BROOKINGS-NOMURA SEMINAR

AFTER THE HORSES HAVE LEFT THE BARN:
THE FUTURE ROLE OF FINANCIAL GATEKEEPERS

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C O N T E N T S

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P R O C E E D I N G S

MR. BOSWORTH: I think we'd like to get started in a minute. My name is Barry Bosworth. I'm an economist here at the Brookings Institution. I just want to say a few things.

This conference is sponsored by an organization we've had a long link with, the Tokyo Club Foundation, for about the last 15 years. The president of that, Dr. Ujiie, who came last year and is not able to make it this year, so he sends his regrets on that. We're, as usual, grateful to the Tokyo Club Foundation for their interest in these issues and their willingness to finance these projects.

I'm going to let Bob run this meeting because he knows much more about these issues than I do, which wouldn't say much.

MR. LITAN: Just a few ground rules, which I'll probably have to repeat at several points. We're recorded, so what we're going to do is we're going to be publishing these papers after any revisions that people want to make. We're going to be publishing the formal commenters and then also a summary of the discussion, so that when we go to the discussion period, you've got to remember to push your little button and say who you are for the record because some anonymous person is recording this, or so we hope.

MR. BOSWORTH: Located in India somewhere.

MR. LITAN: That's right. He's located in India.

[Laughter.]

MR. BOSWORTH: So speak up.

MR. LITAN: The presenters have got roughly 25 minutes or so, the commenters roughly 10 to 15 minutes, and then we have it open for discussion. This is obviously very informal.

I think, just as an introduction, I want to congratulate all of our paper authors. They got their papers reasonably, if not closely, in on time and they did an excellent job. Not to take anything away from the discussants, but they did. They all at least put the issues out there.

By the way, I should just take one other thought about the issues, and that is we titled this "After the Horses Have Left the Barn" because the horses have left the barn. The scandals are over, but the post-scandal debate about what we did to address the scandals has gone on and on and will probably continue to go on, and the purpose of this book will be to, hopefully, contribute to the academic rethinking about what our knee-jerk response was to these scandals in the United States and whether or not there ought to be some rethinking.

It's appropriate to begin, though, with a view from across the Pacific and look at what Japan did, because I think one of the surprising things I found when I read Glen's paper is how much the Japanese look to the United States. They watched our scandals probably with a mixture or horror and glee, and then they decided to adopt a number of their own reforms. So I think it's very interesting for us to hear from Glen and his colleague about what has gone on in Japan, and then that will provide a setup for us to then return to discuss the three major gatekeepers in the United States. Glen, I think you did an excellent job of outlining what the gatekeepers are in Japan, so educate us, please.

MR. FUCHITA: Where do you start explaining about what's going on in Japan? But I think not so many people here nowadays are so much interested in the Japanese situation, so I will not just explain about the Japanese situation but also talk about my view on the financial gatekeeper issue as a whole. Since today there will be deeper and more focused discussion on credit rating agencies, accountants, and analysts, respectively, I hope some overall discussion might be appropriate as a starter.

My friend Tomoo did some statistical analysis of audit fees in the U.S. and Japan. I hope that will be also interesting to you.

As I will explain, the issue of financial gatekeepers has been a hot topic in Japan. There are three reasons.

First, we are very much influenced by the U.S. reforms after Enron. Japan introduced many similar reforms.

Secondly, in the post-bubble period there are many collapses of major firms in Japan, but in many cases accountants, rating agencies,and analysts in Japan failed to warn investors of problems well before the collapses. The other was they could not produce accurate and timely information for investors.

Thirdly, recently it was revealed that big firms like Seibu Railways and Kanebo made false disclosures. Especially just two weeks ago, four accountants of

ChouAoyama, which is an affiliate of PricewaterhouseCoopers, were arrested for possibly assisting the window dressing of Kanebo's financial statement. This case reminds the Japanese of the Arthur Andersen case. If ChouAoyama is sanctioned and the operation of ChouAoyama is suspended, more than one thousand Japanese major firms have to go to the other big three in Japan, which is very much disruptive.

Let me start with accountants, the situation of accountants in Japan. The problems are the following. First, they failed to detect problems of Yamaichi Securities, Ashikaga Bank, or other major corporate collapses during Japan's post-Kanebo period. Second, the minister of finance and politicians used to focus on the order of the financial system instead of accurate and timely disclosure of bad assets problems. In other words, to some extent it was not only corporate officers and accountants who tried to cover up the problems, but also regulators and politicians were involved. I think this may be a unique situation in Japan, but that could happen in other countries as well, and I think that has important implications in deciding who should regulate financial gatekeepers.

The third problem concerning accountants in Japan is traditionally supervision of accountants and accounting firms was mostly left to JICPA. It's the Japanese equivalent to the ICPA, the self-regulatory organization. So this was the as the situation in the U.S. before PCAOB establishment.

So those problems used to be not much criticized internally, but international accounting firms affiliated with Japanese accounting firms are criticized at home. So those international accounting firms triggered discussion for reform in the late 1990s.

Let me explain about what has changed. First, amendments of accountant law in 2003. We prohibited providing any non-audited services to an issuer contemporaneously with an audit. And audit partner rotation was introduced. The period is seven years, not five years, as in this country. There are talks that we should shorten the rotation period to five years like in this country.

And enhanced supervision. We have established something called CPAAOB--the PCAOB of Japan--but there are some differences between the two, as I will explain later.

Introduction of SOCs-type rules for internal controls is being discussed. It will be introduced probably in 2008.

Further reform will come. As I said, there are four accountants who were arrested September 13th and there is increased movement toward further regulations.

CPAOB stands for Certified Public Accountants and Auditing Oversight Board, which was established April 2004. It is modeled after PCAOB, but there are several differences. First of all, this an administrative agency in FSA. FSA is the Financial Status Agency in Japan. They're a financial regulator. So in other words, it is financed by taxes, not financed by fees from issuer or audit firms.

This was not the only choice for Japan. There were some other ideas, like the FSA itself supervise directly, or we should establish a Japanese type of SEC, or establish a private independent body. There were several alternatives we could have chosen, but we decided to establish just the institute in FSA because we had something called CPAEIB--which stands for Certified Public Accountant Examination Investigation Board--that was in FSA. So it was decided that we should utilize this existing body and expand its function.

Another difference between CPAAOB and PCAOB is that Japan's PCAOB oversees JICPS quality control reviews of accounting firms, but in the case of the U.S. PCAOB, it oversees accounting firms directly. Also in the case of PCAOB in the U.S., it has its own disciplinary authority, but the Japanese CPAAOB only recommends to the commissioner of FSA to take action. So in other words, we are still respecting the role of self-regulatory organizations. We decided not to directly oversee the audit firms.

So far, I have explained about accounting reforms in Japan. Even though there are some differences, Japanese environments surrounding accountants are getting closer to that of the U.S. However, I would like to point out that even if Japan introduces the same rule as the United States, there are several fundamental problems with Japanese accountants.

First of all, as you can see in this table, we have too few accountants compared with the number of listed firms--only 3.64 accountants per listed domestic firm. In the case of the U.S., you have more than 60 people per listed firm. So we are really short of the number of accountants.

There are other problems. Because there are very small number of accountants, they are not able to spend much time in auditing. Other countries spend 20 or even 80 percent more time in auditing than in Japan. And also, Japanese companies are paying a far less amount of money to auditors than are U.S. companies.

I will ask Inoue-san to explain about his analysis on audit fees.

MR. INOUE: Hi. My name is Tomoo. It's really nice to meet you, and thank you very much for giving us a chance to talk about my quantitative analysis about auditing fees. Although Fuchita-san's paper talks about auditing fees and other things like credit rating and analyst analysis, I will just do the empirical analysis on auditing fees.

The topic I'd like to talk about is basically I'd like to know what are the determinants of audit fees. Some of you may be familiar with the empirical analysis on this topic. There are a bunch of papers written on this topic, but mainly those papers are on--some of the papers are about the Norwegian economy, Norwegian accounting data, and some other data are on U.K. data. It seemed there was a data limitation in the U.S. and also there was a data limitation in Japan. But recently, because of the change in the regulation, Japanese companies are supposed to report their auditing fees. So because of that, we could do some empirical analysis using auditing fees as well as financial data.

So basically, what I would like to talk about is those five things. Is there any difference between U.S. and Japanese companies in terms of the determinants of auditing fees? I'd like to talk about in terms of the size of the auditees, complexities, and the risk of the auditees. Also, I would like to talk about audit-fee differences between auditor companies, as well as other factors like BCC and premium.

As you see, Empirical analysis in your file contains a bunch of numbers which probably are not interesting to talk about. So let me summarize some of the major points in my PowerPoint slides. If you have any questions, please ask me.

We were talking about the regression analysis. Let me summarize. This basically give you some basic idea about the relationship between audit fees and asset size. As previous literature talks about, the major determinants of an audit fee is the asset size of the company. Those are the 10 biggest companies in the United States in terms of the number of assets. This is the book value of assets.

As some of you may notice, there are no financial companies. Because of the data limitation, we omitted financial companies. If you think it is important to include these companies, please advise me so--but that way, I would like to include these data in a later analysis.

Anyway, these are the 10 big companies. This is the asset size and this is audit fees. And this column is the sum of audit fees and audit-related fees and tax fees and other fees. If you just compare the size of the audit fees with its asset size, the ratio is like .01 percent, or .02 percent at most. IBM is the biggest, but still it is just .02 percent. But if you compare the figure with Japanese companies, the figures are much, much smaller. Sony is the biggest, which pays .02 percent, but other companies pay really small amounts of audit fees compared with their asset size.

As previous literature talks about, it seems that audit fees are mainly determined by the asset size. Probably this graphic will give you some rough idea about the ratio between those two variables. The horizontal axis is the total assets of the company and the vertical axis is the audit fees of the company. Those are the data for about 1,000 companies which are listed on the New York Stock Exchange, and these are the newest data available.

As you can see, if the -- total assets is 10 times bigger compared to the other company, it seems that the companies are paying almost a proportional amount of audit fees. The point is there's a linear relationship between those two variables. I took a log of variables to make the graph visible. But the point is, the relation is linear.

However, if you take a look at the Japanese companies' data, it's not really linear, although if we just take a look at the local--this region, there may be a linear relationship. But the noticeable difference between the Japanese data and the U.S. data is that there is an increasing relationship here which indicates that the bigger companies tend to pay higher audit fees. So this probably gives us some general idea about the relationship between audit fees and asset size.

There are other factors which are supposed to determine the level of audit fees. So from now, I decided to run a regression analysis. For that purpose, I would like to talk about--

I'm sorry. Before that, this slide summarizes the relationship between audit fees and asset size. This line comes from the simple regression analysis of those two variables. So it seems that there's this linear relationship in the U.S. companies, but a kind of quadratic relationship among Japanese firms. That's a noticeable difference.

Other than the size of the company, there are other factors which are supposed to explain the difference in audit fees. One such thing is the complexity of the company. If the company structure is more complex, the auditor will ask for higher audit fees. Typically, those are the variables that the previous literature talked about--inventory/assets ratio, accounts receivable/asset ratios, or quick ratios or current ratios. In my analysis, those variables turn out to be not that important. Some of them are important, but the results are kind of mixed.

Contrary if I increase the number of subsidiaries, which supposedly explains that if the company has more subsidiary companies, the accountant will find more difficulties that require higher audit fees. And that relation has been confirmed in Japanese data. Unfortunately, there are no such data in U.S. companies, so I couldn't do it. I cannot run a regression.

Another thing was the risk aspect--if a company is doing a risky business, the accountant is supposed to spend much time for the auditing business. For that purpose, I collected several data from the balance sheet data and we find out that there's a relationship. If the balance sheet says that the company is running a higher-risk business, such companies are paying higher audit fees.

A second way of measuring the risk was the risk came from the stock market measure. If the company's stock price fluctuates more, people will think that this company may be risky. If that's the case, the auditor may spend much time to audit the company. However, I couldn't find any statistically significant result by using the stock market dataset.

Up to this point I have talked about audit fees and its relationship with auditee company characteristics. But now I would like to talk about audit fees and auditor characteristics. Especially I would like to talk about is there any Big Four premium for audit fees.

For the U.S., PricewaterhouseCoopers, Ernst Young, Deloitte Touche, and KPMG are the Big Four auditor companies. In Japan, [inaudible], [inaudible], ChouAoyama, and [inaudible], those are the four big auditor companies. I ran a regression to see if there are any premiums for those big auditor companies. According to this regression analysis, yes, there was a statistically significant relationship.

And so after observing there is a premium for Big Four companies, I further checked whether those premiums are different between the four companies or the same. Those can be done by some [inaudible] test, which is a statistical test, and by running regression, and we find out that for U.S. companies, those premiums are different among the four auditors; but for Japanese companies, they are the same--

which may indicate that the Japanese auditors are setting their prices. I shouldn't say this [inaudible], but their pricing is harmonized, at least in terms of statistics. It is just harmonized. As far as I can use the statistical analysis, I can't reject the equality hypothesis.

The last factor I'd like to talk about is a busy-season premium. This variable also was important in the previous literature, which says that if a company's auditing time is concentrated in a certain month, these companies are asked to pay higher audit fees. That has been confirmed in U.S. companies, but was not confirmed in Japanese companies. Although 84 percent of the Japanese firms ended their accounting year in March, they actually pay lower premium--although that figure was statistically insignificant, so I should say there was no busy-season premium for Japanese companies.

So those are the results I got. Thank you very much.

MR. FUCHITA: Now let me go back to the story of financial gatekeepers in Japan.

The next issue is about rating agencies in Japan. The problem of rating agencies in Japan is very much similar to that of the U.S. In the U.S. you have a problem concerning NRSROs. In the case of Japan, we have something called designated rating agencies, or DRAs. This designation is used in various regulations, such as capital adequacy requirements for securities companies back in this country, also the eligibility criteria for self-registration.

I would say DRAs in Japan play a more significant role than NRSROs because in securities registration statements and prospectuses, they have a column for DRA ratings, so issuers have to put their ratings when they prepare this kind of document. Of course, if you do not have any ratings from DRAs, you can say that we have no rating, but virtually it is a kind of requirement. So many companies literally have to get great ratings from DRAs to issue securities to the public.

In order to be designated, a credit rating agency must satisfy the commissioner of the FSA that it has the necessary experience, staff, structure, expertise, and independence--in terms of capital structure, for example--and the qualifications are more vague than in the U.S., I should say. And also, since experience is important, it can be used to avoid new entries.

There are five DRAs in Japan--R&I, JCR, Moody's, Standard & Poor's, and Fitch. R&I was formed from the merger of JBRI and NIS in 1998. So in a sense, in Japan the number of rating agencies has decreased, but still we are not in a so-called duopoly situation. There is very good competition among those five DRAs. Also, there is a non-DRA which has got a reputation, called Mikuni & Company. It does not apply to become a DRA in order to keep the status of its ratings as opinions. They use public information only. This company runs by subscription fees only. It is a very unique rating agency.

The problem of rating lag--this is another similarity to the U.S. The default of Enron's bond caused a criticism of rating agencies, since they were too late in downgrading. But before Enron, in Japan there was a similar case. Mycal, which is the fourth-largest supermarket, filed for bankruptcy protection on September 14, 2001. The company defaulted on 350 billion yen of corporate bonds. Ninety billion of the bonds had a face value of only 1 million yen and were targeted at retail investors. As much as 38,000 people who were -- investors lost money because of this default. And this bond for retail was rated is investable, I mean investment good grade.

So the first one, 40 billion bonds issued on January 28, 2000, the rating was A from JCR. So it got a rating only from this single DRA. In September 6, 2000, JCR lowered its rating to BBB. After that December press, Mycal issued another corporate bond for -- investors, 50 billion yen, with a rating of BBB. And what happened on August 17, 2001, JCR lowered the rating on both to BB. Within the month, the bonds defaulted. So, there, I mean, JCR was so late in changing the ratings to junk bond status. Only one month before the default.

Another interesting situation in Japan is the recent upgrades, rush in upgrading by foreign rating agencies since 2004. Traditionally, Moody's and S&P's are famous for being too harsh on Japanese firms. Their ratings tend to be lower than the ratings by domestic Japanese rating agencies. But this situation has been changing lately. Actually, since 2004, those two foreign rating agencies have started to extensively upgrade their ratings of Japanese firms.

This, of course, reflects the recovery of the Japanese economy. But they did say that their policies for rating Japanese firms have changed structurally as well, that if, even in the period of the bubble, Japanese banks managed to rescue--I mean the post-bubble period, the Japanese banks tried to rescue faltering companies and there were only a few corporate bonds that defaulted. So this is something that can't happen in the U.S., and they overestimated the default rate of Japanese firms. By reflecting this reality, foreign rating agencies changed their rating standards for Japanese firms.

And there might be another background to consider in this rush of rating upgrades since 2004. That is, under Basel II it is expected that banks cannot use unsolicited ratings when they choose a standardized approach to calculate risk rates. Foreign rating agencies in Japan issue many unsolicited ratings compared to the domestic rating agencies. So in order for foreign rating agencies to increase the usage of their ratings under the Basel II regime, they tend to emphasize more solicited ratings over unsolicited ones. So if foreign rating agencies' rating policies are too stringent, they will have less chance of obtaining paid corporate clients.

Therefore, according to some observers, they had to change their policies for Japanese corporations. I mean, to get more business, they have changed their policies. That might be the background reason for the recent upgrades rush.

Now, let me explain about analysts in Japan. Rules for analysts have been tightened in several steps in Japan, as is shown on this slide. Especially -- analysts are prohibited from getting involved in investment banking business since March 2004, as is the case in the United States.

