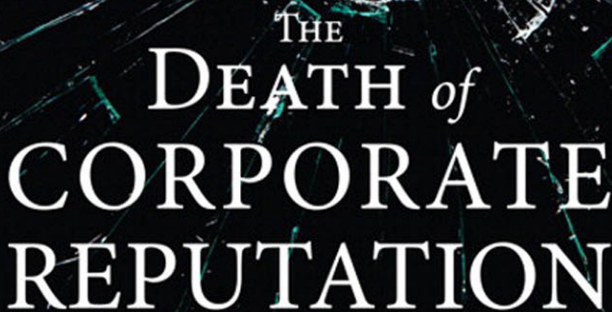
The Death *of* Corporate Reputation



How Integrity Has Been Destroyed on Wall Street

Jonathan R. Macey

Praise for *The Death of Corporate Reputation*

"In his path-breaking new study, *The Death of Corporate Reputation*, Yale Law Professor Jonathan Macey offers a fresh, provocative, and insightful analysis of the intersection of reputation and regulation. In his characteristic manner, Professor Macey invokes close institutional and legal analysis with a commanding understanding of economics, finance, and politics to describe a set of profound changes to the system of American finance that regulators, market participants, and the public at large ignore at their peril. The book is an indispensable read for anyone who cares about the very survival of our system finance and those who are dependent on its functioning."

—**Ronald Daniels**, President of Johns Hopkins University who previously has served as Provost of the University of Pennsylvania and Dean of the University of Toronto Faculty of Law

"The book contains a frank and compelling account of some of the problems that plague our so-called corporate democracy. Drawing on the lessons in this book, we should craft stronger rules to require the corporate directors and the law firms, investment banks, and other businesses that are paid with shareholders' money to work on behalf of the shareholders and not on behalf of themselves. The topic of reputation is an important one that all companies in the financial world should be concerned about."

—**Carl Icahn**, one of the most successful financiers in U.S. history

"In *The Death of Corporate Reputation,* Jonathan Macey chronicles the demise of an era in which ethics and integrity mattered for both personal and economic reasons. Using brilliantly curated real-world examples, Macey describes a new era in which regulatory (and other) forces displace, but fail to replace, traditional incentives for upstanding individual and corporate behavior. Students of finance and participants in the markets will both benefit enormously from and enjoy Macey's provocative and thoroughly engaging book."

—**David Swensen**, Chief Investment Officer at Yale University

"*The Death of Corporate Reputation* is a brilliant, provocative, and persuasive exploration of a root cause of the failure of modern financial market regulation, engendered by lawmakers, regulators and prosecutors, and their legal and accounting acolytes. Systemic change in corporate behavior cannot be engineered solely by externally imposed fiat; it must come from within. In this seminal work, Professor Macey demonstrates, with unerring accuracy, unassailable logic, and wit, that modern financial regulation effectively nullifies and destroys the most potent antidote to corporate malfeasance—the innate drive to create, maintain, and enhance positive organizational reputations. A must-read for anyone concerned about the health and well-being of our capital and financial markets."

—**Harvey Pitt**, CEO of global business consultancy Kalorama Partners, formerly 26th Chairman of the U.S. Securities and Exchange Commission (2001–2003)

"*The Death of Corporate Reputation* is a revolutionary book. It blends incisive analysis and colorful narrative to track the demise of the traditional theory of reputation, with a focus on the decline of Wall Street banks and their dysfunctional support network of accounting firms, law firms, credit rating agencies, and regulators. In a skillful and refreshingly frank about-face from some of his previous writings, Yale Law School Professor Jonathan Macey, once a leading proponent of traditional theories of reputational capital, systemically hacks to pieces the assumptions that once supported those theories and argues for a far more skeptical approach to the complexities of modern financial markets and their regulatory apparatus. A new conversation about reputational theory has begun, and with this comprehensive and engaging book, Professor Macey has emerged as one the movement's leading and most compelling voices."

—**Professor Frank Partnoy**, George E. Barrett Professor of Law and Finance at the University of San Diego, author of *F.I.A.S.C.O.: Blood in the Water on Wall Street*, *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets*, and *The Match King: Ivar Kreuger, the Financial Genius Behind a Century of Wall Street Scandals*

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Jonathan R. Macey

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This book is for my family: Amy, Josh, Ally, and Zach,
individually and collectively, who are invaluable
and precious sources of moral, spiritual,
and intellectual inspiration for me.

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81 *Washington University Law Quarterly* 329 (2003); "Observations on the Role of Commodification, Independence, Governance, and the Demise of the Accounting Profession," 48 *Villanova Law Review* 1167 (2003) (with Hillary Sale); "The Economics of Stock Exchange Listing Fees and Listing Requirements" 11 *Journal of Financial Intermediation* 297 (2002) (with Maureen O'Hara).

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Introduction

My goal is to describe the role that reputation once played in fostering the high-trust environment that is critical to the successful operation of capital markets and corporate financing transactions generally and to try to explain what has caused so many firms in the financial industry to lose interest in cultivating and maintaining their reputations for integrity. Corporate finance and capital markets traditionally relied heavily on the ability of companies and other firms to develop what is known as reputational capital. For the industries on which I focus in this book, credit rating agencies, law firms, investment banks, stock exchanges, and accounting firms, reputational capital historically has been the primary mechanism by which businesses establish trust in markets and in contracting relationships.

