YASUYUKI FUCHITA
ROBERT E. LITAN

1

Introduction

The successive bankruptcies of Enron and WorldCom—once two of the leading U.S. high-technology companies—in the early part of this decade shook the economic and political establishment, in the United States and elsewhere around the world. Officials, investors, and ordinary citizens had simple questions. How could it have happened? Why wasn't the public alerted earlier to problems in those firms and in other large companies that also failed?

In the United States, reaction was swift—almost remarkably so. Within a year of Enron's failure, Congress had passed and President George W. Bush had signed what probably was the most sweeping reform of the nation's laws governing corporate disclosure ever enacted: the Sarbanes-Oxley Act (since commonly referred to as SOX). Among other changes, SOX creates a new system and a new body—the Public Company Accounting Oversight Board (PCAOB)—for regulating the accounting industry; requires chief executive officers of public companies to certify the reliability of their financial statements; and toughens penalties for corporate fraud and other misdeeds. The New York Stock Exchange quickly followed with new registration requirements, among them the requirement that the majority of public company board seats be filled by "independent directors," which generally excludes individuals currently or previously employed by the company and those related to them. And the New York State Attorney General's Office launched a series of investigations into the financial services industry, forcing a variety of sweeping changes. Among the more important of these inquiries was one into misleading research reports issued by many of Wall Street's leading investment banks—and more broadly into the conflicts that compensation systems at those banks created for the analysts who worked for them. That investigation, in particular, resulted in the Global Settlement, which prohibits the compensation of analysts from being based, in part or in whole, on the financial performance of the investment banking operations of the companies for which they work. The settlement also requires the ten investment bank defendants to fund and report stock research by independent third-party analysts.

There is much irony, of course, in these developments. Only a few short years before the scandals in the United States broke, U.S. officials and corporate leaders were busy criticizing Asian economies for the lack of transparency in their business sectors. But, as it turned out, the United States has not been alone in suffering through disclosure problems and associated corporate failures. Europe and Japan have also had their share of the same difficulties and in response have adopted or at least considered similar reforms.

At bottom, the broad theory behind SOX and other related reforms is that corporate managers cannot be trusted and so require much closer oversight, by multiple parties: boards of directors, their accountants, and third-party equity analysts. In turn, each of the "financial overseers" or "gatekeepers," in particular, must be more closely watched by government or quasi-official bodies.

How is all this new oversight, especially the regimes governing financial gatekeepers, working? What changes, if any, should be made? Should policies relating to other gatekeepers that were untouched by the post-scandal wave of reforms—credit rating agencies, in particular—be modified? Are the answers for the United States different from those for Japan? To address such questions, on September 28, 2005, the Brookings Institution and the Tokyo Club Foundation for Global Studies convened their second annual conference on financial issues of mutual interest to American and Japanese audiences.[1]

This book incorporates the papers presented and the remarks of discussants made at the conference. The authors and the discussants are leading experts in their fields, and we are privileged to include their views in this volume. In addition, the book closes with the luncheon remarks of one of the world's leading experts in corporate securities law, John Coffee of Columbia Law School.

1. For the conference agenda, see "After the Horses Have Left the Barn: The Future Role of Financial Gatekeepers" (www.brookings.edu). The Tokyo Club Foundation for Global Studies was established by Nomura Securities Co., Ltd., in 1987 as a nonprofit organization for promoting studies in the management of the global economy.

If there is a common theme running through the chapters it is that the reform efforts, in both the United States and Japan, still are very much works in progress. The measures addressing accountants and analysts, at least in the United States, can be improved, while the rules governing the certification of nationally recognized credit rating agencies should be loosened to make the field more competitive.