Backgrounds for these reforms are, of course, we are adopting reforms in the United States, but there are some specific features happening in Japan. For example, in 2001, an ING Research report on Daiwa Bank caused the bank's share prices to plummet. It seems there were some simple errors in the ING report. But FSA was very much concerned about the situation. At that time, the Japanese bank's share prices were very weak, and this foreign securities broadcast research report caused a further drop in the

Japanese bank's shares. So the FSA got angry and sanctioned ING for issuing a false report.

Also, there are some cases concerning self-party reports, the use of self-party reports, so we have to introduce regulations.

Now, I have explained about the Japanese situation. As I said in the beginning, I'd like to raise several topics concerning financial gatekeepers as a whole. I have raised three questions: Should we regulate financial gatekeepers? How should financial gatekeepers be regulated? The third one is, Who should regulate the financial gatekeepers?

Should we regulate financial gatekeepers? This may sound like a stupid question because I have already kept explaining about the regulation of financial gatekeepers. But the reason I raise this question is that not all financial gatekeepers are regulated equally. For example, buy-side analysts are not really regulated. Also, the regulatory [inaudible] and accountants and [inaudible] agencies are different. I would like to argue whether these differences are justifiable or not.

I think there are two variables which influence our judgment over whether we should regulate financial gatekeepers or not. The first one is the influence on securities trading. If financial gatekeepers have more influence, then they should be subject to more regulation because we are regulating securities trading, so why not regulate those who are influencing securities trading very much? So if the regulations are important for protection of investors, then the regulations on financial gatekeepers must be important to protect investors.

Another variable is uncertainty or subjectivity of the information. If the information is more uncertain or subjective, then there must be less regulation. Because opinions are important--the more information, the more opinion, I believe, the market will be more efficient. So I think freedom of information is important. So if there is too much regulation of that kind of [inaudible] opinions, the market might be less efficient.

So there are two important goals. One is protect investors, the other is to protect information provision to the market.

I would like to compare accountants and sell-side analysts using these two variables. Concerning influence on trade, I think accountants are more influential than analysts. There are so many analysts that accountants are just one judgment to each company. So their influence, very much fundamental in securities, is trading, I guess. Concerning uncertainty and subjectivity, I think analysts' information is more subjective or uncertain.

On the other hand, accountants' information is supposed to be certain and objective--ideally, I should say--and they are important to behave as they are supposed to, based on GAAP. And in this respect as well they deserve to be more regulated. I think it is precious to have as much variety of information as possible, so there should not be too much regulatory interference--as is the case with accountants--in the case of analysts.

So based on those two variables, accountants should be regulated more than sell-side analysts. By expanding this analysis to other financial gatekeepers, I could arrive at this figure to show how the two variables discussed affect the necessity of regulation for different financial gatekeepers.

I think it would be easy to understand why buy-side and independent analysts are not regulated as well as sell-side analysts are. In terms of uncertainty of information, they are basically the same; but in terms of influence on trades, analysts employed by the securities brokers and dealers outweigh other types of analysts.

Looking at this chart, the location of rating agencies needs explanation. Ratings by NRSROs are used by various securities regulations. In this respect, rating agencies are closely related to securities transactions and the need to be regulated, I think.

Also, since investors do not have many alternatives to ratings by NRSROs when making decisions about fixed-income securities, I think the influence of ratings seems to be more significant than that of sell-side analyst information. Therefore, NRSROs should be regulated more than sell-side analysts. Meanwhile, since non-NRSROs are not as influential as NRSROs, they should rather be treated like independent analysts who are not regulated.

Concerning the degree of uncertainty or subjectivity of rating information, it is higher than that of accounts' information, but it is less uncertain and subjective than the information of [inaudible] analysts. Since ratings only deal with credit risk or often only focus on whether an issue is investment grade or not, in this respect as well NRSROs should be regulated more than sell-side analysts.

The reality is that rating agencies, whether NRSROs or not, are not regulated the same way as sell-side analysts. I suggest the situation cannot be explained by the two variables we have been focusing on. I think it should be changed. If NRSROs choose to be non-NRSRO and they become less influential, then they may avoid further regulation. But as long as they are NRSROs, I think they are very influential on securities trading and they should at least be regulated more than sell-side analysts, I think.

So, are the following situations justifiable:

NRSROs all are not really regulated now. My answer is no, they should be regulated more.

Financial planners might be classified as financial gatekeepers, but some are not registered as investment advisors. I think this is justifiable because many financial planners--well, I should say some financial planners do not mention about their choice between securities or non-securities, so they are less influential on securities trading.

Sell-side analysts in Japan are not so strictly regulated as in the United States. I think this is also justifiable because we do not have such charisma as Jack Grubman or those figures. Yes, we have some famous analysts, but not as famous as those in this country, and they are not so much influential.

The regulatory environment for accountants in Japan is not as strict as in the United States. I think they should be equal. So in the case of Japan, we have a kind of PCAOB-type of organization, but it is not as powerful as PCAOB. And that should be corrected, I think, because accountants should be equal universally. Their [inaudible] should be the same in Japan as the United States, so the regulation on these accountants should be the same in developed countries, I think.

How should financial gatekeepers be regulated? I think there are two areas of consideration. One is availability and competition. The other is conflicts of interest.

Concerning availability and competition, I think there are not many players and the influence of one player will be large. So if it is so influential, there should be more regulation. But if there is too much regulation, that situation will get worse. There will be much less players and things will get worse. I think competition would solve potential problems, to some extent, through [inaudible], so probably competition should be important in this area. So one question is should Japan introduce public policy to increase the number of accountants and subsidize independent analysts? I think I would like to hear opinions from you.

The second consideration is about conflicts of interest. It is not easy for financial gatekeepers to collect fees from users of their information, so conflicts of interest is, I think, inherent in financial gatekeepers. What is important is to control the damage. It is not necessary to limit the freedom of business model and so on. Also, if there is too much restriction on the way they do business, then there will be less players and less availability and less competition.

And looking at trends concerning conflicts of interest in financial regulations, concerning banks' securities business, there are less and less strict rules to avoid conflicts of interest. But somehow, in the area of financial gatekeepers who are in the corporate governance area, the rules are getting stricter and stricter. So I'm not sure which direction we should take, but at least I think if there are too much restrictions on conflicts of interest, I think there will be less competition and things will get worse.

So one question is shouldn't accountants provide a non-audit service? Also, shouldn't sell-side analysts be involved in the investment banking business? Well, I think I understand the conflicts of interest when analysts do some business for investment banks, but I think if the analysts do business--if the analysts issue reports for retail investors, in that case there should be strict regulation to avoid conflicts of interest. But if the readers or subscribers of their reports are institutional investors, they should know whether the opinions or ratings by analysts are reasonable or not, so there should be less restrictions on conflicts of interest. That one example--that's one answer from the top of my head, but I'd like to hear your opinions as well.

Who should regulate financial gatekeepers? Well, in Japan, the Financial Service Agency used to prioritize the order or stability of the market in their sense, rather than primary disclosure of bad asset problems. Otherwise, I think investor protection was inferior to stability of the financial market as a policy goal for Japan's financial regulators. Right now, I don't see such biases in the FSA, but in the future they may repeat the same problems.

So specific questions right now are should CPAAOB, or the Japanese PCAOB, be separated from the FSA? Should Japan establish a U.S.-type SEC separated from banking and insurance supervisors? Thirdly, should our country have new and independent organizations solely devoted to investor protection with enough professional staff and independent financial resources, similar to a central bank, for independent monetary policy?

Well, those are some of the questions I can think of, and I hope during this conference I can hear as many opinions as possible from the participants today. So for the sake of time, I will stop here.

Thank you.

MR. LITAN: Thank you very much, Glen. Actually, we allowed both Glen and Tomoo more time because, A, I think very few of us in this audience knew a lot about Japan, so this was very educational for us; and second, I think you provided a very helpful framework for the entire conference. All those questions you asked about financial gatekeepers could be applied to America as well. So hopefully, we'll debate those.

And to start us off, we have Paul Stevens, who is the president of the Investment Company Institute of the United States, which is the trade association for all mutual funds, now the largest financial institutions in America.

MR. STEVENS: Thank you, Bob. First, I should say on behalf of us all a word of very sincere congratulations to Fuchita-san and Inoue-san for an excellent presentation and a very thorough and useful paper. I think it's always valuable to begin with a comparison of other markets' experiences as we reflect on arrangements here in the United States. The thing that I would say is that it makes it quite apparent that, while the context may be quite different, we're grappling with many of the same problems.

In the United States, at least as I appreciate it, the term "financial gatekeeper" is a term that really applies to a range of interests that facilitate or grant or condition access to the public capital markets by issuers of publicly traded securities through the kinds of assistance that they provide in the process of accessing the capital markets.

After Enron and our recent scandals, the focus has been on accountants, obviously; on investment banks and analysts; on lawyers, which is a group not mentioned in your paper; a little less so on the ratings agencies. And I think it's important to note for the United States that this focus is not new. In the 1970s, the Enforcement Division of the SEC proceeded in administering its responsibilities on what was called then "the access theory." The theory held that major corporate fraud was not possible without the complicity or the connivance or the indifference of these kinds of entities. Over time, of course, as Professor Coffee could relate in exquisite detail, the liabilities of our gatekeepers, both under our public laws--SEC statutes and our criminal laws--as well as the civil liabilities in private lawsuits, have grown enormously. In the case of Arthur Andersen, we even devised a form of death penalty for a major accounting firm by indicting it.

You, by the way, described the remainder of our large accounting firms as the Big Four. In the United States, more commonly they're called the Final Four.

[Laughter.]

MR. STEVENS: This refers to our intercollegiate basketball tournament where among the most honored schools are the ones who make it to the final four. We very recently thought we had had one playoff game that was going to leave three, when KPMG had its problems with the tax shelters, but we avoided that.

The core concern, Fuchita-san, that you emphasize in your paper, I think, is exactly the right one, which is the problem that typically these gatekeepers are paid by the issuers of the securities who are seeking to get through the gate to access public capital. This is the core, the source of all of the conflicts, I think, that have concerned us. And it's very important to understand that for these entities, we believe, I think, or have come to believe that they're invested with a mixture of public and private responsibilities. They're not there as toll collectors. They're not simply there to get paid so that someone can go across the bridge. They're actually there to keep the gate. And implicit in that function is to keep some people out who don't deserve to get in, and allow people in who deserve it, and to, in a way, extend the capabilities of our governmental organizations in overseeing what is a very, very large marketplace indeed.

I thought it was interesting that you describe in Japan, given the size of your financial markets, the relatively minor role of gatekeepers. Perhaps that's something that is changing and evolving over time. I think it probably will take time. You aptly describe the dominant role of banks.

I think there's something else that's important here as well, and that is the pattern of the holding of equity securities in Japan is quite different than in the United States. Your paper notes correctly that individual investors hold a far smaller portion of equity securities in Japan than is the case here. In the United States, we have been doing a survey with the Securities Industry Association for a number of years. Equity ownership in the U.S. by U.S. households has increased threefold since the early 1980s. Now over half of U.S. households own individual equities. I think it's important, as we think of the way forward, to realize also that 90 percent of them own stock mutual funds, and increasingly that is the way that our individual investors are accessing the equity marketplace.

Your paper also describes, I think, a smaller role for these key professionals--accountants and lawyers--in capital markets than is the case with us, and less-developed standards.

One thing that I'll commend perhaps as a lesson as we compare the two is that the gatekeeper is only as good as the gate. If it's a big, high stone wall and there's a narrow gate, to use the scriptural phrase, to get through, and you have a gatekeeper, that assures, I think, some greater degree of accountability than a small hurdle with someone tending a gate that people can slip through more easily. That refers to a whole variety of things perhaps beyond our reach here--the nature of laws and regulations, the kinds of accounting principles that we're asking our accounting firms to administer, disclosure requirements, risk allocations and liabilities, which are adverted to in your paper but not discussed at considerable length. That's one of the motivations, I think, for our gatekeepers here particularly because--well, to put it simply, if they screw up, there'll be hell to pay.

There's also, I think, evidence of an extent of political influence in the process in Japan that perhaps is not so evident here. Implicit in some of your comments about the frauds and scandals that Japan has experienced is an undertone, to me, of the avoidance of collateral consequences across Japanese society by the extent of these problems, which was a matter of high governmental concern, justifiably so.

I think a second lesson that I draw from the paper is that the strength and independence of gatekeepers is, to some significant degree, cultural and achieved only over time. I say that even though acknowledging that our gatekeepers have proven to be less than perfect. But the rise of the professions in the United States that are involved in this process, the accounting professional and the legal profession--both highly compensated, both highly skilled in terms of education, and both relatively powerful in their presence in our process--I think stands in contrast to the experience that you describe in Japan.

I wanted to make a couple of quick comments, Bob, about things that I observe in terms of our own gatekeepers. And I want to start with the ratings agencies. I've been following this at the ICI because, of course, we're interested in it. And what I get out of it is that we're hopelessly muddled in the United States about how to think about ratings agencies. On the one hand, they have a form of protected speech and exercise First Amendment rights, as commentators or journalists might; on the other hand, they're thought of as gatekeepers performing some quasi-governmental function. On the one hand, we look at market forces to determine how well they do their ratings and their job; and yet, on the other, we still think consistently about government designations, government registration, some regime that would apply to them.

We're also muddled about what ratings mean, and I gather there's something of the same thing in Japan. Ratings--and I think you're correct in your paper--agencies of that kind began in the United States as a business to fulfill a need in the private marketplace. But they are convenient mechanisms for government to regulate around.

In the United States, for example, we have a multi-trillion-dollar money market fund industry which is regulated by the SEC under a rule called 2a7. Written into that rule are quality considerations regarding the kinds of paper that money market funds that want to maintain a constant net asset value per share must maintain, and they refer to nationally recognized statistical rating organizations for that purpose. So we have for a very large financial intermediary in the United States written into the fabric of portfolio regulation ratings agencies, which sort of defies thinking of them entirely in a private character, if you will.

I'm struck by the similar concerns that you have in Japan--you know, how many ratings agencies should there be, should it be invested with competition, the problem of rating lag, the bias toward issuers, the inherent difficulty of getting it right. I'm a little sympathetic to the foreign rating agencies looking at Japan, and you describe it as a bias towards thinking that there would be poorer economic performance rather than better. I think that's just indicative of the difficulties that all ratings agencies have in this regard.

And then there's also the anomaly in the United States that ratings agencies--although private, First Amendment in their character, they would assert--do get access to more public information than others because they are, as I understand it, Professor Coffee, not subject to Reg FD.

MR. COFFEE: Right.

MR. STEVENS: So we are utterly conflicted about what to do concerning ratings agencies.

On the issue of analysts, I personally think that sell-side analysts are hopelessly irreconcilably conflicted. And I am dubious at best about the efficacy of disclosure, what we call Chinese walls. That's meant as an ethnic slur of any kind, but calls to our mind the Great Wall of China separating one portion of a firm's business from another. The issue of ownership of the securities, provisions to bolster integrity and objectivity, et cetera, et cetera. These are all intended, I think, to prevent outright fraud, where the analyst is used as the charismatic salesman for a firm's investment banking business. And that's probably a good idea, because people can fall victim to that kind of blandishment.

The real problem in the market is how do firms on the sell side recoup the cost of their research? Frankly, I think the only way to do that is by producing really good research that people want to pay for. And the market is moving to solve, I think, some of these problems. Buy-side analysis is becoming much more robust. In fact, during all of the analyst scandals, if you went and talked to my members, the mutual funds, they would say nobody listens to those guys anyway; I'm mean, what's the fuss? Well, the retail investors, the blandishments to them probably were one to be concerned about, but not the institutional investors.

You rightly point out indexing strategies will make this less significant. Reg FD has leveled the playing field. And I would also say that the rise of mutual funds as the way in which people are exposed to our equity markets is important as well because there is an institution behind that, even though the exposure is to the retail investor that can filter out what analysis is worthwhile and what isn't.

I also think that it's been reaffirmed, the importance of a robust third-party independent research capability. We had discussed here in the United States the idea of prohibiting the use of soft dollars to access that kind of research. That was resoundingly, I think, rejected, and independent research, I think, is now much more highly valued.

Finally, with respect to your variables about what influences they have on information in the market and how uncertain or subjective the information is as the variable that ought to guide regulation. I think it's an interesting source of reflection about whether you look at it in that way, and those are two good insights. I do worry, though, about a broader issue, which is the effect of regulation on competition and access. You make a convincing case that the accountants ought to be the most highly regulated.

Well, there are, I think, many who are concerned we're regulating them into extinction. I have been involved on behalf of mutual fund firms in the search for a new public accounting firm for a mutual fund. And very often--this is a surprising result--very often, when all is said and done, you'll come back to the audit committee and say you have a choice of one. Some may not wish to perform the audit because they have financial relationships or access capital through a particular entity. Others may have conflicts with other business entities or other lines of business. And it's kind of an odd thing to say, well, you have the choice of any independent firm you want and, because of our independence requirements, there's only one you can choose from.

In the United States, it's clear that there are going to be two tiers of audit firms--a very small elite group who are going to be venturing into the realm of audits of public companies, I think--largely because of the liability concerns--and many others who will be fine firms but restricting themselves to the private marketplace. Analysts, I believe, will always be in abundance and will probably solve some way the question about NRSROs. I hope we'll do that in a way that allows many more of them to come to the market in a highly transparent manner so that people can look and see what they add and make decisions. But the competition issue and the availability of the services with respect to the accountants is, I think, a very important public policy concern.