I argue here that there has been a collapse in the market demand for reputation, at least in heavily regulated countries like the United States that increasingly rely on regulation rather than reputation to protect market participants from fraud and other forms of abuse. It used to be the case that for a diverse array of companies and industries involved in the capital markets, nurturing and maintaining the organizations' reputation was absolutely critical to their growth and continued success. I argue that this simply is no longer the case, at least in the U.S.

On Wall Street, company reputation matters far less than it used to matter, for three reasons. First, improvements in information technology have lowered the costs of discovering information about people. This, in turn, has made it worthwhile for individuals involved in the financial markets—lawyers, investment bankers, accountants, analysts, regulators—to focus far more on the development of their

own individual reputation than on the reputation of the companies for which they work.

Second, law and regulation serve as a substitute for reputational capital, at least in the minds of regulators and market participants. In modern times, particularly since the promulgation of the modern securities laws, market participants have come to rely far more on the protections of the law, and far less on the comfort provided by reputation, when making investment decisions and in deciding whether to deal with a particular counterparty. The current financial crisis, in my view, demonstrates that, in reality, regulation is no substitute for reputation in ensuring contractual performance and respect for property rights.

Third, the world in general and the world of finance in particular have become so complex that rocket scientists who design complex financial instruments have replaced simple, high-reputation practitioners of “Old School Finance.”

One empirical implication is that we should expect firms in the financial services industry to have weak reputations relative to firms in other, less regulated industries. A second empirical implication is that financial firms in countries like the United States, which have systematic and pervasive laws and regulations for the financial services industry, will have weak incentives to invest in developing and maintaining their reputations. The evidence discussed in this book is consistent with the hypothesis developed in the book.

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

explained by the theory of reputational decline that is the core of this book.

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

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

In contrast, the industries in which I am interested—investment banking, capital markets, accounting, law, credit rating agencies, etc.—require enormous amounts of human capital to deliver their products or services. Indeed, in these sectors of the economy, human capital is the only significant asset that participating businesses actually have. The physical capital necessary to conduct such businesses is trivial. In these sorts of businesses, reputation plays a very important role. In such businesses, it takes a substantial amount of time for a customer to observe the quality of the businesses' human capital. In my view, however, analysis of this sort, though historically accurate, is completely out-of-date because it no longer describes today's world. Specifically, although it used to be the case that loss of reputation generally was fatal to accounting firms like Arthur Andersen, law firms like Vinson & Elkins, and credit rating agencies like Moody's (all of which appear to have failed flamboyantly in protecting their

reputations in the Enron scandal), I argue here that this is no longer true. Whereas these sorts of firms once depended on their reputations to attract and retain business, such firms no longer depend on maintaining their reputations as a key to survival. Instead, regulations often, either directly or indirectly, require companies that issue securities to retain various Wall Street service providers such as outside auditors, credit rating agencies, investment banks, and law firms. Because the demand for the services of these firms is driven by regulation, the firms don't need to maintain their reputations in order to attract business. As such, reputation is no longer an asset in which it is rational to invest.

I am extremely grateful for support from Dean Robert Post and many of my colleagues at Yale Law School. I presented several chapters of this book to the Hoover Institution's John and Jean De Nault Task Force on Property Rights, Freedom, and Prosperity at Stanford University. I am very grateful for the financial support and intellectual stimulation I received from this Task Force at Hoover. I also am deeply appreciative of the comments and conversations regarding the ideas in this book at the Yale Law School Faculty Workshop and from colleagues at Bocconi University, as well as from Bruce Ackerman, Ian Ayres, Richard Brooks, Luca Enriques, Henry Hansmann, John Langbein, Yair Listokin, Jerry Mashaw, Geoffrey Miller, Maureen O'Hara, Nicholas Parrillo, Roberta Romano, and Alan Schwartz.

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This book is for my family, Amy, Josh, Ally, and Zach, who both individually and collectively are invaluable and precious sources of moral, spiritual, and intellectual inspiration for me.

—New Haven, Connecticut, January 2013

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1

The Way Things Used to Work: Reputational Theory and Its Demise

This chapter introduces the traditional theory of reputation in financial markets and gives a few examples of why that theory no longer seems to be accurate. First, it describes the old economic model of reputation, which argues that simple cost-benefit analysis ordinarily should discourage financial firms from acting fraudulently or dishonestly. This is especially relevant in financial markets: Rational individuals will not invest unless they trust that their money will be safeguarded, and this trust can be cultivated only by means of government regulation or a good reputation.

Second, this chapter shows how companies in the manufacturing and consumer goods sectors develop a good reputation by means of warranties and other guarantees of quality. Financial firms cannot offer customers these kinds of warranties because their products fail or decline in value in complex and opaque ways. This product difference is exemplified by the failure of the Facebook initial public offering (IPO). Morgan Stanley, Facebook's lead underwriter, has refuted claims of fraud by insisting that the devaluation of Facebook's stock was out of its control. Morgan Stanley's continued success in spite of its bungling of the Facebook initial public offering highlights the demise of the traditional theory of reputation.

In the world of business and particularly in the field of finance, developing a "good" reputation has been viewed as critical to success. Economists developed an elegant and highly useful grand theory of reputation to explain why having a good reputation is critical to success, particularly for companies in the financial sector, like insurance companies and banks. The point of this book is to explain why that

theory has lost its explanatory power when it comes to understanding the way Wall Street works today.