ALTHOUGH BOTH American and Japanese readers of this volume are likely to be aware that Japan has had its own share of corporate accounting scandals related to nonperforming corporate loans and the fifteen-year slump in stock prices, American readers in particular may not know that Japanese authorities have responded by looking to the United States for solutions. In significant respects, Japan now has its own SOX-like regime for improving the effectiveness of its financial gatekeepers. In chapter 2, Yasuyuki Fuchita, of the Nomura Institute of Capital Markets Research, examines the Japanese system and offers a systematic way for thinking about financial gatekeepers generally.

Fuchita begins by observing that in the early years after the country's stock market "bubble" popped, Japanese corporations and banks, with the assent of their accountants, downplayed the decline in their assets, believing that the situation was temporary and soon would correct itself. Only as the decade of the 1990s wore on and asset values stayed depressed did it become more evident that some accountants had looked the other way while their clients manipulated their financial statements. The first stunning example of this was the disclosure in November 1997 that Yamaichi Securities, one of Japan's "Big Four" securities firms, had huge off–balance sheet debts and could no longer continue operating.

The Japanese government and its political system had long been geared to maintaining "order" in the financial system rather than exposing its difficulties, so when reform came, it was slow. In 1999, the Ministry of Finance set up a working group to consider ways to make external auditors more independent and to improve the system of supervising them. In 2000 the group responded with a series of incremental suggestions. Fuchita observes that more radical reforms came only after Enron. Following the enactment of the Sarbanes-Oxley Act in the United States in the summer of 2002, the Japanese Diet enacted amendments to the Certified Public Accountants Law, which roughly mirrored SOX in several respects, including the mandatory rotation of auditor staff; the prohibition of non-auditing work for audit clients; and the creation of the Certified Public Accountants and Auditing Oversight Board (CPAAOB), a new body to oversee auditors that is similar to the PCAOB in the United States.

Fuchita notes that the new measures did not end the reporting scandals; to the contrary, they may have helped lead to the discovery of several more, such as the revelation in October 2004 that Seibu Railway had falsified its reports. Meanwhile, other reforms continued, such as new reporting guidelines issued by the Financial Services Agency (FSA). Fuchita offers a useful comparison of the U.S. and Japanese reforms, outlining common elements and differences in accounting and its oversight in the two countries. Among the more important differences, he argues, is that there are far fewer independent accountants per listed firm in Japan than in the United States or, for that matter, in other economies. In addition, the time allowed for audits is shorter, and that is one reason that accountants' fees are lower in Japan than in other countries. As a result, although in the United States and Japan the formal rules governing reporting and accounting are similar, there remain large differences in the way the rules are actually enforced.

With respect to credit rating agencies, Fuchita observes that whereas rating services began as a business in the United States, credit ratings were introduced in Japan only recently, in 1992, as a new requirement for issuing a bond. The result, however, has been the same in the two countries: only a limited number of agencies are designated as those whose ratings "count" for some regulatory purpose, although the ratings market is not as concentrated in Japan as in the United States. Nonetheless, Japanese and U.S. ratings agencies confront similar problems (which are surveyed in chapter 3 by Frank Partnoy): lags or lack of timeliness in changing ratings when they need to be changed (illustrated by the celebrated bankruptcy of and bond default by Mycal, Japan's fourth-largest supermarket) and a bias toward issuers. Fuchita urges Japanese authorities to abolish the rating agency designation process or, as a fallback, to subject the agencies to registration and regulation by the FSA. At the time of the conference, similar ideas were being considered in the United States.

Fuchita also highlights a number of key differences between equity research analysts in the United States and Japan. Among the more significant is that equities, directly or through mutual funds (or investment trusts), account for a far lower share of household financial assets in Japan than in the United States. As a result, research analysts have never assumed the same public importance and notoriety in Japan as in the United States. Nonetheless, Japanese law prohibits securities companies from issuing misleading reports, while the Japanese Securities Dealers Association (JSDA) oversees analysts. The Financial Services Agency, in turn, oversees the JSDA. As in the United States, there have been a number of scandals involving analysts' reports, and the JSDA has been prompted by the FSA to tighten its rules in order to establish firewalls within securities firms between their equity research and their underwriting departments.