MR. LITAN: Okay, thank you very much. Now, here are the rules for the people who walked in late. We're going to open this up to discussion. We are recording, and so when you want to talk, you can either put your card up or you can just wave, and so then I'll make a note. And then you've got to speak into the microphone your name so that we record who you are.

I'm going to take the chairman's privilege of asking the first question. And that is, when I read your paper, the thing that is just amazing about it is, as I said at the beginning, the extent to which Japan has copied features of the American system--not completely, but you've moved in similar directions in most of these areas. And so I ask a hypothetical question.

Suppose there had never been any scandals in America, but there were these scandals in Japan. You pointed out in all these cases we had all these scandals. In fact, just two weeks ago, somebody's going to jail. So imagine a scenario where Japan has scandals, we didn't. Would Japan have adopted, essentially, what you ended up doing?

Now, I have my own answer to that question. I'd be interested in your answer to that question.

MR. FUCHITA: Well, I think the market is the market, and I think for a market to function well there should be a kind of similar rules for that. So probably in Japan, if they had similar kinds of scandals, they would try to do very similar types of reforms. The question is whether Japan can implement that kind of reform, but there would be the similar ideas. Probably there are a lot of pressures against that kind of reform within Japan, so it would be very difficult to implement.

The reason we could implement that type of reform that we have introduced is that that is something adopted in the U.S. It is a very persuasive reason for the Japanese people to introduce the same kind of reforms. I think, as human beings, the ideas are universal, similar, to avoid various pressures against any kind of reforms. For the Japanese people, the most persuasive reason is that these are the reforms that are adopted in the most developed market economy in the world. So I think that's the reason we are kind of copying or modeling after the reforms you have introduced here.

MR. LITAN: You gave the answer I thought you would give, and so eloquently.

Okay, the floor is open for questions.

QUESTION: Thank you very much. My name is Taki Anaka [ph], Bank of Tokyo-Mitsubishi.

Thank you, Fuchita-san and Inoue-san.

So you told that the number of accountants in Japan is too small to provide a good quality of auditing. But at the same time, you pointed out that the auditing fees Japanese companies pay ought to be smaller than that of the U.S. I think this situation seems kind of a dilemma. If we increase the supply of accountants, I'm afraid it will depress the auditing fee lower.

What should we do with this dilemma? I think one option is to increase the burden of disclosure of listed companies. It would create more work for accountants. And actually--

[Laughter.]

QUESTION: This is what happened with the Sarbanes-Oxley Act in the United States. So do you support such an option? Thank you.

MR. FUCHITA: Well, I think if there are no regulations, there are a number of accountants' audit fees should be decided by the market forces. But because of regulations, the number of auditors or the fees are not the equilibrium situation.

Concerning the number of accountants, there has been less need for that because our market is very much dominated by banks so banks can have access to more information than disclosed information to the public. So the banks do not need to depend on disclosures which are audited, they can just step into the corporations to find out what are problems.

But as we move to more market oriented economy, we are having more needs for disclosures and so the disclosures should be audited by a fair accountant. So that is happening just right now, so I think we are in a transition period so we need time to seek the equilibrium at the new market oriented economy. So it will take time. What we are seeing now is not an ideal situation, like an equilibrium situation.

Also I should say what we real effect of audit fees. It's not the number of accountants, but probably the number of audit firms. I think the audit fees in Japan are kind of harmonized as Mr. Inoue said. There used to be a kind of agreement on the audit fees, so it not decided by the market forces. I think as we change the situation, the audit fees should move higher.

MR. LITAN: John?

MR. COFFEE: Jack Coffee, Columbia Law School. The two twin and stark facts that you point to, the small number of accountants and low audit fees, particularly low audit fees in a market that's extremely concentrated with only four major audit firms suggests to me you have somewhat of an ogopolistic market structure that could charge higher fees by the usual practices of conscious parallelism. Those two facts suggest that maybe there's a very limited market demand for a high-quality, diligent audit. That is, in the simple language of an American businessman, you get what you pay for and if what you want is a perfunctory limited audit that just goes through the motions and doesn't look too deeply, you don't need highly skilled personnel and you don't need them to work too hard.

The difference may be between this kind of environment and the U.S. environment is that the U.S. if a major firm undertook a perfunctory limited audit of a U.S. corporation, it could face significant private liability through class actions and whatever. That risk has fluctuated over the recent years, but it is certainly there and it's back there today with a new force.

I'm not suggesting that you can establish or want to establish the American entrepreneurial system of private enforcement through class actions. That's a huge debate that we don't want to get into. But absent that, you have a problem that may be what the large Japanese corporation wants is just a quick and cheap look at the books plus a perfunctory blessing of the books. That would suggest that you need a far stronger regulatory process because you don't have the private litigation fall-back sanction that the U.S. has.

One other little comment. I'm a little nervous about relying fully on your comment that there were very few accountants. This is a profession which there's an ease of entry. It doesn't require like medicine or law very costly degrees and a great deal of postgraduate study so that you could have more accountants if there were a market demand. But even the similar problem in Japan is that you have very few lawyers, but when you look at the number of lawyers beneath the surface you find that there are lots of sort of covert lawyers, people who've studied law at their undergraduate university, didn't take the bar exam because the bar exam is ridiculously difficult to pass, but they practice a kind of quasi-law in large corporations without ever going to court. You may have what I'll call quasi-accountants or quasi-bookkeepers around at various levels, too, so I'm a little nervous about that number.

If we look at it bluntly, it just suggests that there is no real demand for diligent audits because there's not enough deterrent threat. That may suggest why you need a far stronger public regulatory mechanism.

MR. LITAN: Why don't we accumulate the comments and then you can answer more at the end? Let's go to the other side of the room and work the room.

MS. PALMROSE: Zoe-Vanna Palmrose. I wanted to follow on to Jack's comment, and this is by way of a comment. One of the things that's happening that may increase the regulation of accountants and auditors both in Japan and other countries is that the PCAOB in order to approve the inspection process by a foreign regulator will not accept self-regulation. One of the things that's happening around the world is being pushed really by the U.S. regulator through the inspection process. It wouldn't be a surprise to me to see everything else equal, more regulation in Japan and other places around the world of accountants. That's by way of comment.

Another comment or question I wanted to make was to probe Paul's statement on the characterization of gatekeepers as keeping companies in or out of the market. I would have thought we'd want to characterize it slightly differently, and I thought the securities laws were really in the interest of full and fair disclosure and that the investor then based on full and fair disclosure keeps a company in or out of the market.

For example, auditors themselves wouldn't keep a company out of the market, it's that the information; even a qualified opinion wouldn't keep a company out of the market. Having said that, if they didn't comply with GAAP or if they didn't allow an audit to be done in accordance with auditing standards, that would then keep them out of the market under the securities laws because there would be the presumption of no full and fair disclosure.

I wanted to get that characterization on the table because we do have this debate now about whether companies are entitled to a Big Four audit because it actually is a surrogate for quality, a quality differentiation some of which is reflected in the pricing on the basis of quality. The notion is that auditors are keeping companies out of the market because you can't get the auditor you would otherwise desire. I think this is an important public policy question because it does increase the cost of capital to companies depending upon who they get to audit their financials.

MR. LITAN: Paul, do you want to take that up and then make your comment?

MR. STEVENS: Yes, thank you. I think I would agree with you, but it amounts to the same thing. If a law firm discovers that there is a fraud, the firm is not going to put in the disclosure documents, by the way, this company is a fraud. They're just don't get past the gate. The same would be true I think with the accountants. Disclosure is the mechanism by which you ferret out whatever those activities are that may preclude, and the law firm will back away, the accounting firm will back away because of their own liabilities.

Which leads me to the earlier point. If you actually sit with an audit firm and interview them for an audit and talk to them about their fees, they would tell you in the United States that what has been driving their fees are two things. One clearly is what Professor Coffee talked about. They have enormous liabilities that they've had to pay. To the extent that they have to provide for malpractice and contingent liabilities, it is a huge financial burden for those firms and I'm talking about the largest firms. That I don't think is the case in Japan, or at least I've not heard that there is that kind of financial consequence for a Japanese audit firm in the cases that you've talked about.

The second thing, and it's a little bit contrary to what Professor Coffee has said. If you talk to them, they're competing for talent and they want to recruit the very best and brightest young people that they can. There is now a 5-year curriculum for accountants in addition then to sitting for the CPA in addition to the kind of training they've got to do for specialized audit services that they may provide. They will tell you there's an enormous investment in the recruitment and training of their people that also gets built into that cost as well.

I think generally that means that they're competing in the U.S. labor market for individuals who might otherwise become associates at law firms or the like to some degree at least, and that pushes up the salaries and that then pushes up the fees.

Those two things I think are really what drives the relatively high level of audit fees plus probably a premium for the highest-quality firms that provide an imprimatur, if you will, some cache to the financial statements when they provide a clean opinion. I think there's a premium in the market for that as well.

MR. LITAN: Frank?

MR. PARTNOY: I'd like to pick up on this liability question as well because I think although Professor Coffee suggested that maybe we can put it one side, I think we can't. I think we'll probably return to it over and over today.

I'd like to ask the opposite of Bob's question, if you look at from the Japanese perspective the mimicking, if we can call it that, of U.S. regulation is large from the ex ante perspective. It's the PCAOB and the CPAAOB and copying the acronyms and things like that. All of that is ex ante regulation, but of course in the United States ex post regulation is also an important piece of the puzzle.

One question is, what lessons really can we draw from a discussion about the Japanese experience where we have such a different civil liability regime? Inevitably when you're talking about not just accounting firms but also this issue will come up in just a second with respect to rating agencies and certainly with respect to underwriters, civil liability is doing a lot of the work. Professor Coffee has suggested and I think the general academic literature on gatekeepers suggests that one important function of gatekeepers is to be able to have a stock of capital that they then pledge, and I think liability is an important piece of that.

One question might be, is there a difference in terms of reputational capital in Japan versus the United States? Are firms able to pledge reputational capital in a way? Do reputational markets work or do we think they might work in Japan in a way they don't work in the United States where we think gatekeepers aren't going to be able to credible only their reputational capital, they actually have to put some money at risk for the risk of ex post liability?

MR. RUTTER: John Rutter [ph], the Commerce Department.

I'm thinking of a request to find out more about the Japanese accounting standards and if there are any improvements or changes to those standards as a result of some of these scandals especially compared to the changes in the U.S. accounting standards that have occurred by issuance of FASB statements. It's my impression, and I'm not an accountant so I may be off base here, but the U.S. generally has a rules-based accounting system and it's based upon generally accepted accounting principles, and FASB writes the rules, and they're fairly specifically rules-based statements and guidelines.

It's also my understanding that the Enron scandal initially came because the company essentially did not go by the full and fair disclosure of its earnings and it did so by creating loopholes with the assistance of accounting firms and investment banking firms in hiding liabilities and expenses thereby inflating its earnings.

The response to this has been for the FASB as I mentioned to issue new accounting standards, variable interest entities, derivatives, recognition and derecognition of assets and liabilities, and a whole number of guidelines had to be done immediately, and it wasn't to hire armies of accountants and auditors by the SEC. It still is not the plan as far as I know.

As a matter of fact, the U.S. may even be moving away from a rules-based accounting system and going more towards the European model which is oriented more towards fair and full disclosure with emphasis on quality of reporting earnings and not to create all these specific accounting standards whereby tax attorneys and tax accountants and regulatory accountants can create loopholes to get around them. It's a never-ending process. You write a rule and someone finds a way to get around it.

My question is then, to what extent do you think accounting standards will play a role in Japan and have there been any changes recently in that area? And how does this relate to the approach to regulation? Thank you.

MR. LITAN: Are there any other questions before we go back to our authors? I'll just venture before our authors talk, in response to your question about accounting standards, correct me if I'm wrong, but Japan has moved to adopt like every other country except the United States international accounting standards. I think Japan moved in that direction around the same time that of these scandals.

I don't know exactly the formal time that Japan adopted international standards, but virtually every other country in the world has done that. The international standards as you know are principles based, not rules based, so I think Japan is part of the international game now and we aren't, but let our authors talk about that.

MR. : The question of the accounting standards, first, we are not exactly the same accounting standards like IASB. Japanese accounting standards are different from IASB, but we are trying to be adopted by E.U. countries for the use of E.U. companies. So there are some changes in Japanese accounting standards and there only a few differences between Japanese standards and IASB.

But there are some differences like accounting for mergers and acquisitions and also pensions; not so many differences, but there are some.

So I think there are three accounting standards, IASB, FASB, and the Japanese one, although the third one is not so famous. We are very much concerned IASB and FASB are talking together to establish more harmonized accounting standards and Japan might be left over.

Thank you very much for various comments and opinions. There was talk about class action or civil liabilities. The fact is Japan will be introducing the kind of class action you have and many people who are very much concerned about investor protection, they are proposing that we should have one. It is very likely that there will be a regulatory change so that Japanese people can easily sue firms using this class-action type of scheme.

Also there will be more regulations on disclosure since we will be introducing SOCs regulations, so there will be more internal control requirements for companies, for--companies in Japan. So hopefully there will be more work for accountants. There might be more demands for accountants.

But the issue of people or staff or professional people are very difficult because even there are so much needs for those type of staff. It takes time to increase the number of people, professional people. Actually, what Japan has decided is to establish a new type of professional school for accountants so that there will be more supply of accountants in the future.

Actually, FSA has established a goal to increase the number of accountants to 50,000 accountants. Right now we have only 15,000 accountants, and we are going to make it to 50,000 by the year I think 2018. So there are a lot of years we have to wait before we can have 50,000 accountants.

We are trying to have the same kind of capital market opened up partially because of pressure from the United States. We are trying to have the same kind of capital markets. It is very difficult to have the same kind of infrastructure because it takes time to have accountants or lawyers. Also I should add to that that the number of regulators are very small. We have just 10,000 people in FSA supervising not only the securities market but also banks and insurance companies. Those types of regulations are done by FSA, but there are only 10,000 people. They are increasing the number of staff rapidly even though we have a big budget deficit. So it takes time.

In this country you have 4,000 people in SEC and also there is the NSD and also self-regulatory organizations. So many people are in charge of regulating the market, but in Japan again it is very difficult to increase the number of those staff. So that will be the fundamental limitation to the development of the market.

So the choice is to have more regulations and avoid to have the same kind of market as in this country because we are lacking professionals. Or let the market expand without having so much regulations and we should balance the problems or collapses. So those are two choices. But right now what we are going to do is to slowly catch up with the situation in the United States by introducing more reforms similar to that of the United States. But we are realizing that we have some fundamental deficiencies in our market, so that is the situation right now.

MR. LITAN: Before we go to a break, I would observe that on the one hand if you adopt more Sarbanes-Oxley kinds of internal controls, that will increase the demand for accountants. But if you allow class-action lawsuits as it sounds like you're going to do, that's going to discourage people from becoming accountants. So it's not clear will predominate.

In any event, this was a fascinating paper, a great introduction. We're going to take about an 8-minute break before we start with the rating agencies. Thanks very much.

[Recess.]

[End Tape 1 Side B, Begin Tape 2 Side A.]

MR. PARTNOY: [In progress] --are giving the inflated views and the rating U.S. rating agencies are simply being forced to compete. That is a very different kind of conflict. I call it a pole conflict where you dangle the prospect of favorable ratings to obtain future fees from the rating agency kind of conflict, typical conflict, which is giving unfavorable ratings to pressure issuers to pay for the fees. I'd describe that as a push conflict where you implicitly threaten the issue with unfavorable ratings to obtain current fees, and it doesn't require a lot of these threats to have an impact on the market and a number of them have been reasonably well documented. I go through some of those in the paper.

The primary difference is no crackdown with respect to either of these. The rating agencies have adopted some voluntary codes of conduct. The Department of Justice has been investigating unsolicited ratings, in particular ratings of Moody's for a long time, but they haven't done anything.

The other area in which ratings agencies differ substantially is the area of structured finance. This is maybe a topic beyond the scope of this conference, but I'd like to talk about it just briefly because I think it's a really fascinating issue. I'm not sure I have the answer to it, but I think I have a partial answer.

A lot of financial economists have been exploring what's known as the corporate credit spread puzzle, and here's the basic story of the puzzle. You can find a diversified portfolio of BBB corporate bonds that are just above the investment grade cliff before you drop off to BB. They will trade at, and these are rough numbers, but you can find something like these numbers in the marketplace, a 200 basis point credit spread. If you look at the expected loss on this portfolio, it's only 25 basis points, so the average spread in the market is 8 times the expected loss from default. So the question is how can this be the case? How can it be the case that for every $100.25 of bonds you can borrow $100 of AAA spreads? You can basically convince the market based on past default rates you're going to end up with $100 with 100 percent certainty and end up with a massive arbitrage profit. So how is it that in a reasonably competitive market the corporate bond market is not enormously liquid but there's a lot of corporate bonds out there and there aren't restrictions on people's ability to amass portfolios of corporate bonds, there isn't that much liquidity but there aren't any explicit restrictions, how is it that this arbitrage could persist? But it does. This arbitrage is there and the CDO market is a multitrillion-dollar market now, so this is a bit deal.

Here's a picture of the CDO. I like this picture because it's really fuzzy so I think it's typical of the CDO market that you can't quite see it, you can't quite see what's going on. That's about how much understanding the typical buyer has I think of these.