The old theory was simple: Firms invest in reputation so that customers will do business with them. Rational customers prefer to do business with companies with good reputations because a strong reputation for honesty and integrity serves as a sort of bond, or credible promise to customers that the business will not act in a dishonest or immoral way. The theory works like this: Reputations are easy to destroy but difficult and expensive to build. As such, it is downright irrational for a company with a good reputation to treat even a single customer dishonestly or unethically because the short-term, one-shot profit gained from doing this inevitably will be less than the long-term cost that will result from the diminution or destruction of the company's reputation. In other words, according to the traditional economic theory of reputation, simple cost-benefit analysis predicts that companies will invest in reputation because doing so enables them to attract customers who will pay a premium to deal with the company with the good reputation.

Because trust is particularly important in financial transactions, the reputational model always was thought to apply with particular force in the world of investment banks, big corporate law firms, credit rating agencies, major accounting firms, and other firms that do business in the financial markets. This is because it is unusually easy for companies—particularly financial ones—to rip people off: Money is easy to steal and hide relative to other sorts of assets. Money is fungible, meaning that one dollar looks like every other dollar and money can be moved offshore electronically and instantaneously. After money, securities might be the next easiest thing to steal. They can be converted easily into cash and they can be moved electronically, and often even anonymously.

People pay premiums to insurance companies and put their money into banks and into accounts with broker-dealer firms, and they know that it is easy for the companies to which they entrust their money to steal this money. It is especially easy to avoid being caught if one steals only small amounts of money. Banks do this in a number of ways. They do it with hidden fees, late-payment penalties, rigged foreign exchange rates, and commissions on services and transactions.

The Bernie Madoff case and other famous Ponzi schemes prove that it is even possible for crooked bankers and dishonest professional investors to get away with massive theft and fraud for very long periods, although not forever. They do this by taking money from new victims, stealing "only" some of it, and using the rest to pay off the first group of victims in order to trick those first investors into thinking that their money is being invested. These schemes, called "Ponzi schemes," work as long as the people behind the fraud can keep attracting new investors and can manage to prevent enough of their old investors from demanding the return of their money. History shows that it is possible for fraudsters to keep their Ponzi schemes going for quite a while before the house of cards collapses.

The problem is that it is hard to tell the difference between the good guys and the bad guys in business. They dress the same. They look the same. They make the same claims about what they plan to do with your money and about how trustworthy they are. The difficulty of distinguishing the good guys from the bad guys, which economists have dubbed the "adverse selection" problem, is extremely serious. Businesses and government must figure out a way to solve this problem or else robust economic growth will become impossible. If people lack confidence that their money will be kept safe, they will refuse to invest.

Without investment, economic growth simply will not happen. Nobody wants to lose all of their money. Because there are a lot of crooks around, people will not part with their money unless they are confident that the people to whom they entrust their savings will safeguard it rather than steal it.

There are only two ways to instill confidence in people that they can invest safely, one of which is generated by the government in the form of regulation. Government regulation can work directly, which is what happens when laws are enacted—and enforced—that make stealing illegal. Government regulation also can work to support private contracts by instilling confidence in consumers that warranties for products and similar promises are enforced. Government regulation also facilitates the ability of companies and people to engage in private contracting to the extent that the government uses its state power to help people enforce the promises that were made to them when they bought financial assets like insurance or securities.

For many reasons, regulation, whether acting by itself or in tandem with private actors, does not work perfectly. In fact, often government regulation does not work very well, and sometimes it does not appear to work at all. This is why reputation plays a vital role in capital markets.

As is the case with regulation in the financial sector, the primary purpose of investment in reputation is to assure investors that they can invest with some degree of confidence that they will not be defrauded. And like regulation, which of course is very costly, developing and maintaining a reputation for honesty is very expensive. It is more expensive to be honest than it is to be dishonest; if it were not, then everybody always would be honest.

Reputations take years to build but can be destroyed in seconds. This adage is no less true for being used so often and by so many. For example, the website of the American Psychological Association advises newly minted psychologists, "It takes years to build a good professional reputation, but only seconds to destroy it....One major mistake can significantly damage your reputation, lead to missed opportunities and make it difficult to restore others' confidence in you."[1]

Still another common feature of regulation and reputation is that neither works perfectly. A major lesson to be learned from the economic history of the U.S. is that neither regulation nor reputation works quite as well in practice as it is supposed to in theory.

Regulation, of course, works by making fraud illegal and then enforcing the rules against those who break them. To the extent that financial fraudsters think they will be caught and punished severely, they will be less likely to engage in fraud. And to the extent that investors think that financial fraudsters will be caught, they will be more willing to invest.

In this sense, regulation helps all firms that are subject to the regulation. For example, tough regulation of the mutual fund industry helps all mutual funds because people will be more likely to invest in mutual funds to the extent that they are confident that they are protected by the applicable regulatory scheme.

Reputation works in a slightly different way because it does not work on an industrywide basis. Whereas regulation affects all

companies in an industry, reputations are built (or used to be built) one company at a time.

The theory of reputation posits that reputations are like buildings. They are built slowly and expensively over time. The idea is that companies build a good reputation by engaging in such activities as offering guarantees and warranties that are expensive and then honoring these promises scrupulously. Companies give "no-questions-asked money-back guarantees." They honor manufacturers' warranties even when they are not obliged to do so. According to the traditional theory of reputation, businesses trying to build or maintain their reputations waive fees when customers complain, even if they are not legally required to do so.

Profit-maximizing businesses, however, can be trusted to make these sorts of costly investments in reputation only as long as the investments pay off. If the costs of investing in reputation are greater than the benefits, then even really honest people will be driven out of business if they persist in investing in reputation, because when this happens, businesses lose money by investing in reputation.

In other words, building a reputation is an investment. Reputation is a valuable investment because people want to do business with businesses that have strong reputations for being honest and trustworthy. From the business's point of view, a reputation is a "credible commitment" that sends a very strong message to customers and counter-parties that they can deal with the business with confidence.