Fuchita concludes his survey of the three gatekeepers—accountants, credit rating agencies, and equity analysts—by offering a useful framework for regulating all three. In particular, he suggests that the need for regulation depends on both the influence each has on securities trading and the need for uniformity in the information being reported. Using those criteria, he suggests that accounting therefore requires the most oversight because investors are likely to place the most trust in accountants' attestations and because all companies must report financial information according to a uniform, common convention (generally accepted accounting principles). Analysts are at the other extreme. Since investors are likely to give less attention to their views, analysts should be free to say what they think. However regulation is designed, Fuchita argues that it ought not to artificially constrain competition among the firms performing each gatekeeping function.

CREDIT RATING AGENCIES are little known—and perhaps less understood—but nonetheless important parts of the financial systems of developed economies, especially in the United States. Credit rating agencies assign alphabetical ratings to new and existing issues of debt. For all practical purposes, corporations cannot issue debt—and financial institutions cannot issue various debt-like instruments, such as asset-backed securities—without having a credit rating.

In chapter 3, Frank Partnoy of the University of San Diego Law School addresses a puzzle: namely, that although credit rating agencies have performed no better than the other financial gatekeepers that are the subject of this book, their market value has soared. A major answer to the second part of the puzzle is that government regulators have conferred oligopoly status on a select few credit rating agencies by designating them "nationally recognized statistical rating organizations" (NRSROs) and thereby allowing them to earn supranormal profits, which are then capitalized in the market value of their shares. Partnoy also attributes their rising profits to the growth of new and increasingly complex instruments that must be rated, especially credit derivatives, which now generate a substantial portion of the agencies' revenues and profits. Indeed, he devotes a significant part of his chapter to explaining these instruments and their risks, especially collateralized debt obligations (CDOs), which are structured, leveraged transactions backed by one or more classes of fixed-income assets. In the mid-1990s, CDOs were backed primarily by high-yield corporate bonds; today, they are backed by a much wider assortment of fixed-income assets, including other CDOs.

As for the first half of the puzzle—the agencies' imperfect performance—Partnoy suggests two explanations. One is that the agencies face conflicts of interest that arguably are more severe than those of other gatekeepers, since the agencies not only are paid by issuers but also often give unsolicited ratings that, in Partnoy's view, have the effect of pressuring issuers to pay them, perhaps for better ratings. That was not always the case; in earlier times, investors paid ratings agencies.

But investors lost their appetite for ratings during and after the stock market crash of 1929, when agencies failed to anticipate the accompanying sharp decline in bond prices as well. Beginning in the 1970s and continuing into the present, the SEC and other agencies nonetheless have established various rules (such as the rule that money market funds buy only Treasury debt or highly rated commercial paper) that depend on NRSRO ratings. Partnoy broadly describes the multitude of these rules, which have now practically cemented the quasi-oligopoly status of the three major NRSROs.

Another explanation regarding their extraordinary profitability and perhaps their lackluster performance is that the agencies have been shielded from civil and criminal liability for mistakes—or, worse, for malfeasance—by having so far successfully invoked the protection of the free speech clause in the First Amendment of the Constitution. Partnoy outlines legal arguments that contest that view, but until the courts make clear that the NRSROs do not enjoy First Amendment protection, their effective immunity from lawsuits will remain intact.

Partnoy concludes by reviewing various proposals that he and others have advanced in recent years for bringing greater competition to the credit rating function. Some analysts have proposed eliminating the NRSRO designation altogether, while others want it more liberally construed or applied. At the time of the conference, Congress was considering legislation that would require the agencies to register with the SEC and then disclose material facts, much as other public corporations are now required to do. Partnoy describes a proposal that he has been advocating since 1999, one that substitutes market-based measures (based on interest rate differentials between various kinds of securities) for credit ratings in the numerous regulations that now depend on NRSRO ratings.