Basically is the idea is you see the blue box in the middle, you have a special purpose entity and you put a bunch of either bonds or in a synthetic CDO you actually put credit default swaps which are private contracts based on the bonds, into this special purpose vehicle and then the special purpose vehicle issues claims in various traunches that are then rated by the credit rating agencies. So a AAA, a Aa2, a BBB2; these are Moody's ratings. The arbitrage comes out because the arranger and the managers are able to earn substantial fees and the purchasers of these assets that are on the far right side of the chart are able to buy cheaper assets, higher yielding assets, than they could get anywhere else in the market.

So this thing clearly works. It throws off some sort of arbitrage income. These, by the way, are the simplest CDOs, what I describe as cash flow CDOs which have bonds in them, and then synthetic CDOs which have these credit default swaps in them. Those are plain vanilla CDOs.

There are also what are known as CDO squareds which have as the assets, going in on the far left, instead of those being bonds or credit default swaps, they're other CDOs. So you can think about how that would work. Then there are also a few CDO cubeds where the assets going in are CDO squareds. So if you remember back to all the financial innovation in the derivatives market during the mid-1990s that scared the bejesus out of everyone, you have the same sort of thing happening in the CDO market today.

What are the possible explanations for all this? One is an arbitrage explanation and corporate bonds are not liquid and it's costly and difficult to diversify. Economists would shutter to hear this, that you're able to earn a 1 percent profit in a multitrillion-dollar market, but there's this explanation out there and this is the one that the agencies give.

I think there's a second explanation that's at least equally plausible. I haven't figured out how to test it yet, but I can at least explain it to you, and that's the shell game explanation. It says that the rating agencies are misrating various bonds. So they have a bunch of BBB bonds and some of them are much cheaper than others, some of them really shouldn't be BBB bonds, but people can go out and buy the really cheap BBB bonds and put them in a portfolio, put them in an SPV, and then the rating agencies will assess the default probability of those bonds not based on their risk as perceived in the market, but based on the default probability matrices that they have for all BBB bonds.

These default probabilities, they also have correlation assumptions with respect to the various bonds that would go into these portfolios. If those are wrong, if some of them are wrong, then you'd create an arbitrage profit merely if people would be willing to overpay for these traunches, AAA, AA, BBB, if they would pay more than the actual risk associated with those traunches. Why might that happen? There might be a story that people will be anything AAA regardless of the risk, that they don't really care about the risk, they're investment managers and they have to buy AAA and they'd like to have a pick-up in yield so if they can get an extra 20 basis points they'll do it, and the default probability and correlation assumptions are wrong and the statistical models are flawed.

I've talked to a lot of math folks who work in this area and they'll tell me off the record that I'm right but no one can prove it yet, so this is an area that I think will require a lot of work. I want to express some caution. I'm not entirely certain with respect to these conclusions. It might be the case that there's just a high degree of undiversified credit risk in CDOs.

S&P made a rather alarming disclosure on Monday that according to their models, if there's one default in a CDO it could cause a massive downgrade, and people should not be entirely sanguine about this I think.

So this is just a picture to show you to reinforce the point that it's Chart 4 of the paper. It shows the set of assumptions for S&P for various kinds of assets that go in the CDOs. Again, they're fixed. So they make these assumptions with respect to all of the assets. And remember, this is a $5 trillion market so there has to be some explanation for why--these CDOs.

MR.   : Frank, may I ask you a question?

MR. PARTNOY: Sure.

MR.   : Are you implying that the rating agencies, what's the motive for them to misprice all this or to misrate this? Because what you're describing if I understand it in my simple mind is they're creating an arbitrage opportunity out of these ratings. Why would they do this?

MR. PARTNOY: A perfect segue for the next slide.

[Laughter.]

MR. PARTNOY: Back to the cash cow. These are Moody's 2004 revenues. The reason they do it is that it makes them a lot of money. I'm not necessarily ascribing nefarious intent. I actually think there's cognitive error happening at the agencies. I think many of them believe that there's actually an arbitrage here that they're achieving or maybe they just don't think about it because the models work.

These are models are created by the investment banks. When I was at Morgan Stanley we created some of the very first CDO models working with Moody's and we did them in an Excel spreadsheet at Morgan Stanley and these models have evolved sort of like Frankensteins into much more complicated things. But I think the motivation is this right here, that big blue piece of the pie chart of Moody's revenues which is something like 37 percent of their revenues. This is a Moody's chart so it doesn't have the numbers on it, but that big blue piece is 37 percent. So the same sort of rationales that you might attribute to gatekeepers with respect to other conflicts, you would say this is just a fancy sort of high-tech version of that.

MR.   : Again so what you're saying is, or implying, that they have wittingly or unwittingly created these arbitrage spreads or arbitrage opportunities which has led to the creation of these special purpose vehicles which then they can rate and which they can make more money on? Is that the idea?

MR. PARTNOY: Yes. Well put. Thank you. I would have saved us 5 minutes by saying what you just said.

MR.   : I wouldn't have understood it until you got there.

MR. PARTNOY: The surprising thing about this, and again this is why the inflammatory slides are there, the rocket scientists who are doing this are Moody's and Standard & Poor's. They're doing this at the behest of very sophisticated participants in the market. So the market participants who are out there, many of them who are participating in the CDO market, are much more sophisticated.

These are the differences. How did we get there? Just in the interest of time I'm going to very briefly describe where S&P and Moody's are situated.

My claim is that this picture, that we can array on a spectrum reputational intermediaries from a pure government rater like the USDA to a pure private rater who you might think of as a classic subscription oriented gatekeeper. The argument in the past has been that S&P and Moody's are over on the far right side. I'll skip that one. My claim is that S&P and Moody's are somewhere in the middle and this may account for the muddle that was discussed earlier, that they're sort of performing this quasi-regulatory function. I've called this in my previous work regulatory licenses. I don't want to dwell on this too much here except to give you some numbers as to how deep this problem is.

The problem again is that starting in the mid-1970s, various regulators began using NRSROs, essentially S&P and Moody's and a handful of others which has fluctuated over time, using their ratings in regulation, and this is just the tally of where the chart stands right now as to how many regs in the CFR, and Paul Stevens mentioned Rule 287; many of these are quite important. Then how many statutes. So we have eight statutes and 69 regs and they vary from what you might expect, broker-dealer haircuts, to federal highway funding. So there's a lot of reliance on these rules.

I've never looked at this before, but I thought it's sort of interesting and I'm not sure what it means, but this shows the annual federal agency decisions that are based on NRSRO status. There have been 1,700 federal agency decisions based on NRSRO status, which is a lot. In the past I've looked at this chart as a cumulative chart, but I broke it out by year and, I'm not sure why and I'd like to hear if anybody has any thoughts about why, but we had this peak during the 1987-1989 period and then a trough in 1991, and then back up later on. But this is the first explanation for why credit rating agencies are different, and maybe why they make so much money is that they're not really engaged in the pure gatekeeper function, that they're really selling what I call regulatory licenses, they're selling the keys that unlock the financial markets for money market funds, pension funds, various participants. They lower capital charges, they have all these enormous regulatory effects.

That means that they can have bad decisions, fritter away reputational capital, miscall Enron, WorldCom, Parmalat and so forth and still make 55 percent operating margins. That's one story as to why they might be able to be enormously profitable even though they've also done a poor job just like all the other gatekeepers in the past few years.

The second reason why they differ is liability. I mentioned this just briefly earlier in my comments, but credit rating agencies have largely not been subject to liability, certainly not the same scope of liability as other gatekeepers. One reason for that is Amendment One, the First Amendment to the U.S. Constitution, and here it is for those of you who haven't looked closely at it. So I thought for this paper I'll look very closely at it and see if I can understand how the argument comes up that the credit rating agencies fall under the First Amendment. Here it is, yes.

[Laughter.]

MR. PARTNOY: "Congress shall make no law respecting an establishment of religion or prohibiting the free exercise thereof, or abridging the freedom of speech or of the press, or of the credit rating agencies." I hadn't noted that before, but it's there. Should have asked John Roberts about this one.

The remarkable thing is I mention this argument to people and almost everyone laughs except for the lawyers who are arguing on behalf of Standard & Poor's and Moody's. This is a serious issue. This liability issue is a serious issue. The rating agencies are explicitly exempt from Section 11 liability. As Professor Coffee mentioned earlier, they're exempt from Reg FD. And over time they've had to various degrees but large success in private litigation. I go through a number of these in the paper and I won't spend too much time on them now, but suffice it to say that they've done pretty well in these cases.

In the Orange County litigation, they were sued. Remember Orange County was rated AAA, some people remember, and then famously defaulted, and the rating agencies were sued along with everyone else. Judge Taylor in California dismissed the lawsuits against the rating agencies on First Amendment grounds and ended up denying Standard & Poors' motion for a summary judgment. The case was sort of odd procedurally, but it ended up settling.

Standard & Poors' McGraw-Hill paid $140,000 to settle that case. $140,000. Merrill Lynch paid $400 million. Morgan Stanley paid $70 million.

So there's an argument that credit rating agencies shouldn't have the same scope of liability, that they should be less responsible than other gatekeepers. I think that there is some force to that, but that's a big difference, $140,000. In some of these other cases they didn't pay anything. In the Enron litigation most recently I go through this in the paper in detail, I won't bore you with it now, you can be bored if you read the paper, the three major agencies were sued by one of the Connecticut funds and Enron, and the judge dismissed the claims against them. I'll get to this in just a second, but I think there are some reasons to believe that the First Amendment argument has limits to it, but at least in court the rating agencies haven't had to cut a check.

There have also been cases in the antitrust area and subpoena enforcement cases that the agencies claim are analogous. I don't think they are, as I describe in the paper. Here's where we are on the First Amendment claim. I think this is actually going to be a significant issue that gets litigated in the next few years particularly if Congress ends up passing legislation

There is no Supreme Court precedent that's directly on point. In the past it hasn't been well litigated because unlike many of the other cases involving gatekeepers, the parties are not on the same level. You have private plaintiffs' firms who don't have any First Amendment expertise who are litigating against some of the best First Amendment counsel in the country.

The one thing I found is, and again I go through this in the paper, that the privilege that's given in these cases although the agencies claim that it's an absolute privilege, most of the cases suggest it's a qualified privilege. I think there is some reason to believe that that's right, but again these cases are out there. In the Enron case, although it's suggested the privilege is a qualified one, still dismisses them.

I've got some suggestions as the distinctions that we could find in these cases. There are distinctions between agency active involvement and agency information gathering which might make sense. You might think that if the agencies are simply gathering information and publishing information they'd have a stronger Frist Amendment claim than if they're involved in structuring a CDO, for example, and taking a very large fee. And by the way, the fees for those structured finance transactions are substantially higher than the fees for a typical corporate bond. A typical corporate bond agency fee would be in the range of 4 basis points, and the structured finance fees can get up to a million dollars or more for complex transactions.

Second, the complexity of the issue could be a distinction. In the more complex cases you'd have a less viable First Amendment claim, and then the role of fees.

Most recently the agencies have used the First Amendment argument to avoid having to comply with the U.S. government's subpoena power which is interesting, and they haven't adopted any of these distinctions. They've seen the cases as very similar, but I think at minimum the subpoena cases should be treated differently from other cases.

Just briefly I'll describe these proposals that are out there. I would put the important proposals, I'd say if we're going to think carefully, if we won't have this muddled thinking anymore about credit rating agencies, if we're going to think carefully and systematically, we should think about we know that rating agencies are different, we know how they're different, and we have some understanding about why they're different. The proposals should be directed at why they're different. There are two categories of why they're different, the regulatory license explanation, and the threat of liability explanation, and so I've grouped the proposals into these two categories.

There are three proposals with respect to regulatory licenses. The first would open the market to new NRSROs, and that's a fairly straightforward notion. It's already been done to some extent, so we have five NRSROs now, where we had three in the past. One question with respect to this first proposal is whether that business is a natural monopoly and if it is then you might think that this is a game that the regulators simply aren't going to be able to win or affect and this might be one reason why the rating agencies don't particularly care. In fact, Moody's has lobbied in favor of eliminating NRSRO status. They might believe that given their first mover advantage and given the structure of the market that they're going to be able to make money regardless of whether there is other competition.

The SEC proposal to open the market to new NRSROs requires that the NRSROs have an established track record and that they be established, and there's a Catch-22 here because it's very difficult for new NRSROs to enter the market and it's particularly difficult for NRSROs that aren't based on the subscription model that are issuer-based NRSROs to establish themselves. So I'm not sure opening the market to new NRSROs alone solves the problem.

The second proposal is a proposal--I've been banging my head against various walls for last 7 years on this market-based proposal, but I think it's at least an interesting idea to be part of the mix. The notion here is that the regulatory licenses, the regulatory decisions that people make, should be based on the market rather than on what the NRSROs say. Initially there were a bunch of objections to this notion. I initially proposed that the regulatory regime should be based on credit spreads, the market spread of bonds as observed in the market.

Since then there have been a number of innovations. There are now credit default swaps which are quite liquid and there's a market that could be used there, and there are also equity-based methodologies. So KMV at Moody's uses analysis of equities to generate market ratings, and Moody's itself has what are called MIRs, market implied ratings. So they use quite sophisticated methodologies based on the market and there's no reason we couldn't simply import those into the regulatory apparatus.

The objections have been that would be too volatile. Spreads potentially are more volatile than ratings, but ratings are quite volatile especially as you move from off the cliff from investment grade to below investment grade. But one of the great advantages to a market measure is that you could select your amount of volatility so you could pick a 90-day rolling average or a 180-day rolling average and so you could limit volatility. But the other point is that if there is volatility then it's there for a reason and if there's a lot of volatility in a particular credit then maybe that should be important for regulatory purposes.

The second objection was that the markets are backward looking, and I just find that ridiculous given that all the financial literature has suggested that ratings are much more backward looking than market, and also you can make markets as backward looking as you want just be using the rolling average.

Then there's a liquidity objection, but at minimum we could use market-based measures for liquid securities. So I still want to push this even though I know no one will pay attention to it.

The one thing that is getting attention is the notion of replacing the recognition idea with registration, and this is HR 2990 which is now being debated in the House.

It's modeled after a brother-dealer investment adviser type registration requirements and would essentially require registration of agencies but would open the market to virtually anyone who has been involved in a statistical rating, either qualitative or quantitative, for the previous 3 years.

There are I think many attractive elements to this proposal particularly if it includes market-based registrants, and at minimum it would lead us to think through the second set of proposals which is that it would force the First Amendment issue I think because S&P in particular has said that this legislation is unconstitutional and I think that's a sufficiently important issue that we might as well pass the legislation in whatever form we can get it passed in and then litigate that issue. That's creating the threat of liability. It could either be a legislative approach or a judicial approach, but I think it's important to resolve the First Amendment issue.

Do I have just one more minute?

MR.   : Why do they say it's unconstitutional to register when in fact they have a legally conferred recognition on them? That's not unconstitutional, but to have them register is unconstitutional? What's the argument?

MR. PARTNOY: That's a very good question. I don't know what the answer to the question is. I'm not sure that the counsel who have been posed this question have had a good answer to it.

I think one thing they might say, they could say there's some coercion involved in the registration requirement or they could say, fine, the existing regime is unconstitutional, too, but we're going to challenge this new one. I don't know. Implicit in your question is there's no good answer to that question, and I think I agree with that.

I want to mention, and especially because we're honored to have Professor Coffee here, that there is another set of proposals floating around. I know that liability is maybe not a realistic option for legislation at this point, but there has been this--I've got Professor Coffee versus Professor Partnoy there.

[Laughter.]

MR. PARTNOY: Professor Coffee and I have been debating, the heavyweights here, have been debating this issue of what we call modified strict liability. I think it's something people should keep in the back of their minds.

We have essentially a fault-based or negligence-based liability regime which is really costly for all gatekeepers. This expands beyond just rating agencies. When the securities laws were being debated initially there was this notion of strict liability floated but no one was able to figure out how to limit the exposure for gatekeepers because if you made people strictly liable they'd have to pay too much money and so you wouldn't have people performing the gatekeeping function.

We have a couple of ideas for limiting the amount of liability. I think the debate that you and I have been having is not as important as just getting the issue on the table which is either contractually, which is my point or from a regulatory perspective, you could have gatekeepers be strictly liable for issuer damages but cap their liability in some way and you would avoid the enormous cost and dysfunctionality of having gatekeepers make arguments and engage in elaborate due diligence processes in order to establish defenses in liability ex post. I just wanted to briefly mention that there is this concept of strict liability out there.

My main message is really that we should think I think more carefully about credit rating agencies. They're not like other gatekeepers. They're more profitable. They're subject to greater conflicts. They're increasingly involved in structured finance which is where they're making much of their money. It's clear that two of the reasons for these differences are that they have these regulatory entitlements that no one else has and that they have not been liable. So in my view, proposals should address those reasons and try to level the playing field, treat these gatekeepers just like everyone else, reducing regulatory licenses or imposing liability.

MR.   : Thank you. That was a great presentation. Our commenter is Justin Pettit. Justin is from UBS and therefore may feel constrained to say what he wants to say because of the rating agencies' looming presence around the room or outside the room. When I called around for experts to comment on Frank's paper, everyone told me that Justin was the person to talk to, and so we're pleased that you're here.

MR. PETTIT: Thank you. Frank is certainly a hard act to follow, but I'm glad we have it on public record now that I'm a nice guy. Thank you for that.

I'd also like to thank Frank for an insightful and colorful contribution to the literature on rating agencies which unfortunately is a horribly underrepresented area in the corporate finance literature, and it's surprising because of the importance that they play in corporate finance decisions.

I'm going to take a capital markets perspective in touching on some of Frank's points and that's in large part because I'm wholly incapable of taking a legislative perspective. As our investment banker, our view is always one of efficient markets and capital markets trying to become more efficient.