Economists studying reputation have long recognized that even when a business has a good reputation, there is money to be made from tricking and deceiving customers. There are two ways to think about this problem. First and foremost, the theory of reputation posits that companies that have strong reputations are far less likely to engage in fraud, sharp business practices, and other shenanigans because they have more to lose from behaving badly. Firms with little or no (or bad) reputations have little or nothing to lose by cheating people. Firms with solid reputations will refrain from cheating as long as profits garnered from such cheating are lower than the losses from whatever reputational damage the fraud is likely to produce.

This is one way in which regulation and reputation work together. Government action against fraudsters has the potential to supplement

and enhance the value of businesses' investments in reputation because when the government successfully sues (and when the government accuses) a firm of fraud, the firm's reputation is damaged. Government regulation supplements businesses' investment in reputation because the publicity that surrounds government action can increase dramatically the reputational cost to a business of engaging in fraud.

Second, the theory of reputation posits that firms will not invest in developing reputations for honesty and trustworthiness unless the benefits from making such investments are greater than the costs. Just as government regulation can increase the benefits of investing in reputation by noisily enforcing antifraud rules against fraudsters, so too can government regulation diminish the benefits of investing in reputation. For example, if businesses think that the government will undermine their reputations by charging them with fraud falsely or unfairly, they will be less likely to invest in developing their reputations in the first place. It is for this reason that financial regulators like the U.S. Securities and Exchange Commission (SEC) sometimes go to great lengths to keep their investigations secret until they think that they have sufficient proof of fraud to merit announcing that they are bringing a lawsuit to enforce the law against a financial firm. On its website, the SEC acknowledges the threat its own actions pose to the reputations of the companies they regulate:

> Securities and Exchange Commission (SEC) investigations are conducted confidentially to protect evidence and reputations....A confidential process...protects the reputations of companies and individuals where the SEC finds no wrongdoing by the firm or the individuals that were the subject of the investigation. As a result, the SEC generally will not confirm or deny the existence of an investigation unless and until it becomes a matter of public record.[2]

On the other hand, the SEC is not above garnering publicity for itself when it does file suit. The publicity comes whether the SEC actually tries a case or merely announces that a settlement agreement has been reached and that judicial approval for that settlement is being sought. As the SEC puts it, "An investigation becomes public when the SEC files an action in court or through an administrative

proceeding. The SEC website contains information about public enforcement actions."[3]

Unfortunately, government regulators like the SEC sometimes have incentives to jump the gun and announce their lawsuits prematurely. Regulators sometimes do this in order to bolster their own reputations for toughness. Sometimes regulators and others think that a lot of businesses are engaging in bad behavior. They come under considerable pressure from the public and from their Congressional overseers to do something about the actual or perceived problems, so they announce lawsuits (called "enforcement actions") against innocent market participants in an effort to curb bad behavior by making "examples" of one or two businesses.

Another reason SEC officials often seem like publicity hounds is because they are. The SEC is largely evaluated on the basis of how well its Division of Enforcement performs. In the words of the SEC's own website, "First and foremost, the SEC is a law enforcement agency."[4] As the economic sociologist William Bealing has observed, the activities of the Enforcement Division of the SEC are what "legitimize the Commission's existence and its federal budget allocation to Congress."[5] Political scientists have observed that the SEC's enforcement agenda is designed to meet the interests of the relevant Congressional leaders responsible for the SEC's funding.[6]

The SEC satisfies its monitors in Congress, in academia, and in the press by focusing on factors that can be measured. In particular, the SEC focuses on two factors: (1) the raw number of cases that it brings, and (2) the sheer size of the fines that it collects. The more cases that are brought and the greater the amount of fines collected during a particular time frame, the better the enforcement staff at the SEC is thought to have performed. This has long been the case, but the problem got worse as a result of the political challenges that the SEC has faced from politically opportunistic state attorneys general, most notably Eliot Spitzer, the former Attorney General of New York who parlayed a campaign against Wall Street into an election as governor of the state, a position he held until he was forced to resign due to salacious public revelations about his involvement with a high-priced prostitute.[7]

Even worse, regulators sometimes pick on the weakest firms in an industry. They do this not only because the weakest companies are the least able to defend themselves against cadres of government lawyers, but also because their actions have the greatest impact on the weakest firms. It would be hard for the government to drive giant firms like Bank of America or Goldman Sachs out of business. These firms simply have too much political clout and too many resources to have to worry too much about the government. But it is easy for the government to drive smaller firms and new entrants out of business.

Perhaps the most important reason small firms get picked on is because of the so-called "revolving door." Small firms do not hire as many people as big firms. Many government lawyers want to move from their low-paying, low-prestige government jobs into the private sector with big firms like Deutsche Bank and Citibank (former government officials currently hold the top legal jobs in these big firms). Suing one's prospective employers is not considered a winning strategy for garnering a job in the future.

In other words, while reputation always has been important, there always have been a few market failures—this is what economists call major glitches in their theories—when it comes to the application of reputation in the real world.

