Reluctant Guardians:
The Responsibility of Gatekeepers for Effective Corporate Governance

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Who Are Gatekeepers?

• Third-parties (intermediaries)
  – Whose cooperation is essential
  – Who can prevent misconduct by withholding cooperation

• Examples
  – Accountants and lawyers
  – Bankers
  – Rating agencies
  – Physicians, ISPs, bartenders, gun dealers
Role in Corporate Governance

• Gatekeepers
  – Provide information and certification for directors and investors
  – Have ability to detect and deter misconduct
  – Are relied on for effective corporate governance

• Recent corporate scandals (Enron, etc.) due to multiple gatekeeper failure
Properly understood, Enron is a demonstration of gatekeeper failure, and the question it most sharply poses is how this failure should be rectified.

John C. Coffee, “Understanding Enron: It’s about Gatekeepers, Stupid”

The failure of this network of gatekeepers was a recurring theme in the business scandals. In too many instances, the gatekeepers in pursuit of their own financial self-interest compromised the values and standards of their professions. . . . In the recent round of corporate scandals, the first tier—the managers—failed, and then the gatekeepers failed as well.

AAA&S, Report of the American Academy’s Corporate Responsibility Steering Committee
Responsibility of Gatekeepers

• Gatekeeper role
  – is largely a by-product of providing for-fee services
  – Imposes a cost on gatekeeper institutions and the economy

• What responsibility do gatekeeper institutions have beyond providing contracted services competently?
Main Conclusions

• Each intermediary institution is different; no “one-size-fits-all” answer is possible.
• Moral responsibilities are linked to legal responsibility/liability.
  – What (morally) should the law be?
• The appropriate moral and legal principle is what investors would choose.
• Answer: Cost-effective deterrence
Legal and Political Background

• Gatekeeper role is currently unsettled and highly controversial.
• Scandals have been blamed on gatekeeper failure.
• Hence, reforms to make gatekeepers stronger (e.g. Sarbanes-Oxley).
• But previous actions weakened incentives by reducing legal liability.
Weakening of Legal Liability


• Motivation was to reduce “litigation tax,” but may have led to scandals.
Further (Mixed) Developments

- *In re Enron*: Prosecution of intermediaries as primary violators
  - based on SEC definition of what it means to “make” a false statement
- Legal doctrine of “deprivation of honest services”
  - at issue in prosecution of Merrill Lynch bankers in Nigerian barge case
More (Mixed) Developments

• Aggressive federal prosecution guidelines
  – Pressure on potential defendants to cooperate and settle
  – Recent revision of prosecution guidelines

• The backlash against Sarbanes-Oxley
  – “Paulson Commission” recommendations
  – Challenges to the constitutionality of PCAOB
3 Arguments for Responsibility

• **Complicity**: An obligation not to be knowingly complicit in (aid and abet) wrongdoing of clients

• **Contract**: An obligation to fulfill a contract to serve as a gatekeeper

• **Welfare**: An obligation to protect others from the harm of client’s misconduct
  – The “good Samaritan” argument
3 Objectives of Responsibility

- **Rectification**: To ensure that perpetrators of fraud are rightly punished
- **Compensation**: to ensure that victims of fraud are fairly compensated
- **Deterrence**: To ensure that potential perpetrators are deterred from committing fraud
The Complicity Argument

• There is a moral (and legal) obligation to avoid knowing substantial participation.

• How much effort should be made to know:
  – Whether client is engaged in wrongdoing?
  – The extent to which services enable the wrongdoing?

• Answering each of these questions involve considerable costs
  – Which are paid by investors.
Costs of Avoiding Complicity

• To avoid complicity, intermediaries may
  – Gather considerable amounts of information
  – Remain purposefully ignorant

• Costs of high standards of liability
  – Litigation and settlement costs
  – “Ripple effects”: avoidance of risky clients, higher costs of capital ("litigation tax")
The Investor’s Bargain

• If investor’s could write the law, what would it be?

• Why should investors’ preferences be considered?
  – They bear the costs and accrue the benefits.

• Principle: There is no justification for more stringent gatekeeper responsibility than investors would choose (and pay for).
What Would Investors Choose?

- To forgo compensation if deterrence is more cost-effective.
  - Cf. no fault automobile insurance
- To have the most cost-effective system of deterrence.
- The most cost-effective system involves
  - How much deterrence?
  - What means of deterrence?
The Means of Deterrence

• Gatekeepers are only one means
• Other means include
  – Direct sanctions on primary violators
  – Structural rules, e.g. PCAOB
  – Safeguarding rules, e.g. on conflict of interest
  – Empowerment rules, e.g. independence
  – Market incentives, e.g. reputation
• Challenge: to find the optimal total system
Contractual/Fiduciary Duties

• What contractual/fiduciary duties does an intermediary have toward a client?
• Merrill Lynch case: What is entailed by a duty to provide “honest services”?
• Principle: What contracts would be written by shareholders/investors?
• To what extend should intermediaries be able to rely on assurances of top management?
Arguments from Welfare

• When may the law justifiably create a duty for intermediaries to act as gatekeepers to protect investors?

• Kraakman:
  – Ineffectiveness of direct deterrence
  – Inadequate market incentives
  – Gatekeepers who can be induced by legal rules to deter reliably at low cost
Implications

• Developing a cost-effective system of deterrence requires information processing that can be done only by government and markets.

• Intermediaries should not determine their responsibility unilaterally but abide by legal rules and market incentives.
The End