What we have here is a case of growing, profitable businesses. They display tremendous capital and labor efficiency as Frank's have shown. And certainly stock market success in the case of Moody's, we can only presume that S&P would be doing very well also were it publicly traded.

These achievements are shared by other companies. Certainly Dell Computers, Southwest Airlines and many others would how similarly remarkable trends in the numbers. However, I think the real question here gets back to market efficiency and whether or not this success is an indication of superior execution, superior strategy, or if it's an indication of an imbalance, effectively a general market failure and raises the question whether or not there's a need for intervention.

I think the question of intervention always gets tricky once you start looking at successful businesses because ultimately business strategy in the Michael Porter sense of the word is really all about deriving an economic advantage, it's all about creating barriers to entry, superior bargaining power. Effectively, all of these business strategies are reducing market efficiency, so business strategy is all about, if you will, making the market less efficient so that you may derive an economic advantage. To counter superior business skills with regulatory intervention seems at the surface at least somehow un-American. So I think we need to be careful about why we are considering intervention.

Coming back to Moody's, S&P, Fitch, and now also DBRS and AM Best, we have clearly some sources of value and I'd like to touch on what we see the sources of value from a capital markets perspective.

Firstly, it's generally in primary issuance, not secondary trading. When you're pricing and taking to market a deal, that's really the point at which the rating is most helpful, and frequently you will see many cases where in secondary market trading they are pricing right through spreads associated with the rating. So over time as the credit seasons, what you'll find is relevance lost to some extent on the actual rating.

New issuers, new issues and speculative grades are where the ratings are most important, and also that's where the market data is least helpful. So in terms of one of the solutions being the use of credit spreads as a proxy for rating, that breaks down right where ratings are most helpful, on new issues and new issuers where you really don't have any history yet of spreads.

Or on the speculate grades where, unfortunately, spreads are notoriously unreliable, not only volatile, but also what you'll find that the bid ask is very wide and in many cases there's no volume behind the bid, so it's not really a real bid. A good example of that is when we're advising let's say a large German multinational on foreign direct investment in China and they want to understand the sovereign risk associated with investing in China. If you look at the yields on Chinese sovereign bonds, you would imply that there is a fairly low level of sovereign risk, the spreads are consistent with a weak AA or a strong A credit, and yet when you look at the rating agencies or even the Economist in its review of the sovereign risk of China, you'd get really more of like a BBB kind of credit spread ought to be assumed with those bonds. So when we're advising a corporate issuer with respect to foreign direct investment, we'd be suggesting that they might want to think about the risk profile of that country being more consistent with the rating than with the spread. So it's just one indication that spreads aren't always necessarily the most useful piece of information especially in cases where the markets just aren't as liquid as we would like them to be.

The information content is a third area of value by ratings, and it's the one area where there has been some literature in financial economic circles. Unfortunately, it's a big of a chick and egg question in practice because what you'll often find is there's a constant dialogue between the market and the agencies, and when Moody's bought KMV which is effectively market-based approach, they started to effectively incorporate then market perspective in the ratings, and the market is constantly looking at what the rating agencies are doing. So it's hard to say which one came first and whether or not there's really truly information content in either one without the other. It's a very circular reference.

I think probably the one area that you'd see the least reference to in terms of the value that's being created is actually in the corporate behavior that you'll see exercised by issuers not only in terms of financial policy and setting leverage levels. Also equity issuance, the path to investment grade, is a corporate objective of many up and coming growing corporations. Cast balances especially in technology are largely driven by rating agency guidance, if you will. Dividends and buy-back decisions, recapitalization decisions, are always corporate finance decisions that are made in the context of implications or impact on credit ratings.

On the M&A side, when we take something to the board, I think probably the two most commonly asked questions at the board level, this isn't right or wrong, it's just that these are the questions you get, is it creative, earnings creative, and can we do the deal within our rating. So you do have a fair amount of fiscal discipline being imposed upon corporate finance decisions by ratings consequence concerns.

I think in terms of where the value is being created, it may not be so much on secondary market trading and information content so much as on the primary side and on the issuer side. To some extent I guess that is perhaps some justification as to why fee structures have migrated in that direction. The fees are being born where the ratings are having an impact, as opposed to the subscription-based fees that we saw a long time ago.

I think though it does raise questions around the whole market efficiency. Clearly we can see some areas where market efficiency is not being supported in the status quo, and just the issue of unsolicited ratings if the customer, if you will, is the issuer, if the source of the revenue is the issuer, it begs the question as to why you would have unsolicited ratings. If the source of the fees is going to be subscription based, then by all means you need unsolicited ratings to support that business model. So it's kind of like we have a legacy from the past that has not been yet brought on side with the new fee model.

Marketing of ancillary services could raise questions around moral suasion. I think Frank has touched on that potential source of market inefficiency pretty well.

The last one is really the supply-demand. You've got a legislated demand and legislative restriction of supply, and again, Frank does a nice job of touching on that supply-demand imbalance. To the extent that you can move to a more free market on the demand side of the equation and open things up on the supply side, then we would hope that you could move towards a more efficiency market in the flow of the information.

MR. LITAN: We're open for questions and comments. We'll start down there. Remember, for people who weren't here before, say your name so that we can capture it for the record.

MR. WILMAR: Art Wilmar [ph] from GW Law School. It seems that a big part of the story, Frank, that you've sketched is that what the ratings agencies are doing is creating an illusion of transparency in products that in fact are quite opaque.

The other piece that I can't remember from your pie is, how much do they earn from ratings decisions on securitizations? Because obviously the whole securitization process relies very heavily on ratings of the traunches and I can't tell from that pie. Maybe that's part of the structured finance, too. I don't know. So you have now close to 40 percent from securitizations and CDOs and other structured products. Most people would say those are really opaque products. It's really hard to break down the risks that are either being undertaken by the participants or being retained by the originating institutions.

In a sense, the ratings agencies are conveying an illusion of transparency. We've looked at these things and we say they're AAA, AA, A, and is that really where the game is played in the sense that it's hard for them to add much value on transparent exchange traded, market traded instruments? But when you get to these really opaque instruments that are being treated as if they are marketable, now they are considered the only seal of approval that will make those things marketable and that's where the spreads are. But it's also a concern that they have every reason to err on the upside, on the positive side, and say, yes, these are safe when in fact we've got plenty of experience to indicate that these vehicles aren't so safe.

MR. LITAN: Frank, do you want to answer that?

MR. PARTNOY: I completely agree. I think that this notion of an illusion of transparency is helpful. Of course, it's the same illusion with respect to rating complex financial institutions' debt as well or any sort of complex corporate enterprise. But once you start adding the layers associated with structured finance, then you're inevitably relying much more on the rating agency's apparatus for determining the rating, determining the price and so forth.

The area that worries me the most, a lot of securitization is relatively standardized now and I worry much more about CDOs because CDOs actually have quite a bit of discretion embedded in them and so forth, but I think that's a nice way of describing the problem.

MR. LITAN: We're going to keep on going down the row. I think you had a question.

MR. DODD: I'm Randall Dodd [ph] with the Financial Policy Forum. It's good to meet you in person after the phone calls.

I wanted to offer one bit of economic hopefully insight into this issue of why they make so much money. Our commentator suggested perhaps it was a regulatory problem of creating demand on one hand, and limiting supply on the other. But from the data you presented it looks also like an creasing returns to scale business model. In other words, it may be a natural ologopoly. If so, the remedy should be different because also if you look at where they're making their revenues from, that's not where there is regulatory demand. The statutes and the regulations to not require them to rate synthetic CDOs in a regulated business. So the growth seems to be occurring in the area where they're not having regulatory demand.

If you think of what they're doing, they're providing information. You'd rather have standard information. It's like everyone wants to be on a base 10 numeric system, so competition is hard. If you've got to come up with a base 12 or base 8 method of numerating things, it's tough. So the standard guys have a huge, not just a first leader advantage, but just probably returns to scale also on the fixed costs of assembling all that sort of information and having that institutional value. In which case the remedy I think might be a little different. For example, you might think of some Sherman Act type of solution. If you lower their profits that might help remedy some of these abuses that you very well identified, and I think you did a great job on that. You might have, what's it called, a global settlement issue, take the consultations out of the research. That would be another issue.

I also like the idea of increasing liability. I suggest you look at what the Commodity Futures Trading Commission did with their Commodity Trading Advisory News Letters, a similar First Amendment problem but they still were able to do something with that. Maybe that is some help. I just wanted to throw it out there to you.

The last thing I wanted to offer, I think it's a great idea to explore this issue of the excessive spreads in the BBB market. There may be some yet other explanations that we may not have time today to discuss, it may just be sort of a more heterogeneous segment of the market. It does straddle the investment, noninvestment grade. There may be some other factors that are in there that might help other than just simply saying that the credit derivatives market or creating some sort of negative arbitrage where it's not reducing the spreads but exasperating the spreads which I think where you were going with your argument.

So I think that's a great thing to explore and would be glad to help.

MR. LITAN: Frank, why don't we just collect and we'll just keep on adding.

MR. COFFEE: Jack Coffee, Columbia. You sort of left something out in telling the story that you usually give greater emphasis to. It may be because you have less confidence in it or you think it's less important.

I think that what you've said in the past generally is the greatest public harm here has been the staleness of ratings. In truth, a rating downgrade is not a prophesy, it's an obituary. It's something the market already knew.

It's not surprising that ratings are stale on an ongoing basis because we have, as you were saying, a classic ologopoly here and when you have just two producers, you're going to have some incentive to enjoy the advantages of the quiet life. And you're enjoying the quiet life with no liability so you're not upgrading your ratings on a regular basis, there's no special payment from the issuer motivating you to upgrade on this kind of basis.

Given that kind of structure, I do think, and here I'm sort of dovetailing with you, that it may be that besides liability where we've agreed there's a case for greater liability, and besides opening up the market, there really be ultimately a need for thinking about an antitrust divestiture kinds of remedy because we have seen the third entry in this market Fitch is really an amalgamation of four or five corpses of rating agencies that came into the field and died off. It's very hard to penetrate this market. I'm not sure you can bring new entrants in very successfully, it's worth trying, but it's a long shot bet and, therefore, you may have a case where you really want to break up the New York Yankees or break up Moody's.

Then I think you could have real competition and with real competition there would be much more pressure to upgrade your ratings on a current, ongoing basis. So you can respond to that.

MR. LITAN: Is there anybody on this side who wants to comment? Actually, Jack, I'm going to give you a quick answer on the antitrust issue, and that is you can't sue them under the Sherman Act unless they've done something wrong. For whatever reason, whether it's regulatory or whatever, they've required monopoly or ologopoly status, and unless they've engaged in a bad act, there is no way legally you can break them up.

It's sort of like the accounting profession. In the accounting profession we have an ologopoly. In retrospect I think we'd all agree we'd rather have eight accounts rather than four, but you can't just go in and break up the accounting firms now after the fact.

MR. COFFEE: [Off mike] many things you could say here that might be a shared monopoly. We could talk about the Two Ratings Rule. There is this practice that you have to get one rating, but two ratings and that's something that they have cooperated in developing, and that is a way of sharing a monopoly.

I agree with you. The Alcoa defense is always there, that you acquired this through efficiency, but I think there are answers to it on the facts.

MR. WALLISON: I'm Peter Wallison [ph] from the American Enterprise Institute.

The profits that you show here for Moody's remind me of two things. There are probably more, but the two are the GSEs, Fannie and Freddy, and also New York Stock Exchange specialists. What both of them have in common is they are living off some sort of government regulation. Of course, in this case it's the NRSRO status which gives them a certain cache that is keeping our competitors. That's one of the things I think that is keeping out competitors.

On the question of registration and this issue of constitutionality where there seems to be some question, it's clear why there is a constitutional question. This is free speech. They're giving their opinion of any of these securities and it seems to me very hard to imagine that the SEC or anyone else could register someone to give an opinion. That would be the government having some kind of control over who states an opinion about something. So registration I don't think is really a starter here, although it's the thing I agree that has been looked at mostly here in Washington as a real possibility.

So if registration won't work, and I agree with Bob certainly that an antitrust solution, a Sherman Act solution doesn't work unless you can show some kind of wrongdoing, and we don't have that, what we do have is these organizations having gotten a huge boost from the SEC with this designation of NRSRO. I think before we try and other remedy, the most sensible thing to do first is to have the SEC eliminate the idea of the NRSRO and then have that designation removed from all of the federal statutes where they have picked up this idea which has no foundation in statute itself, it is simply a designation by the SEC but has been picked up because it was an easy thing to do I think on the part of all the legislators drafters looking for some way of providing some kind of government imprimatur.

I think if after we've done that if the profits are as high as you suggest there are, and there's no reason to believe they aren't, there should be a good deal of entry here. I'm kind of encouraged in that view by looking at GSEs and looking at New York Stock Exchange specialists because over time both of them have begun to assemble a pretty strong base of opposition to the monopolies or the ologopolies that they have enjoyed.

GSEs I think are on the way out. That's a little hopeful, but I think the likelihood is that over time it will happen, and New York Exchange specialists are basically gone now after the new regulations that have come out from the SEC. Part of the reason for that is that the tremendous benefits that they had gotten from regulation have stimulated the development of ECNs and other competitive methods of conducting Stock Exchange activities.

The only remedy that I can really think of here, Frank, is to eliminate the reason that these organizations have gotten this boost and then see how the competitive market responds.

MR. BOSWORTH: Barry Bosworth. I guess partly as an economist I'm a little leery of the suggestion that exposing them to greater liability is a solution to the problem. It seems to me that's been the creation of a lot of problems. Instead, what the issue is is why these differences haven't been bid away by competition.

It does seem, I think, I agree with Peter, that the evidence is the government has created much of this problem by putting into law and other regulations. What you had on one of your slides which is not in the paper was the chart you showed where the CFRs, the frequency now with which these organizations are mentioned. I thought that right there was kind of compelling, a number of times, that gives them a highly preferred status.

It's in a world in which they can't be sued but they're enormously valuable to people who think they might be sued. I have a colleague here, for example, who for many years served on a lot of corporate boards but by accident was dealing with things like mergers and acquisitions. They just hired Wall Street experts. They said the guy just sat in the corner, never said a word, never contributed to the discussion, and they paid him an enormous fee, and it was known as cover your ass. That's what these organizations do it seems to me and it has value. Knowing that, why does the government then contribute to letting them be a monopoly and doing it?

The other aspect then it seems to me, I wasn't quite sure I agreed that this is just limited to primary as in Justin Pettit's remarks because the one that strikes me as puzzling is municipal bonds. These are state and local government bonds that are issued by entities that have been doing it repeatedly, so these are not like new companies you didn't know anything about. They have a long historical record, and those risk differentials in the markets, the value that the market attaches to the risk differential, is dramatically overvalued and has persisted for decades. It's just absurd that they get this kind of market differential.

How can you account for that? I think it is again the certification process that the state governments have created insurance and other areas that must account for it. But here this is not something that goes away, and the amazing thing in the municipal market is despite the proliferation of new types of investment organizations, they haven't eliminated the differential. It still persists today that you can go by low-grade municipal bonds and with an extraordinarily high probability. Just hold them to maturity and you'll make a very high rate of return, and it's a puzzle about why the market doesn't get rid of these differentials.

MS. PALMROSE: Zoe-Vanna Palmrose. I have both a question and a comment. This is going to be a little naive because I'm not a lawyer, so this is all new information to me and it strikes me as very bizarre and interesting.

One of the things after Sarbanes-Oxley was happening in the private sector and I think with Moody's and S&P is that they started sections to do ratings of the quality of financial reporting. Have you ever heard anything about that? Would the limitations on liability apply to that type of service, so it's irrespective of what you do just because you call yourself Moody's that your liability is limited? In other words, it seems to me that you ought to be able to get under the 34 Act liability if you're evaluating the quality of financial reporting, so would that exclusion still apply? And what's happened in that area if you know?

MR. LITAN: Frank, why don't have a quick answer to that question and then we'll continue making comments and go back. What's the answer to that?

MR. PARTNOY: There are a number of areas, it's not just that, but all sorts of corporate governance ratings and those kinds of things. To the extent the First Amendment argument works for credit rating agencies, it works for those folks as well.

I don't believe any of them have been sued so far. If other people know of those lawsuits--

MS. PALMROSE: [Off mike.]

MR. PARTNOY: There are a bunch of them now.

MR. COFFEE: [Off mike.]

MR. PARTNOY: I think that's probably right, and you're better able to address that than I am, but I think the First Amendment argument is probably the same which is to say I don't think it works, but I think it's a similar kind of argument.

MR. COFFEE: They'll get a quick motion to dismiss on something called lost causation. I'm not sure that you can show an inflated rating on corporate governance that relates to any later decline in price of the particular company.

MS. PALMROSE: And that was even on quality of financial reporting, if you move out the quality of financial reporting part of it from governance in general?

MR. COFFEE: You'd have to show that on a correction of your erroneous high-quality rating there was a sudden major stock market decline. I don't think anyone has observed that to this point.

MR. WALLISON: May I raise a political economic issue? Let's suppose we follow Peter's suggestion and I guess by implication Barry's suggestion and we took away the NRSRO status and there was a law that basically said in effect this doesn't mean anything anymore. I think Peter's point was there's no registration. In your world there would be no registration.

Let's suppose we just took away that, but then you're stuck with your chart up there, Frank, that's got all these different statutes and regulations that mention NRSROs. What do you do? You'd have to have an omnibus bill I take it that would just wipe the slate clean off of every place it's mentioned in effect. I'm just thinking politically, in Congress every committee that's up there would want to grab a piece of this legislation. Do people see that this could be a really had bill to get through?