One aspect of the traditional theory that still appears to have force is that the need for reputation is far greater in the world of finance than in the world of manufacturing or even in the world of technology. This is true for several reasons. For one thing, as mentioned at the outset of this chapter, it is generally far easier to rip off customers in financial transactions than in other sorts of transactions. In the financial world, buyers part with their money in exchange for highly ephemeral financial assets; sellers part with their financial assets in exchange for cash. They must trust financial intermediaries to carry out these transactions on their behalf. There are so many ways for unscrupulous financial institutions to defraud their customers that it is difficult to list them all. Here are some examples:

- It is common for customers to give their stockbrokers an order to purchase securities at the "market price." When this happens, the law requires that customers receive the best available price in the market and that the markups or commissions

that the stockbrokers charge are reasonable. Unfortunately, it is very hard to monitor stockbrokers who are executing market orders for customers, especially, as often happens, when the stockbroker is filling the customer's order from its own inventory rather than going out and buying it in the market. And, of course, there is a conflict of interest when a stockbroker is buying from one customer in order to sell to another customer.

- Another problem is called "front-running." If a stockbroker receives an order to buy a substantial number of securities, the stockbroker can profit by entering its own buy order ahead of the customer's in order to profit when the price of the securities goes up in response to the large buy order. The problem here is that front-running drives up the price of the securities, which of course is bad for the customer who is buying.
- Front-running also happens when customers are selling securities. Unscrupulous stockbrokers can sell securities before they execute the customer's sell order, thereby getting out before the price drops. Of course, this hurts the customer because the stock generally drops when the stockbroker sells, which causes the customer to receive a lower price for her securities than she would have received if the stockbroker had not sold ahead of her.
- Problems also arise when customers ask their stockbrokers for advice. Stockbrokers can be tempted to advise their customers to buy securities that are already in their inventories, particularly when they have had a hard time selling these securities and are worried that they will drop in value.
- Stockbrokers work on a commission basis, so they have incentives to sell the securities that pay them the highest commissions rather than the securities that are best for their customers.
- Stockbrokers work as investment banks that are trying to get underwriting business from their corporate clients. The most common type of underwriting is when an investment bank like Morgan Stanley or Goldman Sachs buys securities from a company that is issuing securities and sells those securities to the public. Investment banks want to show their prospective corporate clients that they trade a lot of their securities at high prices in order to garner underwriting business from those clients. This creates a temptation for investment banks to give their stockbrokers incentives to tout stocks of favored or

prospective customers rather than the investments that are best for the customers.

- Customers put money in accounts with stockbrokers. This money is supposed to be used to buy securities. It is not difficult for stockbrokers to steal some (or all) of this money and tell their clients that the money was lost on improvident investments.
- Stockbrokers can simultaneously buy and sell the same security. Then, if the security goes down in value, they can claim to have owned the security that they sold. If the security goes up in value, they can claim to have owned the security that they bought. The other security goes into the customer's account.
- One of the most prevalent ways that stockbrokers abuse their clients is by doing what is known in the securities industry as "churning" customers' accounts. Churning occurs when a stockbroker engages in many trades in a customer's account in a short period for the purposes of garnering trading commissions, rather than to benefit the customer. Although it is not difficult to notice that a stockbroker is churning if the frequency of trades is egregious, sometimes it is difficult to tell. Worse still, customers who are unsophisticated might not realize that this is happening to them until it is too late.
- Selling investments that are not suitable for a customer is another common problem. As one plaintiff's lawyer observed on his website, "A disturbingly prevalent form of abuse occurs when a broker either lies outright to the client or offers up half-truths in order to induce a client to purchase or sell [particular] securities....Common misrepresentations and material omissions include: (1) telling a client that a company is a "hot prospect" when it is virtually bankrupt; (2) implying that the broker has inside knowledge about a company's plans or prospects ("I know that the stock will double after the company announces its new contract," etc.); (3) describing an investment as safe, secure, guaranteed or government-backed when it is not; and (4) recommending a stock without telling the client that the broker or his firm is receiving "undisclosed" payments from the issuer or others."[8]

Another reason it is easy for financial firms to defraud or outright steal from their customers is that, unlike with regular products, when stocks and bonds and other securities decline in value, it often is

difficult or impossible to tell whether fraud was involved. When a refrigerator or a car breaks, the problem often will be attributable to one of two sources: a defect in manufacturing or the customer not using the product properly. It generally is not difficult to distinguish between these two causes, particularly when experts like mechanics or repairmen become involved. On the other hand, securities can decline in value and even become completely worthless for many reasons.

For example, financial assets can decline in value for reasons that have nothing to do with a particular company or security. When the financial markets decline, by definition, individual financial assets like stocks and bonds decline with it. Even when a particular stock goes down while markets generally are going up, the reason for the loss might not be fraud. A company could have a glitch in its manufacturing process, or have a problem with a patent or some other sort of intellectual property. A new product might be introduced that outcompetes the products made by the company whose stock is falling precipitously, or consumers' preferences might simply have changed.

Another important reason it is easier to defraud people in the securities markets than in other markets is the complete absence of warranties for securities. Companies that sell stocks and bonds, and investment banks that underwrite these securities for the companies that issue them, do not have the same ability to make credible, binding contractual promises that their products are of high quality. Take the case of a manufacturer of new cars or refrigerators. Of course it is difficult for most people to figure out the value of these manufactured goods until they actually start to use them. It also is true that manufacturers have financial incentives to cut manufacturing costs and quality control expenditures if they can get away with it. But there are ways in which high-quality manufacturers that lack reputations can distinguish themselves in the marketplace.

