, and, in any event, litigation risk is certainly higher. Securities analysts have similarly changed their behavior, and while optimism still dominates pessimism in their recommendations, the percentage of "sell" recommendations is now substantial. But there has been a cost to reform: employment and coverage within the field of securities research has declined markedly. The dilemma underlying these reforms is that securities research is today more independent but less available.

Against this backdrop, it is now time to move from description to prescription. Given that reputational capital will not automatically be defended, several alternative strategies can be proposed: (1) Gatekeeper Empowerment – increasing the leverage that

the gatekeeper has over its principal – for example, by requiring mandatory certifications or opinions; (2) Re-aligning the Principal/Agent Relationship – gatekeepers could by a variety of means be made directly responsible to investors, not management; and (3) Restoring the Litigation Threat – here, the issue is less how to increase the threat, than how to avoid market failure. The next chapters will evaluate each of these approaches.