MR. COFFEE: Now you know why the SEC won't go that way.

[Laughter.]

MR. PARTNOY: I'm very sympathetic to this notion of eliminating the designation as is Moody's, but it's very difficult to do. The registration legislation tries to do something like this just by essentially having an omnibus approach and every time it says recognition, replacing that with registration. So it's possible to do.

But if you think about it, this is how we got started in this mess initially. It used to be the case that ratings weren't the basis for regulation and then in the 1930s there was a very small number of somewhat important rules that started to depend on ratings. Then for three decades plus we didn't have regulations that depended on ratings, and then we started this mess in the mid-1970s. The first article I wrote on credit rating agencies started with this same premise that we should simply remove this.

Beyond the political economy question of it being difficult is you have to replace it with something because all of these regulators, and there are hundreds and hundreds of federal agency decisions that are based on NRSRO status, to either you're going to leave money market funds to make their decisions on your own or you're going to have to come up with some replacement for all the regulators out there that have been making these substantive decisions relying on credit rating agencies.

So you have to come up with some sort of viable proposal. I understand that spreads or a market-based proposal is not perfect, but that's what the genesis of that idea was, to try to come up with some kind of a substitute to go into this black hole that you create when you eliminate the NRSRO status from all those rules.

MR. WALLISON: Peter Wallison. I guess I just don't understand yet why if you simply eliminated the status and you substituted in each of the regulations and statutes involved here something that said instead of being required to use an NRSRO, any of the affected organizations, entities, regulated bodies or whatever it is, are now required only to use a qualified rating agency, that would be--in an individual statute it could be some kind of problem, but what would happen I think over time is that the market would select out, I don't see why it wouldn't, those organizations that have very highly qualified raters.

Now granted, it would take some time because Moody's and S&P as you call them, first movers, have a tremendous advantage at this point, but we'd certainly be eliminating a lot of the advantage if we took away from them this idea that the government finds them particularly qualified.

MR.   : Peter, you just mentioned the magic word qualified. So the question is who qualifies them? We're back to some kind of governmental designation aren't we?

MR.   : Who qualifies accounting firms?

MR. PARTNOY: This is Frank Partnoy. This is exactly how this all started, and when the term was used, when nationally recognized statistical--they could have used qualified rating agency, it wasn't even defined at the time when it was first used. So we had this evolutionary process, and it wasn't a free-market process, it involved a lot of lobbying as well, but this is exactly how the whole mess got started in the 1970s.

MR. BOSWORTH: May I just finish? I guess you're entirely right, if you substitute something that implies any kind of--

[End Tape 2 Side A, Begin Tape 2 Side B.]

MR. BOSWORTH: [In progress] --backing for it by calling it qualified or calling it nationally recognized, that would be more difficult. But if the point that you make here is that all you have to do is find a rating agency that you believe will be--that is the issuer of the security believes is, or the validator in some way of the security, maybe a regulatory agency on the part of the government, believes is suitable for this purpose, the market can then decide whether that decision was correct.

We use auditors, for example, and auditors are not in any way government qualified, and companies select their own auditors and if they select an auditor that people believe is not a qualified auditor, they suffer the consequences of that. I don't see why it should be any different in the case of statistical rating agency.

MR.   : I wanted to sort of also reply to Peter's objection to the idea that these guys are just natural monopolies because if they are, the more competition will not work. I just need to point out that they were natural monopolies or ologopolies before they got the NRSRO designation. It wasn't competitive before they were officially recognized as such, just like they're not now.

Secondly, I can point out that anyone can apply for this designation. If you read through the rules, it's not that high a hurdle really, and quite a few firms actually have qualified. They've been subsequently merged into the larger firms, but that doesn't mean it's a high hurdle to get into.

More firms don't apply probably because they don't see a lot of benefit it, because they're small they can't compete by size. His data showed that their rate of profit goes up with their volume of business. This is a classic economies of skill firm. If you're small firm you have a very hard time competing with someone who's already so far out along their production function, if you will, that their rate of efficiency and profit exceeds what you can do as a start up. I think these are very serious economic fundamentals that are different than just saying they're being protected by some sort of government registration.

So the solution then I think you might look at as being very different, and I think this market-based approach is one. You might make it a little more complicated in a sense that you might say if the spreads are less than 150 basis points you don't need a rating agency, but if it's a new issue you do. If it's a speculative grade, you do. Or when you're doing something that's away from the market, let's say the SEC wants to say securities clearance firms should be AAA rated or how else can they designate that the clearing house should have a tip-top quality of credit quality to it? How can they say that because the clearing house itself is not market traded and so you can't use a market rate. So you want the clearing house to be AAA. I do, I think, and so what else can they do but say have some recognized or registered or qualified entity do this rating, and you've got to address that. As you've pointed out, whether you call it qualified, registered or recognized it's the same problem.

MR. COFFEE: Frank has been saying for about 7 or 8 years now that the NRSRO designation was a mistake and the discovery you're making down here is that it's a mistake as Frank has been saying. I want to make sure the dialogue is understood.

The question is what do you do about it in midstream? You could abolish it. All kinds of havoc is created. The other possibility that I think is equivalent is to simply open it up by telling the SEC that they have to let anybody in who wants to come in who has the most minimal qualifications and not a felony conviction. It is not true that the SEC has been easy. They have kept a number of people out. They have kept out a number, and others have gotten in. There is a question about whether if it's a natural monopoly whether or not you'll be able to compete, but if you let everyone else who wanted to to be in, then you'd have to reform any legislation. You don't even have to have registration. You have to instruct the SEC that we want anyone who has minimal qualifications, lightly as defined, into this NRSRO and at that point you get into a reputational market who will work.

I have some doubt that anyone will be able to crack this monopoly at this midstream stage, but at least it's simpler to go that way, open it up, level up rather than level down by abolishing it. It's sort of a transitional problem. We now know it was a mistake. How do we get out of it at this point?

MR.   : What is known about the profitability in other countries? These organizations exist in Japan, they exist in Europe and the U.K. Do they have the same high rate of profit as you find here?

MR. LITAN: We'll take one more question. Art, you had a question?

MR.   : I was revisiting the history of the early-1970s. One important piece of that history was the growth of money market mutual funds which essentially were unregulated or less-regulated alternatives to bank deposits and they were based on commercial paper. Not surprisingly, money market mutual funds competed in yield and they began to compete by buying increasingly aggressive companies. Of course, Penn Central was Exhibit A and all these money market mutual funds loaded up with Penn Central and Penn Central crashed and pretty much almost froze up the financial markets. That was when the big push came to say now you have to have NRSRO-rated commercial paper in order to put in these money market mutual funds.

There's at least an analogy it seems to me between that and what we're seeing with structured finance, that people are piling into these structured finance products in the search for greater yield and we're asking NRSROs to put their stamp of approval on it. But frankly, there are really some perverse incentives involved with NRSROs to certify this stuff.

I think we can understand why we have these requirements from the history of Penn Central and others, but the problem is that we're relying upon the rating agencies not to be captured by the people who would essentially sell us a lot more risk than we think for this yield that they're dangling out there.

MR. LITAN: Frank, do you want to wrap up?

MR. PARTNOY: Thank you very much for those very helpful comments.

[Laughter.]

MR. PARTNOY: I think I agree with most of them. Since we have a record here, we'll reflect that this is a quite lively debate and exactly the sort of thing I hope will continue to happen on this issue because I think it's a very important issue.

It sounds like there's an agreement in the room on some major themes, that there are substantial market inefficiencies in this area and that it was the government's fault, and we can at least start with those two findings, we might call them, here as a premise.

Among the comments, and I'll try to respond to a few of them in just a second, but Art's last comment and initial question I think are among the most important, and structured finance as we study these animals, the rating agencies, you can see that there is some competition with respect to the plain vanilla products, but you know if you're watching ologopoly behavior. I thought it was interesting that Justin described essentially monopoly as being uniquely American which is true. But when you're watching an ologopoly you look for where the money is, you look for where the profits are, and right now they're to some extent overseas which is a new market that's being developed by the agencies and they're increasingly trying to gain toeholds in non-U.S. markets and lobby for more NRSRO-based regulations outside the U.S. including Basil 2. But really where the money is is in the structured finance, and the dangers are in CDOs in particular.

So what we're talking about are really two series of problems. We have a whole series of low-grade problems which people have talked about where rating agencies are charging 4 basis points instead of the 3 that they would charge in a competitive market or 2 or something like that, which is a significant problem but maybe not one we should worry too much about. And we have the subsidiary issue that ratings aren't necessarily reflecting all the information that we're like them to that they might reflect in a competitive market.

But we also have a high-grade, high-risk issue which has emerged in the last few years, and I hope that this debate that we've just had will try to move towards that issue which is why is there a multitrillion-dollar market in CDOs and what role are the agencies playing in that market? That market is increasingly becoming a global market. In answer to Barry's question, that market is quite lucrative for the rating agencies, similar rates of profit in CDOs outside the U.S. including, the market we talked about this morning.

I don't know how time I have, if I should try to go through and tick of the list of comments, but I think I'll just thank you for them and stop.

MR. LITAN: Thank you. That was a very stimulating debate. We are now adjourning to lunch which I believe is next door, and Jack's going to talk to us after lunch, post-Enron, his thoughts and so forth. Am I right? We're downstairs? We're going to follow Shannon. We knows where we're going.

MR. : We're right below here.

MR. LITAN: We're right below here.

[Luncheon recess.]

AFTERNOON SESSION

MR.   : All right. It's time for dessert. Our dessert is our lunch talk. Just keep on eating. Jack won't mind. I guess he's used to, these days--

MR.   : [inaudible].

MR.   : Yeah. These days, when I hear law professors or professors from school, they tell me they're lucky to have anybody pay attention to them in between the cell phones, the Blackberrys, the video games, and the computers--the whole bit. Right? This is a big problem; right?

MR.   : If you sit in the back of the class, you're going to see e-mails to loved ones by 30 percent of the students.

MR.   : There you go. Well, at least here you have a captive audience. I don't see anybody with their computer out. So we're really lucky at lunch to have talk with us Jack Coffee. He's a professor of law at Columbia. You've probably seen him a lot on TV. Every time there's a corporate governance scandal, I always see him on TV. Maybe even when there's not a corporate governance scandal.

But, in any event, Jack has written about corporate governance and securities issues for ages but then became sort of a staple, as I said, for the media after all these financial scandals broke, and that's the occasion for our conference and our book. So we thought it would be very timely to have Jack come back and talk to us.

He was, as I said, in the thick of the debate, at the time, about what we ought to be doing, Sarbanes-Oxley, and so forth, and so we're interested now, a couple years later, after the horses have left the barn, what Jack thinks next.

Jack.

MR. COFFEE: Thank you. By the way, this first slide is very revealing, because what it tells you is this guy up here is probably the last professor in America who doesn't use PowerPoint. I am an electronic Luddite. I was traumatized once when someone locked my PowerPoint slides into the computer, and ever since I've stuck with transparencies. Fortunately, the staff was nice enough to go to the Washington Museum of Antique Technology and get this overhead projector. It was on the shelf right next to the spinning wheel. Maybe the last time you'll see an overhead projector. Anyway.

However, there is some point in this first slide, we were talking about gatekeepers, and we need to think a little bit about the definition. There are two that keep getting used in the literature. Someone who's a necessary consent, the gatekeeper has to open the gate. That could mean a lot of people. For example, the board of directors is a gatekeeper under that first definition.

The second one, a reputation intermediary who pledges his considerable reputation of capital to assure investors or others as to representations made by the client that it verifies.

You are pledging your reputational capital, that you built up over probably hundreds of clients, and maybe a century more of operations, because the client itself is not perceived as trustworthy. We don't trust this young company's numbers but if PriceWaterhouse pledges reputational capital it's developed for 150 years, then we will trust those numbers. Okay.

Now it's important to focus on what the implications are of the second definition.

We've been noting, this morning, recurrently, that there somehow is a recurrent lack of competitiveness in many markets for gatekeeping services, and guess what? That shouldn't surprise you because you can't develop reputational capital overnight.

You could put together assets to be the equivalent of one of the Big Four auditors but people wouldn't say we trust them because we don't know them. It takes some history of operations before you could acquire reputational capital. It can't just be purchased.

On this basis, people like the auditor and the securities analyst may be a gatekeeper. But the board of directors probably is not because the board of directors, none of those directors has been around for 150 years, none has been on 50 other boards and can't pledge the capital. Possibly Warren Buffet's an exception, but in other cases, no one else is quite that kind of reputational intermediary.

Okay. Now the social utility of all this, just to have you focus. If I'm the typical entrepreneur, about to do an IPO, and I represented these people back in my days in practice, I have a decision tree that looks like this. The decision tree says within four months I'm either going to be bankrupt or very, very rich. I'm either going to be in bankruptcy court or I'll have done this IPO and made millions.

With that kind of set of decisions, I wouldn't trust this fellow when it comes to disclosure issues. He's under a great deal of pressure. In contrast, the gatekeeper can be deterred because the gatekeeper is getting a much smaller fee than the entrepreneur or principle that it's serving, and thus we can deter the auditor, even when we can't deter the issuer.

That's why I think gatekeeping is to be encouraged. It's a form of a law-compliant strategy that I think can work very well.

In situations where we don't always know, we can convince the entrepreneur to obey the law.

Now who are gatekeepers? Which ones are some of the traditional ones? I want to point out that there are new gatekeepers appearing on the scene. We've seen all the ones under one that are traditional. The new ones. We now have class actions in which there's a lead plaintiff, Calpers or TIAA/CREF. For all the other institutional investors, when a class action is filed, the first question is do we opt out or do we stay with it? They often do opt out. But if they trust the lead plaintiff, this is TIAA/CREF, we trust them, they may decide not to opt out and stay with.

They're making a guess about the ability and the reputation of the person serving as the lead plaintiff.

Next I mention the Nomad. This is a fascinating example. You should all take a look at the AIM market, which is the alternative investment market. It's part of the London stock exchange, it's been around for about seven-eight years; maybe ten years now. It's been really "big time" since the Neuer market exploded and crashed, cause it is a market for emerging companies, and set up to compete with the German Neuer market, and to a lesser extent with Nasdaq.

It tends to list companies that are emerging high-tech companies but has a lot of mining and oil companies that have assets, and in the past have often been exploited and manipulated. How does it work?

Its attraction is that it has no regulation, no regulation as such. The only rule is that to list on this market and do an offering, your nominated adviser--Nomad is short for nominated advisor--has to both approve that it is appropriate for you to do an offering, that the terms of these offerings are appropriate, and they have to approve all disclosures you make.

Your obligation to disclose is to disclose whatever the nominated adviser requires you. To be a nominated adviser, you have to be approved by the exchange. There are now 75 nominated advisers. They are principally major underwriting firms but they're also major accounting firms and one or two law firms, and they had to take responsibility that you've made adequate disclosure and that the terms of the offering are somehow appropriate. This is the British system. There's no liability, but in Britain, you have to decide that things are appropriate.

So this is the extreme case of what a gatekeeper could be--someone who must make all, approval of everything--terms of the offering, disclosure, whether or not you are market-ready, because you may be a company without assets, without operating history.

Another example. We're going to talk about the securities analysts this afternoon, but my generalization is the recent reforms have made the analysts relatively more independent. We can be skeptical about how independent but more independent. But we have a lot a great deal of market transparency, because prior to the reforms we had, on average, maybe a half a dozen analysts for most of the companies in the New York stock exchange, and the SEC found in recent reforms, they had twelve but well-capitalized company on--12 analysts.

Now the bottom two-thirds of Nasdaq does not have a single full-time analyst covering those companies. Why? Because the moment you cut off the subsidy--none of the underwriters couldn't influence analysts, they cut off the subsidy, there's a huge migration from the sell side to the buy side, but it means no one is publishing regular research on two-thirds of the Nasdaq market. That's a problem. We have independence but not transparency. It's a pyrrhic victory if we get only one without the other.

These bodies, NRA and the IRE, are trying to develop a new business model, something called intermediate research, under which a marriage broker, an independent objective body would select an analyst for a company. You, on the buy side, would pay money to the marriage broker and it then finds an objective analyst. That all works on whether or not you trust the reputations. Most of these bodies have come out of Nasdaq. The NRE is formed by the former CEO and chief operating officer, and the IRE is a joint venture between Nasdaq and Reuters.

It's a new kind of possible gatekeeping. So they're out there and the general theory of what a gatekeeper is is going to apply to new institutions.

Now what happened to gatekeepers? We know there are some problems. I'd like to start with this slide. This is the GAO study of the amount of financial statement, restatements.

If you went back to 1990, different studies, not the GAO's, you'll find that, on average, about 40 to 50 companies a year announced the financial statement, restatement. Now we get a hyperbolic increase, in a moment we'll talk about whether it's meaningful, when we see a rapid increase, and these numbers translate into 10 percent of all the publicly-listed companies, companies on the stock exchange, over this five-year period restated their financial statements at least once, meaning a fairly pervasive rate of restatements against a prior rate of only

40 or so a year. Now that's the GAO study. Here's even more recent data.

This is Huron Consulting. I always have to stop and tell you who Huron Consulting is. They are all of the consultants at a little beleaguered firm called Arthur Anderson. Arthur Anderson shuts down, they walk out in the street, it's Huron Street, and they call themselves Huron Consulting.

They have been an IPO. They're making an awful lot of money. If there's a nuclear war, six weeks later the consultants will survive, come out of the ground and give you reports on what happened and how it all occurred. But your consultants always survive.

