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

- Private Securities Litigation Reform Act (1995) and Securities Litigation Uniform Standards Act (1998) made investor suits more difficult.
- *Central Bank of Denver v. First Interstate Bank of Denver* (1994) virtually eliminated aiding and abetting 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 by 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