For example, in 2009 the Korean automaker Kia announced that every new Kia sold in Europe offered a seven-year, 150,000km bumper-to-bumper, parts-and-labor warranty for all vehicles sold and registered starting January 1, 2010. As Gizmag, a popular and influential European website observed, "This is far-and-away the longest fleet-wide warranty ever offered by a car manufacturer anywhere at any time and the move could have far reaching consequences."[9]

Gizmag fully understood the relationship between the new Kia warranty offer and Kia's efforts to enter the European car market against existing manufacturers with established reputations. These established brands charge much more than Kia, yet are clearly unwilling to financially back their quality in the same way. So, perhaps "the public finally understands that new price does not reflect quality, that quality is measurable, and that reputations for quality are distinctly at odds with reality."[10]

In other words, Kia used its warranty as a way to substitute for its lack of reputation in the marketplace. It did this by offering a long warranty that was extremely generous. The warranty had few exceptions or exclusions, and it was transferable to subsequent owners. As the Kia Press Release noted, "The comprehensive new 7-Year Kia Warranty is a 'bumper-to-bumper' full manufacturer's warranty and covers each vehicle for up to seven years (whole car)."[11]

As Gizmag observed, "We expect the new warranty to become a disruptive force in the auto market as it will add significant pressure to other car manufacturers to stand behind their production quality and offer similar guarantees of workmanship."[12]

Other car companies have tried to offer generous warranties. Fifty years ago Chrysler "upset the industry" and offered a five-year, 50,000-mile warranty. But Chrysler cars were not worthy of the warranty and Chrysler lost significant amounts of money honoring these warranties for older models that were breaking down at unexpectedly high rates. Rivals were forced to match the Chrysler warranty, but all of them, including Chrysler, "quickly reverted to the tried and true 12 month/12,000 mile warranty which more accurately reflected the quality of the products of the period."[13]

Warranties work like reputations to signal product quality. If the quality of a product does not live up to the promise implied by the product warranty or the company's reputation, the company offering the reputation and the warranty will suffer exactly where it hurts companies the most: in their wallets. As product quality improves, companies can offer better warranties at low cost because, by definition, higher-quality products do not break down as often as lower-quality products.

Firms in the securities industry, however, cannot offer warranties in the way that automobile manufacturers can. Warranties, like other forms of insurance, work only because of the law of probabilities. Manufacturers calculate that a certain percentage of their products will stop working properly at some point over their lives and need to be repaired. Manufacturers, of course, have much better information about the reliability and longevity of their products than consumers do. If manufacturers consistently offer reliable and long-lasting products over long periods, they will develop a reputation for quality. Alternatively, through research and development manufacturers can improve the quality of their products over time, and through product testing, the same manufacturers can measure improvements in the quality and reliability of their products. As product quality and reliability improve, manufacturers can make credible, binding, costly promises to consumers that they really are making better products by offering more generous warranties, just as Kia did. This, in turn, puts pressure on other companies in the industry, which have to offer similarly strong warranties, or explain why they can't or won't.

Thus while warranties can supplement and reinforce the work that reputation does in assuring customers of product quality, the same process does not work for financial products such as stocks, bonds, and financial derivatives because these products are fundamentally different in one important way: Concerns about defects in products such as cars and refrigerators can be alleviated by manufacturers' warranties, but concerns about fraud or other problems with financial products like stocks and bonds cannot be alleviated by warranties from the issuer.

Manufacturers like Kia can make hundreds of thousands of products and then estimate statistically what percentage of these products will fail. They can work to reduce the number of failures as a percentage of the total number of products manufactured in order to increase sales by improving their reputations and offering better, less costly warranties than their competitors. This dynamic does not work for financial products. When an issuer hires an investment bank to sell securities, the securities are not differentiated the way that manufactured products are. Specifically, one refrigerator can break while

dozens of others work perfectly. In sharp contrast, securities do not fail one by one. An issuer cannot default on just one security. If the issuer goes bankrupt, all of that company's outstanding securities simultaneously decline in value. All the equity is wiped out and creditors such as bondholders usually get pennies on the dollar.

In recent years, however, the quality of automotive products has improved dramatically, and Kia and its parent company, Hyundai, seem intent on bringing this to the attention of the consumer in the most logical way possible: by offering a warranty on their vehicles that other companies will be very reluctant to match.

In other words, the securities markets have significant problems. It is easy to rip people off. It is sometimes difficult for people to figure out when they have been ripped off. The IPO of stock by the social media giant Facebook in the spring of 2012 provides a good example of the difficulty of distinguishing between honest mistakes and fraud in the financial markets, as well as a good example of the uselessness of warranties in the world of finance.

Facebook

Facebook stock was priced at $38 per share. This was the price at which Morgan Stanley, the lead underwriter, and the 32 other underwriters involved in the deal were able to buy the $16 billion worth of stock that Facebook was selling in its IPO. The lucky selected few (favored institutions and big clients) that were able to get stock in the IPO bought in at this price. Immediately after the underwriting, Facebook's shares started trading at $42.05.

Just four days after the IPO, Facebook and its investment bank underwriters were sued for fraud. This was only the first of dozens and dozens of lawsuits that were filed in the month following the Facebook IPO. The plaintiffs in these cases typically allege that Facebook, and many of its officers and directors, lied on the official documents that they had to file with the SEC and distribute to investors. The forms used in IPOs like Facebook's are SEC Form S-1/A Registration Statement (the "Statement"); the Prospectus, which provides crucial information about the company's financial results; and the so-called

"MD&A," or Management's Discussion and Analysis of the company's current business and future prospects.