This shows that the great--once you count these really accurate--GAO didn't do it quite right--you find even a larger amount of restatements over this period. This comes to about one in eight companies or 12.5 percent restated their financial statements over this period.

Now does that mean that this is all meaningful? Do the statements matter? Well, I've suggested they were pretty pervasive, and actually a restatement, cause it's so unpleasant, it triggers SEC investigations, class actions, board shakeups. You will do anything to avoid it. I suspect there were lots of compromises made between auditors and companies to avoid a restatement if we promised never to do this again, et cetera, et cetera. But are they meaningful?

Well, the best answer I think is the GAO study, which found that a typical restating firm lost 10 percent of its market capitalization over a three-day trading period, for a total loss of about 100 billion.

Now I'm not saying that all restatements are meaningful. There were many restatements that actually increased earnings. There were many that were technical and meaningless, just SEC rules that required you to do something differently.

But if the average restatement causes a 10 percent decline over a three-day trading period, these are not trivial. The market was surprised. There was real loss to investor confidence and what we're really talking about, in my judgment, in terms of the goal of reform, the goal of Sarbanes-Oxley, is the more we can increase the predictability and certainty of financial reporting, the more we reduce the cost of capital.

The cost of capital is a very real, very important objective. It benefits not only investors. It could benefit the entire economy. And there's some reason to believe that investors did feel that they lost confidence with this high a level of pervasive restatements.

There's some other studies too, and they find that restatements are not all equal. These studies find that the most negative market reactions are those that were associated with restatements involving revenue recognition issues.

What that really means is the premature recognition of income, taking stuff that's only a consignment and treating it like a sale. There's a reason you're doing that. Okay.

GAO also finds that revenue recognition issues were the most common. They were about 38 percent of all restatements. Now that gets us to what lurks behind revenue recognition. This is the new "disease," let's say, that began to spread over the financial market in the 1990's.

Historically, there were revenue recognition problems in the past when I was a young lawyer. They were the opposite way. They were income smoothing. A manager decides the market's not going to credit us with a 300 percent increase in earnings this quarter, so we'll take 200 percent of it and put it in the reserves and call it a rainy day reserve, and we'll smooth earnings, pushing the peaks over into valleys. That's a way of avoiding disrupting the market and constantly but smoothly increasing earnings, an illusion of no volatility. That's the old world.

In the 1990's, managerial behavior changes. The new pattern becomes a heavy pressure for premature recognition of income, contingent sales, channel stuffing, all done because managers want to maximize the current earnings and hold nothing back for the future. Big question.

What explains this change in behavior? And here I'll give you the most important slide I'm putting up here. This shows executive compensation over the 1990's. I'm looking at the median CEO pay of an S&P industrial company. So this is not Silicon Valley. This is your smokestack company, your basic industry, not somebody out taking a huge risk in Silicon Valley.

In 1990, you will find that that compensation was 92 percent cash, 8 percent equity. In 2001, you'll find it to emerge so it's two-thirds equity, one-third cash.

I keep showing this to Europeans and all they want to focus on is the increase in pay. All I want you to focus on is the change in composition of this payment, because during the 1990's, without it being fully recognized, we went, almost overnight, from a system of cash compensation to a system of equity compensation. I am not telling you that equity compensation is bad. I think all systems have some perverse incentives.

What I'm telling you is there's been a very rapid change, and as often happens, the market moves quickly, corporate governance moves slowly, corporate governance was a full number of years behind rapid changes in the market.

What I'm leading to is what happened to gatekeepers. They came under intense pressure from managers who were subject to a very different system of rewards and incentives, carrots and sticks, and as a result it put more pressure on gatekeepers without there being any changes at the time in corporate governance to compensate for these pressures.

Now, again, cash incentive, cash compensation has its own problems. It introduces what Michael Jensen would tell you is empire building under a free cashflow story.

That's why institutional investors were one of the causes of this change. They wanted managers to be more sensitive to the market. They partly insisted on great use of equity compensation. They didn't fully realize there could be too much of a good thing.

But under equity compensation, we now have an incentive to inflate earnings, take greater risk, even if you can't sustain the earnings spike managers of asymmetric information, and if you were to sell six months, nine months before the crash, it'd be very hard to trace that back and call that insider trading.

That may explain something what happened to Mr. Ellison of Oracle, where he was selling 900 million, and six months later there was a sudden decline. You can keep the spike going until there's a safe distance between when you sold and when the market collapses.

Now I use this as an illustration for audiences that don't count well, but assume a very realistic number. Two million stock options, a 30 to one price earnings ratio. If you can create just one dollar of unexpected earnings that the market doesn't anticipate, then you're talking about the CEO at that kind of ratio becoming $60 million richer. That's an incentive to try to push for more aggressive accounting policies. Okay.

Now that's a hypothesis. Here's some proof of this. There have now been a series of control studies done. This is by Afendi [ph] and four others at a Texas university. They took a control group of all firms that restated in the late 1990's, over a two or three years period, and they matched them with an equivalent number of companies, same market cap, same industrial classifications. What was the leading difference between these two groups of companies, the restating and the nonrestating?

Their answer was it wa the amount of in-the-money stock options held by the chief executive officer. The restating firms held, on average, 30.9 million while the nonrestating CEOs held, on average, 2.3 million, a 14 to one ratio. That's a comprehensible story to me.

Okay. We're seeing the increase in financial statement restatements. Over that same period we see some changes in other areas. We'll talk later about the securities analysts. But this was the evidence presented to Congress. I won't say this evidence is [inaudible--moving away from microphone source] what Congress saw. [inaudible] between 1991 and 2000, moved from six to one to a hundred to one.

Now I can see why there should be some change. It was a bull market and there should be some change. But that's a very sharp change and we have [inaudible] the Journal of Finance, what explains the analyst's advancement, what most predicts whether an analyst will succeed and rise. Compensation increase. Basically optimism being above the mean. You can't be totally inaccurate but the more you are above the mean, but within a ball park distance of the actual results, the more you'll advance as an analyst.

Optimism is very, very profitable [?] during this period.

Now these numbers are a little bit more accurate. This is done by Barber and three or four others at UCLA. These are analysts stock recommendations, '96 to 2000. I'm using it to point out two things.

We do find that by the end of 2000, when the market is a very high bubble, we have only hit 98.4 percent of all recommendations, being either buys or holds, one 1.6 being sells, at least suggestive evidence that analysts were subject to the same influences and were being subject to the same distorting pressures as was the auditor.

But I also think other debt is just as important. The number of analysts in any given year cannot double the next year. There are barriers on entry. There are educational licensing requirements.

If you look at the number of recommendations going up here over this period of time, you see them jumping up 30 percent or so over a period of years. That suggests to me that the old system of preparing a limited number of projections and reports turns into an assembly line system because the analyst is under pressure from underwriters and others to get those analysts' recommendations out there.

We're seeing a huge increase in the number, which means, because the number is relatively limited to over a one or two year period, more analysts are producing more recommendations and it becomes less of a professional and more of an assembly line system.

Okay. So I'm giving you an overview of what I think was happening to the evidence. Now what caused all this? I mentioned first, increased pressure from managers because of the change in equity compensation. I'm not saying stock options are bad but it came without any corresponding changes in terms of corporate governance.

There was a reduced litigation threat. The reduced litigation threat only shows up markedly in the case of gatekeepers, because of the PSLRA, the Private Securities Litigation Reform Act, which passed over President Clinton's veto in 1995. This was a study by the SEC's general counsel office, mandated by Congress.

We find that there is just no litigation against either lawyers--or auditors, excuse me, for two years thereafter. In other words, beforehand, there might have been 200 suits a year against auditors. Afterwards, because of the PSLRA, and the central bank case, there were like two or three suits, a huge decrease in litigation. Put the two together, increased pressure, increased benefits from the CEO talking to the auditor, and reduced litigation threat. If the benefits go up and the costs go down, you'll probably get an increase in output, and what's being increased here, the output I'm talking about is acquiescing in [inaudible] policies. Okay.

Other factors are there. We've talked about reputational capital, but in a bubble, no one really cares about the auditor. If you are expecting 30 to 40 to 50 percent returns increasing each year, I suspect the auditor is not on your mind. You're not thinking about losses, you're not thinking about fraud. Therefore, maybe that reputational capital isn't as important and maybe you don't have to worry about preserving it quite as much.

Now everyone else talks about conflicts of interest, I'm putting this last in my story, because the empirical evidence here is very much in dispute. There are studies this high on the use of auditing income. I think Professor Palmrose is here who's done a number of these, and I would say--you can correct me--that although there were mixed studies, most of them do not find the corporations who had a high ratio of nonaudit services to audit services experienced a higher rate of restatements. Is that an accurate statement from your studies? Hmm?

MS. PALMROSE: Fair enough.

MR. COFFEE: Okay. That means, however, to me, that the Big Four was not selected. They didn't acquiesce in favor of those who gave them the most consulting income. That still leaves open the possibility that the Big Four thought they were part of a major transition. They were moving from being bean counters to financial information specialists, and that therefore consulting income was the future because audit income is basically fixed; can't increase that much. Consulting income could increase exponentially. As a result, you have a potential interest to acquiesce in the favor of all collects [?], not just those paying you high audit income, high nonaudit income, any kind of income for consulting, because the real conflict is not the receipt of consulting income, it's the expectation that you can develop consulting income, and thus you might become more acquiescent for any client that's in a position to give you consulting income.

This wasn't a simple, implicit bribe. They didn't take a bribe and then ease their standards. But they were marketing themselves as your friendly neighborhood financial services specialist and maybe you'd be paying more acquiescent across the board. That's at least consistent with the fact that the rate of restatements went up very, very significantly.

My basic point here--I'm not saying anyone is corrupt and dishonest. I'm saying that managers gained leverage over their gatekeepers and that was the problem that Sarbanes-Oxley sought to address.

Did it address it well enough? Here we get all kinds of controversy, but I want to suggest what kinds of reforms could work, because I want to move beyond just talking about auditors or analysts. I want to talk about gatekeepers generally. What are the kinds of options that you have? More or less a general discussion of gatekeepers, even though every gatekeeper is somewhat distinctive.

We can talk about gatekeeper liability. I personally would support restoring aiding and abetting liability for auditors. That will get me boos in any accounting convention around the world.

But the downside is, Can we afford to lose another accounting firm? It was patently obvious to me that there had to be deferred prosecution of PPMG with two of them out of business in a four-year period. We can't afford to put too much weight on liability, is part of the answer but it's not the sole answer, because these are personal services firms. They can be destroyed, and we have a real problem to the extent we disrupt them. So part of the answer but not a complete answer.

Increased regulatory oversight. I personally would applaud Picaboo [ph]. We've only seen about two years of Picaboo and there's always the prospect of regulatory capture. The chairman of Picaboo resigned earlier this week. I don't know who's going to come in. I don't know whether it's going to be maintaining a tough standard or whether it's going to become a much softer body. [inaudible].

Now here's what I'll call [inaudible]. This is what many answers are. Gatekeeper empowerment, trying to change the leverage of the agent vis-a-vis the principal, cause the gatekeeper is an agent of the principal. The paradigm here is what the SEC did decades ago. They said any time the auditor is fired or resigns, there has to be specific disclosure, you have to disclose any disagreement they've had within the last two years. What did that do? It made it very hard to fire an auditor. That was desirable. It gets the auditor somewhat more empowered vis-a-vis--you can say we fired him because he was too expensive; he charged too much.

Then the auditor has to comment. It might say no, you fired us because we wouldn't go along with that particular booking of income and it makes it more difficult to remove the auditor, gives the gatekeeper more leverage vis-a-vis the principal. That's one example.

I think SOCs 307, which requires attorneys to report misconduct up the ladder is similar. It doesn't get that much public reporting but it may get the attorneys saying you can't do that because if you do that I'll have to go up to the audit committee and you know it will leak out.

So again, I think we are putting responsibilities on the agent but we are also increasing the agent's leverage, giving him more power, the gatekeeper more power to say no. Regulation AC, regulation analyst certification. This says every analyst has to personally sign his stock recommendations, buy or sell, and say these are my personal judgments. It had come out, after the events at Merrill Lynch, that many analysts were putting out recommendations under pressure and writing private e-mails and saying they weren't their view at all, they were being forced to say.

Again what you're doing here is giving the agent somewhat marginally enhanced power, leverage, vis-a-vis the principal. It's not a bad regulatory strategy. But my bottom line, marginal effect. We haven't really cured the analyst problem. We've just done some marginal movement.

Now a more significant kind of reform. Revising the principal agent relationship. If I had a longer time, I could make the case, that if all of these gatekeeper relationships, they started out in the first instance with investors hiring the gatekeeper, and over time they moved to managers hiring the gatekeeper, and that does begin to compromise the gatekeeper.

You go back to history. The auditors, they were first put in place--and the British companies act was about 1844, 1845. What was required then was the shareholders had at each annual meeting select the auditor and the auditor actually could go out and hire accountants. An auditor didn't even have to be an accountant at that point. That was a system for trying to get a watchdog on behalf of shareholders.

Today, of course, before Sarbanes-Oxley, management hired the auditor and maybe the watchdog is less faithful when he comes to watch the person who's paying him. Sarbanes-Oxley--I thought it a most important and relevant provision. Sarbanes-Oxley does change the reporting system, so that now the auditor reports to the audit committee and I think that is a significant improvement.

There have been more radical [?] proposals. There's a radical proposal called financial statement insurance. This would try to use insurance companies as the principal. Insurance companies would give insurance out for the financial statement covered, and then they would go out and find an auditor to review them, the auditor would know that this insurer was going to be liable if there was a hidden problem and the auditor should be loyal.

I think there are problems with that proposal, without the whole separate half hour to go into that. One way that you could try to find a new kind of principal. In terms of analysts, analysts used to be paid based on brokerage commissions. That meant that their client was the investor. That was a better system than having the analyst subsidize out of underwriting revenues, because, once again, underwriting revenues are really coming from the issuer and the party you are watching is also the party indirectly paying you.

There have been proposals for vouchers, other systems by which we could have the investor, again, pay the analyst and choose the analyst.

I don't like the voucher proposal for lots of reasons. The key reason is I want a strong principle and vouchers just go out to millions of shareholders who really aren't going to make a very careful or a carefully-weighed decision. Federated agencies, until the 1970's, were basically funded by subscribers. That, to me, is the way the system should work, not issuing. I don't say we can get back to that system overnight, but what I most want to do is allow anyone, any kind of federated agency, it's going to try to pay its way by selling its services to subscribers to be able to qualify for the NRSRO designation, which you've heard about this morning.

And then lastly, which I got rejected on summarily this morning, antitrust divestiture. It doesn't have to be antitrust. It's not beyond the power of Congress to say we're breaking up this industry. In fact in Europe, I'm not sure that they would require an antitrust violation at all.

In fact the European regulators are extremely skeptical of federated agencies, not for any of the good reasons that Frank gave, but because it's essentially an American monopoly and they don't like an American monopoly controlling much of Europe. There's a good possibility that we will see antitrust or similar divestiture proposals. What's the rationale for it? Not that they can [inaudible]. But essentially that one, you can't easily acquire reputational capital. There are huge barriers to interest into a gatekeeper market dependent upon reputational capital, and secondly, reputational capital is the weak constraint in highly-concentrated markets, because once the auditor is paid by the managers, what the auditor beings to recognize is I don't have to compete with my three other competitors.

We can all be in about the same ball park, all of us [inaudible] about the same number of reputational hits. As long as I don't fall seriously far behind--the Arthur Andersen story--it doesn't matter that I'm going to be occasionally stigmatized, as long as I can absorb the financial costs, as long as I don't fall behind in my career [inaudible] I can continue to do what the managers want.

It's only when investors have a clear choice, or where there is a broad enough market, that even one disaster puts you way behind the rest. That's the world in which reputational capital I think will hurt you.

Otherwise, I use always the story about the two campers. I'll end on this. The two campers in Yellowstone.

I think of two audit firms, in an ultimate final two market, and they see the grizzly bear coming at 'em, and one says to the other: The grizzly bear is coming. The other says: Stop while I put my sneakers on. And he says: You fool, you can't outrun a grizzly bear. And he replies: I don't have to. I only have to outrun you. As long as you're going at about the same rate of speed as your competitor, you don't need to have to win.

You just [inaudible]. That is why I think, talking about a system based on reputational capital works well in competitive markets, not nearly as well in highly-concentrated markets. I made enough controversial assertions in the last 15 minutes to give everybody in the room at least four or five shots at this. So why don't I stop here and you answer me. Thank you.

[Applause.]

MR.   : People, start firing away.

MR.   : I guess I didn't quite understand your argument about equity versus cash compensation for [inaudible].

MR. COFFEE: Let me try it again, very briefly. If--

MR.   : Let me just say what I thought you said, and then, you can just tell me I got it wrong. But I thought you said that when equity compensation is much more significant, then there is an incentive to boost the earnings or [inaudible].

MR. COFFEE: If you've got stock options; yes.

MR.   : Now that's what I didn't understand, if that's what you're saying, because it seems to me that unless what you also were able to show is that the managers exercised those stock options.

MR. COFFEE: They never hold them. They exercise and sell them in one day.

MR.   : Right. But you do find--at least these studies that were done show that in these cases the managers are actually exercising and selling their--

MR. COFFEE: Oh, let me tell you, that's--

[Simultaneous conversation.]

MR.   : Or they just get--

MR. COFFEE: One of the interesting regulatory changes. In 1991, the SEC liberalized the rules under something called section 16B. Prior to that, you had to exercise a hold for six months in order to avoid what's called the short [inaudible]. They'd telescope [?] them all together, saying there's no difference. That made it possible to have an option but you paid nothing. Go to a bank, borrow the $20 million to exercise those options, and sell it in the afternoon. It was a very simple transaction to do.