It is unclear whether any significant reform is in the offing. In the meantime, scholars, investors, and policymakers will continue to live with another paradox: that while rating agencies historically have not been a good guide to risk and market participants know it, parties increasingly rely on the ratings. Partnoy suggests that this paradox will continue as long as the law requires the NRSRO designation and allows only a few organizations to receive it.

SINCE ACCOUNTING FIRM failures were the "real world" triggers for SOX and related reforms, it is appropriate to focus, as Zoe-Vonna Palmrose of the University of Southern California–Los Angeles does in chapter 4, on the impact of those reforms on the accounting profession.

The gatekeeping function that auditors perform is a legal one. In the United States, securities laws require public companies to have their financial statements certified by independent public accountants. Historically, the Securities and

Exchange Commission (SEC), along with state regulators and the profession's self-regulatory body, the American Institute of Certified Public Accountants (AICPA), oversaw auditors. SOX fundamentally changed that oversight structure by vesting regulatory oversight of the profession in a new, independent entity, the Public Company Accounting Oversight Board, although technically the PCAOB itself is overseen by the SEC. SOX gives the PCAOB authority to set auditing standards (which used to be set by the AICPA); to inspect auditors for compliance with those standards; and to impose sanctions against wayward auditors. SOX also imposed additional requirements and duties on the auditors themselves, obligating them to report on public company managers' assessment of their company's internal controls over financial reporting (so-called section 404 obligations). As a result, auditors are even more highly regulated than they were before SOX.

And all the while, auditors remain subject to civil liability for negligence, as they were before the recent scandals and reforms. Elsewhere, tort law serves a dual function: it deters actors against negligent actions, and it also compensates parties injured by negligence. Yet liability law cannot realistically compensate for any more than a fraction of the losses suffered by stakeholders when a major public company fails. Nor, because the company's market capitalization usually would far exceed the combined net worth of its audit firm and the firm's partners, could the audit firm typically cover damages awarded (through trial or settlement) for the firm's negligence in failing to discover or disclose problems with the company (in the event that the limited liability shield of the firm was "pierced" in a legal action). Moreover, auditors cannot obtain insurance against their negligence, if they can obtain any at all, that will cover all of the losses that injured parties may suffer. For that reason, legal liability serves primarily a deterrent rather than compensatory function, at least with respect to auditors.

Palmrose points out that although auditors are subject to liability for financial misstatements by a client, some of that risk is not of their own making. The accounting standards that govern financial reporting by public companies are sometimes unclear and difficult to audit; thus they can actually facilitate misstatements. Indeed, Palmrose argues, auditors can conduct a "perfect audit" and nonetheless be held liable for client misstatements. Furthermore, even the best internal controls cannot eliminate fraud, which more often than not triggers lawsuits against not only the company that commits fraud but its auditor.

In short, auditors are subject to liability arising out of their engagement with a client—or what Palmrose calls "engagement risk"—even if objectively they have done nothing wrong. Palmrose presents data indicating the rising liability costs confronted by auditors, not only the costs from suits that already have been resolved or settled but also the potentially much greater costs from the "mega" liability cases now in the legal pipeline, flowing largely from the poor stock market performance of the 2000–02 period. It is the apparently random nature of the way that juries sometimes award enormous damages in such cases that drives auditors to settle rather than put the future fate of their firm on the line in a trial. Meanwhile, not surprisingly, audit firms have been trying to reduce their future financial risk by rejecting clients whom they believe to pose unacceptable engagement risk at the outset and by substantially raising fees for those clients whom they seek and with whom they accept engagement.

But even higher fees cannot fund all of the costs that can arise out of negligence actions and pose a potentially catastrophic financial risk for auditors in the future. Accordingly, Palmrose urges the PCAOB—the auditors' new regulator—to bear at least some of the responsibility for sound auditing itself, but in a novel fashion. In particular, recognizing that the oversight board was intentionally structured not to have accounting expertise so as to avoid even the appearance of conflict, none of the board members can have been a practicing certified public accountant within the five years before their appointment. Palmrose therefore urges the board to establish an auditing master's office, which would be independent of the board.