The complaints filed in the various lawsuits further charge that the Registration Statement and Prospectus issued in connection with the Facebook IPO were false and misleading because the Company and its employees and underwriters did not tell investors that Facebook was experiencing a pronounced reduction in revenue growth at the time of the IPO due to an increase of users of its Facebook app or Facebook website through mobile devices rather than traditional PCs. In addition, the complaints allege that the Company gave this important negative information to some of its biggest underwriters and told them that they should lower their predictions and estimates about how well Facebook would perform in 2012, but that this information was not passed along to the general public until much later, after all the shares in the IPO had been sold at a profit by the initial investors. Some of the lawsuits allege that Facebook made downward adjustments to its own internal earnings estimates, and that this negative information was passed along to certain of the underwriters by a Facebook financial officer and that these underwriters then sold their own allotments of Facebook stock to unsuspecting clients and members of the general public.

Needless to say, there was a lot for investors to be unhappy about. The Facebook IPO was such a disaster that it even got its own Wikipedia page! The page informs readers that after the IPO, Facebook stock "lost over a quarter of its value in less than a month and went on to less than half its IPO value in three months."[14] A quick look at what happened to the unlucky investors who wound up with Facebook shares after the dust settled at the end of the IPO, as charted in Figure 1.1, tells the story.

Private investors were not the only people mad at Facebook after the IPO. The Facebook IPO was a big black mark for regulators as well. As one of the biggest, and certainly the most highly publicized, securities deals in history, the Facebook IPO did not make regulators look very good either. Regulators were considerably embarrassed. Because many large sophisticated investors stayed away from the Facebook IPO, unsophisticated public investors of relatively modest financial means bought a far bigger percentage of Facebook's shares

in the period immediately following the IPO than they generally are able to. Usually, shares in IPOs by “hot companies” like Facebook are accessible only to a select group of big customers and insiders. This is why most sophisticated observers consider the whole IPO process to be a “sucker’s game.”

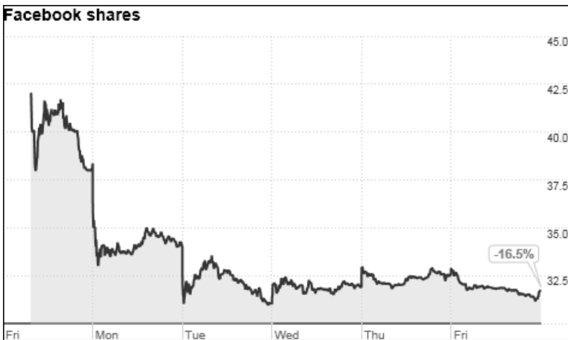

Figure 1.1 Facebook IPO.

As one blogger observed in a post on the VentureBeat website, “If there was any doubt that Wall Street is a sucker’s game designed to take money from stupid people and put it into the hands of bankers and powerful corporations, Facebook’s initial public offering should clear that up.”[15] Another person posting on a blog observed, “Most IPOs are a sucker’s game. For every Google (up 8 times since its IPO) there are dogs like Facebook and Groupon.”[16] This post, which was on “a personal finance blog aimed at regular folks,” followed an article whose author observed:

> [IPOs] are best for the underwriting companies who make millions by underwriting the initial public offering of the stock. They are also usually very good for founders, early stage investors, and venture capital firms that own a share of the company that is going public. Coming in dead last is the individual investor that buys into the company at a price dictated by the underwriting firm in hopes of the shares either skyrocketing immediately or over time.[17]

The intuitions that these angry bloggers are expressing have a sound basis in economic theory. Over 25 years ago, in what has come to be one of the most famous and important papers in finance,

University of Chicago professor Kevin Rock explained that the IPO market in the U.S. is plagued by what is known as a "Winner's Curse," which means that the so-called "winners"—the investors who wind up owning the stock that is sold in an IPO—are really losers, because the securities they succeed in buying so often decline in value.[18] This is due to the fact that big, influence-wielding investors who have access to privileged information about stock offerings are able not only to avoid IPOs that are "losers" but also to gain privileged access to the IPOs that are likely to be winners. This means that the only securities to which the real investing public is able to gain access are the losers. Therefore, according to Professor Rock, new issues must be priced cheaply in order to be sold, and, on average, they are. This pricing strategy produces some big winners, but also some big losers in IPOs; and the big winners overwhelmingly tend to be insiders while the big losers tend to be "outsiders," which is to say that the losers are ordinary investors without fortunes large enough to generate millions of dollars in fees for their bankers and advisors.

Not surprisingly in light of all of this, regulators have piled on the litigation bandwagon. The SEC and the Financial Industry Regulatory Authority (FINRA) and state officials like Massachusetts Secretary of State William Galvin are investigating the claims that Morgan Stanley and other Facebook underwriters leaked information to select clients and did not share it with the general public.

A big question, which will be dealt with at length in Chapter 3, "The Way Things Used to Be: When Reputation Was Critical to Survival," is what impact (if any) all of these lawsuits by class action attorneys and regulators have on the behavior of the companies in the financial industry. The short answer is that people are no longer embarrassed to be sued the way they used to be. It is just a cost of doing business. Moreover, there are so many nonmeritorious lawsuits mixed in with the meritorious lawsuits that getting sued does not send a strong negative signal in the financial industry about the cost of being sued. Everybody is sued all the time. In addition, virtually all lawsuits settle; and they settle without the bank or investment bank admitting or denying any guilt or responsibility, so the public never even finds out whether a judge or jury would have decided that they are guilty. In sum, litigation, whether it is brought by private plaintiffs or by government agencies like the SEC, no longer provides a reliable

indication about whether the companies or individuals being sued actually have done anything wrong.