The office would be responsible for assessing auditor compliance with accounting and auditing standards and would stand ready to provide its opinion in court actions in which auditors are charged with negligence in carrying out their audits. The defendants in such cases (the audit firms) would have the option of asking for the office to furnish its opinion to the court. In cases in which the office's report would tend to exonerate the audit firm, not only would the firm be expected to call for the report but also, presumably, the report would accelerate settlement of the case to the benefit of the firm. When the report is not favorable, the defendant would not ask for it, but then the court (or jury) would be entitled to draw a negative inference from that fact. All in all, Palmrose argues, the office's reports would reduce some of the randomness in jury trials on auditor liability and thereby help make the legal system a more effective instrument of deterrence than it now is. The establishment of the office also would enhance, albeit indirectly, the expertise of the PCAOB.

STOCK MARKET ANALYSTS are financial gatekeepers only in the loosest sense of the term. In fact, no public company needs to have outside analysts reporting on its financial prospects, although the more analysts that cover a company, the more liquid the company's stock is likely to be on public markets. In addition, some retail stock investors pay attention to the views of stock analysts. Or, at least, the investment banks that employ analysts must believe that investors do; otherwise, why would the banks continue to pay the analysts?

In fact, stock market analysts initially were not one of the main targets of federal reform efforts in the wake of the Enron and WorldCom collapses, but they soon came to the attention of Eliot Spitzer, the attorney general of the state of New York. Spitzer's aggressive investigation eventually prodded the Securities and Exchange Commission and the National Association of Securities Dealers (NASD) to reach the Global Settlement agreement with ten of the largest U.S. investment banks, which radically changed the way that analysts are paid and provide recommendations to investors. Spitzer's investigation focused only on the so-called "sell-side" analysts—those who were employed by investment banks that also underwrote (or sold) the same stocks that the analysts covered (and recommended). Of particular interest to Spitzer and eventually the SEC was the question of whether analysts issued excessively optimistic investment recommendations because their compensation arrangements gave them incentives to do so.

Spitzer's investigation uncovered several important facts; one was that the compensation of many analysts did indeed depend on the success of their investment banking counterparts. That fact was widely known among institutional investors, who therefore tended to discount analysts' recommendations, but presumably it was not known or sufficiently appreciated by many retail investors. More disturbing were the numerous internal e-mails that Spitzer's office obtained through formal discovery, in which various analysts privately scorned the same companies whose stocks they were recommending to the public.

Spitzer's discoveries almost certainly account for the decisions by the investment banks to accept the Global Settlement in 2003. The agreement prohibited basing analysts'compensation on the performance of the investment banking operations of their employers and subjected the ten defendants to nearly $1.4 billion in total penalties. The penalties are to fund investor education and research for a ten-year period by independent analysts, whose recommendations must be provided along with those made the banks' own analysts. In addition, the settlement required the banks' analysts to disclose their historical recommendations, and it prohibited their research departments from benefiting from revenue derived from the firms' investment banking activities. All of the requirements were designed to remove conflicts that presumably biased analysts' investment recommendations while improving the amount of information made available to investors.

In chapter 5, Leslie Boni of the University of New Mexico and UNX, Inc., reports her findings from a comprehensive study of how the agreement affected analysts' recommendations through September 2004, thirteen months after it became effective. In principle, if the settlement were achieving its objectives, the recommendations of analysts employed by the ten defendant institutions presumably would have been more accurate or worthy of investors' attention than was the case prior to the settlement. Boni outlines a series of statistical tests of the validity of that hypothesis.

Boni assembled a data set on recommendations from recognized sources and divided the analysts' recommendations into three broad categories, "high," "medium," and "low," which are roughly equivalent to "buy," "hold," and "sell" recommendations. Among her many findings:

—Since analysts' research budgets can no longer benefit from investment banking revenues, one would expect that the banks' analysts would cover fewer stocks. On average, that reduction appears to have occurred, although the number of stocks covered by three of the banks increased after settlement.

—As already noted, one would presume that analysts would be less enthusiastic in their stock recommendations after the settlement. On average, such a change was not evident, at least through the end of Boni's study period. The share of recommendations in the "high" category actually increased substantially from 2003 to 2004, while the share of recommendations in the lowest category actually declined.

—Did analysts' recommendations enable investors systematically to outperform "the market," and did they do so before and after the settlement? Boni finds that in both periods, the stocks recommended most highly in fact did outperform the market, but surprisingly, investors could have done even better by buying the stocks in the *lowest* category, or those stocks that the analysts typically would have recommended that investors *sell.* Furthermore, there is no evidence that the Global Settlement has improved the investment value of the highest recommendations.

Given these and other findings reported in the chapter, Boni implicitly questions the value of the Global Settlement. But more than that, she offers concrete suggestions for improved disclosure going forward. In addition to disclosing past recommendations on specific stocks, as analysts were required to do by the New York Stock Exchange (NYSE) and the National Association of Securities Dealers even before the Global Settlement, Boni suggests that analysts and their employers disclose on an ongoing basis their *aggregate* performance across all stocks. Regulators could compile that information, which all firms, not just those subject to the Global Settlement, would then disclose on their websites. Boni doubts that the firms would do so voluntarily.

CHAPTER 6 CONCLUDES this volume with an even broader look at gatekeepers, by John Coffee of Columbia Law School. Coffee begins by offering both a narrow and a broad definition of the term "gatekeeper," noting that under either definition gatekeepers can be deterred from socially undesirable conduct more easily than their clients because they derive relatively little gain from such activity and suffer a disproportionate loss if discovered and punished. Coffee argues that gatekeeping should be encouraged because it cost-effectively encourages clients to comply with the law.

He then outlines different types of gatekeepers: the traditional ones that are the subject of this volume and a new breed, including the "lead plaintiff" in class action lawsuits; "nominated advisers" in alternative investment markets (which tend to be unregulated); and intermediated research or "marriage brokers," who find objective analysts to cover companies.

In Coffee's view, gatekeeping has become more important and has attracted more public attention because of the rising number of public company finance restatements. In turn, restatements matter. Coffee suggests that restatements cause companies to lose about 10 percent of their market capitalization on average. The most common reason for restatements is that revenue was initially overstated. In earlier times, firms had, if anything, an incentive to understate their revenues or to defer revenue recognition by establishing "rainy day reserves" to smooth out earnings. In the 1990s, however, the management of some companies began to recognize revenue prematurely. Coffee attributes the shift to the rising use of equity, stock options in particular, in CEO compensation agreements. When compensation is substantially, if not largely, tied to stock values, then some unscrupulous managers will choose to recognize revenues prematurely since doing so enhances the value of the company's stock and thereby the managers' compensation.

Securities analysts also grew more optimistic during the 1990s. In part, Coffee suggests, the change occurred because analysts' careers tended to progress more rapidly if analysts were more optimistic. In addition, analysts tended to be most optimistic about the stocks that were underwritten by their employers. Coffee concludes by arguing that auditors became less effective gatekeepers during the 1990s because the Private Securities Litigation Reform Act of 1995 made it more difficult to lodge suits against them.

IN SUM, the corporate accounting scandals that rocked the United States corporate landscape in the late 1990s and early part of the next decade have led to major changes in the way various financial gatekeepers are governed. Although only a few years have passed since these changes were introduced, analysts are already debating their effectiveness and necessity. If the authors of the chapters in this volume are right, the recent reforms are unlikely to be the last word on this important subject.