Interestingly, one of the most troubling characteristics about IPOs is that the underwriters make tons of money regardless of what happens to the stock price of the company (or indeed to the company itself) after the underwriting. If the company goes broke, the underwriter still keeps the millions in fees it makes on the underwriting. Stranger still, investment banks serving as underwriters in IPOs make money in the period immediately following an IPO regardless of whether the value of the stock being underwritten goes up or down. In fact, the underwriters can make even more money when the stock goes up than when the stock goes down. This is because underwriters routinely sell even more shares in the underwriting than they buy initially from the company. As for the excess shares that they sell, the underwriters usually make an agreement with the issuer granting them the option (that is, the right but not the obligation) to buy the additional shares needed to fill customers' orders directly from the issuer. If the share price goes up immediately after the underwriting, the underwriters buy the shares from the issuer at a discount and sell them to their customers at a healthy, risk-free profit.

Even if the share price of the stock in the IPO goes down immediately after the underwriting, the underwriters can still make a lot of money. When the stock price goes down, underwriters can decline to exercise their option to buy the additional stock they need to fill customers' orders directly from the issuer. Instead, they can take advantage of the drop in market price after the offering and buy the low-priced shares in the open market. If the shares have fallen by enough, the underwriters will make even more money buying cheap shares in the open market and using those shares to fill their customers' preexisting orders. This is exactly what happened in the Facebook IPO. The underwriters, led by Morgan Stanley, made significant profits by buying up shares of Facebook at depressed prices and using those shares to fill their customers' orders.

But what about the reputation of Morgan Stanley, the lead underwriter of the Facebook IPO—was it in any way injured by the debacle at Facebook? It would seem to be inevitable that a company like Morgan Stanley would be hurt significantly by the reputational

fallout from the Facebook IPO. Claims that Facebook's problems were leaked selectively and that individual investors were sold stock at prices that the underwriters knew were inflated would be particularly damaging.

Under the traditional economic model of reputation, this sort of thing simply could not happen. There would be no way that a company like Morgan Stanley could survive this sort of reputational fallout. But it seems there is something very wrong with the traditional theory because this sort of thing now happens all the time.

First, there is no question that Morgan Stanley's reputation was damaged by the way it ran the Facebook IPO. Although it is difficult, if not impossible, to measure empirically the rise and fall of companies' reputations, it is not hard to tell when a company's reputation has been tarnished because people notice. With regard to the reputational fallout from Morgan Stanley's handling of the Facebook IPO, the best source of information about the public reaction is the immensely popular website Wikipedia, which attracts billions of readers a year (470 million during February 2012 alone).[19] Although Wikipedia is not written by professionals, it is written, edited, and read by masses of people, so Wikipedia often provides good information about what the public is thinking about a particular issue.

According to Wikipedia, "The reputation of both Morgan Stanley, the primary IPO underwriter, and NASDAQ were damaged in the fallout from the botched offering."[20] Wikipedia noted that Morgan's reputation in technology IPOs was "in trouble" after the Facebook offering. And Morgan Stanley clearly had plenty of reputation to protect: The underwriting of equity offerings like Facebook is an important part of Morgan's business after the financial crisis, generating $1.2 billion in fees since 2010. According to Wikipedia, however, "By signing off on an offering price that was too high, or attempting to sell too many shares to the market," Morgan damaged its own reputation.[21] And it would appear that the mishandling of the Facebook IPO clearly would be "something that other banks will be able to use against them when competing for deals" in the future.[22]

Sure, Morgan Stanley made a lot of money on the Facebook IPO. Morgan Stanley made hundreds of millions of dollars in underwriting fees and in secondary market trading in Facebook shares immediately

after the IPO. One industry insider at one of Facebook's other underwriters asserted to CNN Money, "We think Morgan has done pretty well on the deal....Reputation of the bank aside, Facebook hasn't been a bad trade for Morgan." This is because even as the share prices dropped, Morgan "racked up big profits" trading the shares.[23] For several years running, they were the number one investment bank for the tech industry. In light of these facts, the traditional reputational model in finance would predict that Morgan Stanley would suffer losses in the value of its reputation that would dwarf the one-shot gains that Morgan Stanley made on its Facebook deal.

But the traditional reputational model almost certainly is broken, and has been for some time. Brad Hintz, a financial analyst at Sanford Bernstein who follows Morgan Stanley and recommends Morgan's shares, acknowledged that "the fact that Morgan Stanley is a powerhouse in equity underwriting is not going [to] change."[24] Morgan Stanley appears to be able to ignore the reputational consequences of its very high-profile, exploitative bungling of the Facebook underwriting without suffering the reputational damage that traditional reputational theory would associate with this debacle.

Morgan Stanley is certainly not the only firm to have taken a reputational hit in recent years. Many other firms, perhaps most notably the venerable and infamous investment bank Goldman Sachs, have taken even more serious blows to their reputations.

This chapter introduced the traditional theory of reputation and demonstrated why that theory is no longer correct. Under the old model, the economic cost of a bad reputation exceeded any financial gains a company might achieve through fraud or dishonesty. Moreover, a good reputation is essential for financial firms to gain customers' trust and investments: It is expensive to build but easy to destroy. So rational economic actors in the financial industry should always choose to preserve a good reputation at the expense of short-term profit.

In the manufacturing and consumer goods sectors, companies highlight their good reputations by offering warranties and other money-back guarantees. These are not available for financial firms, because their products decline in value for complex and opaque reasons, and it is not always clear whether the failure is the result of

dishonesty or of unavoidable factors. The failure of the Facebook initial public offering is a perfect example of this: Morgan Stanley refutes claims of fraud by insisting that Facebook's stock lost value for reasons out of its control. Morgan Stanley's consistent success in the financial markets since the Facebook debacle emphasizes that the traditional reputational theory is no longer relevant.

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