No one--99 percent of corporate executives exercise themselves on the same day. It's unusual to exercise a hold because you have to go and borrow a significant amount of money.

MR. : Of course. But no, my question is your thesis depends on the idea that they are exercising and selling, and all I'm asking you is there data to show that or are they just turning paper profits--

MR. COFFEE: The data shows [inaudible] slightly different. The data shows that managers who have large options are generally the senior managers of companies that have restatements. There's a long, long paper called "The Dark Side of Options" by a financial economist that [inaudible] I can't tell you that they always find them selling. But they may just be holding the option. What they don't do is exercise and hold the stock. They may just hold the option, waiting for as long as they think that the trajectory will go on upward.

Mr. Ellison of Oracle [inaudible] someone selling 900 million four months before a huge crash in Oracle's price. Managers do have asymmetric information. They have the ability to sell before the market suspects there's a downturn. We look at the cash--let's [inaudible]. If you're a cash-compensated manager, your incentives are to grow the size of the firm.

[inaudible] empire building because larger size historically correlates with higher compensation to senior management and also correlates to the lower bankruptcy risk.

The world in the early '90s, before there was high takeover activity. Your only great incentive, to grow the size of the firm, because that meant less bankruptcy risk, less takeover risk, and a higher cash concentration.

By the '90s we get institutional investors insisting on equity compensation, so now you focus on maximizing the per share value of the firm rather than simply the overall [inaudible] in the firm. I think that was a wise decision by institutions, that they needed [inaudible].

MR.   : That chart that you showed before with the cash and the equity, I thought that the equity numbers were, those were realized gain, I thought. Or not?

MR. COFFEE: Yeah. They were valuing--they [inaudible] sold that, they were saying the amount that you received that year--this is all done by Barry Hall and Harvard Business School. These [inaudible] the change in executive compensation. He's looking at what you are receiving in stock options and cash on a year by year basis, in terms of percentages.

MR.   : But I'm wondering how the stock options were valued. He didn't use [inaudible] to do that. I mean, he had to--

MR. COFFEE: I can't answer how he did it. He's a financial economist. He should have thought about that. But I can't right now answer how he did it. It's not selling the option. He was looking with the, into the [inaudible] money value of that option was.

MR.   : The [inaudible] money value; money value. [inaudible] money value at the time it [inaudible].

[Simultaneous conversation.]

MR. COFFEE: [inaudible].

MR.   : [inaudible] below--

MR. COFFEE: It was in the time--

MR.   : [inaudible].

MR. COFFEE: On that, you've got to go back and read Hall studies and then Journal of [inaudible].

MR.   : I believe you too. I mean, I think clearly stock options are driving it. I don't think it was an accident.

MR.   : [inaudible] all previously issued options?

MR. COFFEE: I don't think we're talking about the--I'd have to go back and look at his study. I think he's talking about the compensation you were given each year. You might be given a salary--there's a tax side to this that you may not be aware of. Because of tax changes around 1990, if you paid your seven highest executives more than one million in cash, the corporation no longer got a deduction. That was a major tax constraint too. so that made you say we'll pay our manager one million and the rest of this will be paid in equity compensation.

So there's a tax distortion [inaudible]. I'm not saying who was causing this so much as what was the impact of this, and the impact of this is destabilizing corporate governance.

Professor Palmrose.

MS. PALMROSE: [inaudible].

MR. COFFEE: I've got to finish the answer here--you may be right, that there's something happening in ninety--I don't know what your statistics are--

MS. PALMROSE: [inaudible].

MR. COFFEE: No question that securities litigation escalated against corporations in '97 and '98. The question is whether it escalated in simply the professional [inaudible].

MS. PALMROSE: You can actually get the numbers. The numbers are public information--

MR. COFFEE: Yeah. But here's what [inaudible]. The SEC did report, general counsel study, litigation against both investment bankers, law firms, and auditors, right up in the first two years after PSRA. I don't have data beyond that two-year period. You're talking about seven, eight, nine. I'm not saying I--the other question that's really important is what the settlement value of the case was. To the extent that I talked to litigators, the settlement value of cases against auditors went way down because it's very hard [inaudible] what PSLRA said is that you cannot plead a complaint or get in discovery unless, at the outset, you complete [inaudible].

You can often do that against a CEO. It's almost impossible to do that against the auditor. So I'm suggesting that the combination of data I see shows that it dries up for at least two years afterwards. You're saying it doesn't thereafter.

If the settlement value of the case [inaudible].

MS. PALMROSE: [inaudible] I don't even know why I'm trying. But having said that, I would [inaudible] on the settlement also. So I mean [inaudible].

MR. COFFEE: Well, the problems are definitely [inaudible] auditor. I certainly agree that today, now, in the post-Enron mood, people are skeptical of auditors and there have been lots of $100 million settlements [inaudible].

MS. PALMROSE: And the second point is really on your audit PAs responsibility for monitoring and [inaudible].

MR. COFFEE: They control [inaudible].

MS. PALMROSE: Yes. But that was there prior to [inaudible]. What was happening, unfortunately, was that the audit community was [inaudible] rather than looking at the [inaudible]--

MR. COFFEE: We're going to have some disagreement here. You're entitled to your view. I think there's a marginal change where the audit committee has significantly enhanced powers.

MS. PALMROSE: Oh, I agree and I think that what's done is, what's happening [inaudible] in the post [inaudible] the behavioral shift is not [inaudible] it's changing the environment and that [inaudible] part of that.

MR. : Yes. He's agreeing with you.

MR. : Okay; okay.

MS. PALMROSE: [inaudible] agreed with the result. You disagree with how [inaudible] change the environment and that's a more complex problem.

MR. COFFEE: Well, I think the variety is changed by a variety of factors, including the press, public attitudes, and I think that there's a great deal more skepticism about letting the auditor have as much discretion to do anything else. That would be my sense. I serve on some boards.

MS. PALMROSE: Oh, I think that there's no doubt about it, irrespective of whether we have a legal [inaudible] a number of boards will say "We don't want to go there" and the disclosure [inaudible]--

MR. COFFEE: I'm certainly not against disclosure. I think there is no cost to the prohibition in stock, the provision in stock that says control over the hiring and control over the auditor has to be given to the audit committee [inaudible] if you're talking that there's no harm, you have some question about [inaudible].

MS. PALMROSE: Oh, no, no, no. I think [inaudible] I'm just thinking if it's there before, and it wasn't being exercised in the way [inaudible] now. So it takes more than just [inaudible].

MR. COFFEE: Okay.

MS. PALMROSE: No. I [inaudible].

MR. : Do we see that shift in manager compensation now more toward stock grants [inaudible] the executives have to hold for a period of time and--

MR. COFFEE: Restrictive stock options. It's a marginal change, but restrictive stock options are--the other thing that's happening to is the FASD has thrown a great deal of sand in the gears by requiring spending of stock options.

That isn't the [inaudible] optimal reform from the standpoint of the compensation but it does make it more difficult to use very extensive stock option grants. That hasn't fully played out yet. Frank?

MR. : I'd be interested in hearing your views on how the gatekeeper changes have affected the mechanisms [inaudible]. So how these changes are operationalized. Now that maybe we have more disclosure and gatekeepers are behaving differently, how do you see--

MR. COFFEE: Well, I'm not going to--

[Simultaneous conversation.]

MR. COFFEE: --[inaudible] market efficiency has gone up or down. I will say this. I think there is a problem. There is a category of firms on Nasdaq which now do not have a single analyst [inaudible]. In that world, which is less transparent, I think it's much more possible to manipulate those stocks, if you are someone who's interested in stock manipulation.

[inaudible] other kinds of practices. I realize that [inaudible] would like to investigate earnings [inaudible]. I think there's problems with the disappearance [inaudible] analysts. [inaudible] probably consistent with 20 to 30 percent of the companies he covers. [inaudible].

MR. : [inaudible].

MR. COFFEE: [inaudible]. If they see something going on, they want to participate. Why was--

MR. : No, that's what I mean. So the mechanisms can get [inaudible]. In other words, how do these changes [inaudible] from the auditor's perspective? [inaudible].

MR. COFFEE: I understand that there's a strong buy side, that, in theory, they should be buying [inaudible] slow process. They want it to be a slow process. They want [inaudible] as long as possible. So I'm not saying that we won't have long term [inaudible] but I think there are significantly more [inaudible] companies where they are trading in nontransparent [inaudible].

MS. : [inaudible] these small cap Nasdaq stocks that don't have any coverage or perhaps they look like they have coverage but they've bought it from a boutique [?]. There's some of that as well--

MR. COFFEE: Yes, paid-for research is the most basic conflict of all.

MS. : Yeah. So there's some [inaudible].

[Simultaneous conversation.]

MR. COFFEE: [inaudible]. I have a further problem. There needs to be a new business model. There should be some mechanism [inaudible] trying to do, by which you can get someone who really wants to pay for the research, put into a fund, [inaudible] or corporate issuer, and then the honest broker finds [inaudible]. I realize [inaudible] but it's better than simply paid-for research. Why is it not happening? The SEC has blocked this. The SEC does say under the global settlement, they will not allow, right now at least, any of the major firms that have [inaudible] analysts to participate in any kind of paid-for research including intermediary research.

I think the SEC's got to be persuaded [inaudible] big different between paid-for research and some kind of [inaudible] research. Otherwise we get no research. Someone's got to pay for it. Underwriters are no longer there. Voucher proposal are unrealistic. We've got to find someone to pay for it and I think it's got to be a way that divorces the payment from control over the analyst's valuation.

MS. : And further [inaudible] hedge fund section [inaudible].

MR. COFFEE: There's some legal restrictions in some places too.

[Simultaneous conversation.]

MS. : [inaudible]. And it's even worse if you're a hedge fund, trying to sell those. [inaudible].

MR. : At the FTC, there [inaudible] where you've come up with a good argument for a short and then the FTC has [inaudible] you're abusing [inaudible]. So there's this persistent--even after the short sell rule, you still have this asymmetry in the market [inaudible] being able to arbitrage positive information for negative information [inaudible].

MR. : A clarifying question. The [inaudible] market research proposal again, who pays for it?

MR. COFFEE: Well, they would like to get anyone they can to pay for it. There's two people doing this, the NRE and the Independent Research Exchange. Both come out of [inaudible]. Their goal is to have issuers pay them an advance fee and if they will--

MR.   : Sort of on a lump sum?

MR. COFFEE: This is on a lump sum for, say, two years, and they will find analysts over that period of time. They say they will replace the analysts if [inaudible]. If he misses, they'll replace him and get someone else. We have to show that our research is at least as good as other [inaudible] research. So they know they're going to have to have their clients' sell recommendations be somewhat similar to the buy-sell recommendations of [inaudible], and they'll be able to predict what the next quarter's earnings are coming to. So they would like to get [inaudible]. But their idea is they would be paid for a two-year period by [inaudible] they would go out and find an analyst from one of the major firms, Goldman Sachs, Morgan Stanley [inaudible] reputation.

MR.   : They just rent them basically, for an hour.

MR. COFFEE: The analyst would cover, in the industry he knows, a company down there at the Nasdaq level, that he wouldn't ordinarily cover because the market capitalization [inaudible].

MR.   : Okay. But [inaudible], I mean--

MR. COFFEE: He's going to pay on a two-year basis. That's correct. Not to the analyst.

MR.   : He's going to pay it to the intermediary. Okay. But I'm still unclear, when we talk about issuers, we're talking about, you know, [inaudible] why would they subsidize the coverage of other companies? I don't understand.

MR. COFFEE: The company's paying for research, going in. There are different ways this works.

MR.   : [inaudible].

MR. COFFEE: Hmm?

MR.   : Small issuers.

MR.   : So the small issuers are gonna pay--

MR.   : To get coverage--

[Simultaneous conversation.]

MR. COFFEE: Even the medium coverage, you may want one more analyst. You might want three, four, or five.

MR.   : [inaudible].

MR.   : So that the only reason this doesn't smell is that you've got--they're basically trusting the intermediary to pick the analyst. So they're not--

[Simultaneous conversation.]

MR. COFFEE: The intermediary--you have to trust the intermediary and secondly, the intermediary's going to go to a major sell side firm, Goldman Sachs [inaudible]. What you have today is paid-for research under which the company goes to a freelance analyst, no connection with anybody, and says we'll you pay several thousand dollars if you report no us [inaudible].

MR.   : Okay. I see. And so I can see why the SEC wants to stop this. I mean, the global settlement, they don't want these guys working for the intermediaries.

MR. COFFEE: What they clearly said, all along, is that we can't have analysts at Merrill or Goldman getting paid directly by the issuer. The question is whether [inaudible] brokerage mechanisms that they should accept; otherwise there's no money. You know, the debt becomes [inaudible] I agree that you can't [inaudible].

Okay?

MR.   : Okay. Thank you very much.

[Applause.]

MR.   : We've got a ten minute break and we're back upstairs.

[Brief recess.]

MR.   : Okay. Let's try to calm down and let's get started here. We're going to begin this afternoon's session with Zoe-Vonna, we've talked a lot about accountants, and Zoe-Vonna's one of our nation's experts on accounting, so we're looking forward to hearing from you.

MS. PALMROSE: Thank you, Bob. I'm delighted to be here to discuss the future role of auditors as financial gatekeepers, and what I decided to do is frame my paper using an overarching question which is, Are regulatory and legal forces, post SOCs, undermining the continued value and viability of large external audit firms as financial gatekeepers?

And to explore this question I used a risk management framework and examined risk management from both the perspective of the auditor as well as the audit regulator, which of course now post-SOCs, with the shift from our self-regulatory to government regulation of auditors, of SEC registrants, means the public company accounting oversight board or PCAOB, which is an independent body, although it is subject to SEC oversight.

For example, the SEC has to approve standards promulgated by the PCAOB before they take effect and the SEC has to approve the annual budget of the PCAOB.

However, funding for the PCAOB is actually from support fees assessed to SEC registrants and registered audit firms. So now you cannot audit public companies, SEC registrants, unless you are registered with the PCAOB and you do pay a fee for that.

But the majority of fees come from SEC registrants, so issuers are providing the funding for this regulatory activity, and this means that the PCAOB is not beholden to the SEC or not beholden to Congress for its funds.

And this gives, this changes its position relative to other regulators. For example, it doesn't have the normal excuse of inadequate resources or lack of funding in the face of audit failures.

To briefly overview for you the responsibilities of the PCAOB, which are to promulgate rules or standards for auditing, quality control, ethics, and auditor independence. So they have the whole plate of rulemaking here.

They also monitor and inspect audit firms and audit engagements for compliance with their rules and they investigate and sanction audit firms and auditors for not complying with them.

Now this last bullet represents a new layer of discipline. In other words, the PCAOB discipline is layered on to everything else that went before for auditors, in terms of civil liability, criminal liability, regulatory actions. This is a new layer of discipline.

In the paper I discuss a number of issues that I think likely affect the PCAOB's approach to risk management and one of the important ones, I think, is that this is a nonexpert board.

This is not an organization with broad and deep relevant accounting and auditing expertise.

It's really lawyer-dominated, and the primary experiential commonality is really SEC experience, which gives it, I would argue, an enforcement perspective.

And rather than being captured as Jack is concerned about, the regulator being captured by the profession, at this point there's a general exclusion and disempowerment of practicing auditors, so I think we have the opposite problem, is that we have a lack of expertise on accounting and auditing matters within this regulatory organization.

Also it's important to remember that SOCs makes no requirement on the PCAOB to consider the costs and benefits of their regulations. The board members say they do so but there's no formal requirement or formality to that cost-benefit consideration.

And then I would argue that there's a lack of transparency within the operations and processes of the PCAOB, and this goes beyond just the need for keeping data confidentiality. So it goes beyond just the confidentiality restrictions here.

So with this background, then let's talk about the risk management activities. To do this, I use a general risk management framework that I borrowed from a textbook by Bill Kinney, and this is one that can be used by any organization, firm or company, and the first step is to identify the risks and then assess the risk/reward relationship.

If that's acceptable, accept the risk and monitor for exceptions and changes.

If it's not acceptable and you can't get it to be, then you avoid or prevent the risk and monitor for exceptions and changes.

Then there's this middle ground of risks that you have to assume but you want to mitigate and there's a number of risk sharing and transfer mechanisms that, in theory, would be available to do that, that are noted on the bottom of the slide.

But I want to point out several things. First of all, most of these risk transfer and sharing mechanisms are foreclosed to auditors by laws, rules or professional standards.

In particular, rules related to auditor independence. Plus, under current market conditions, the larger audit firms cannot obtain insurance against higher claims for significant or catastrophic amounts.

Moreover, trying to price out the assumed risks--and here I mean not doing more effort, I mean simply pricing out the assumed risks, and estimating them for the future, not as a pay-as-you-go system, but I mean estimating your future, the cost of future events that are low probability but very significantly costly--trying to price those out either--and charge them in fees for either a subset of risky clients or all clients, is really not a feasible option for audit firms.

However, I'll discuss in a few minutes that risks faced by auditors really coincide with the risks faced by the PCAOB.

So risk sharing with the audit regulator is indeed possible. But unfortunately, rather than risk sharing, so far, it appears that the PCAOB is really engaging in risk transfer activities, so that the firms are facing additional risk.

And to understand this, let's talk about the risks that the firms and the PCAOB actually need to manage, and the first of these is the risk of financial misstatement.

So this is the risk of loss from the auditor unknowingly certifying materially misstated financial statements.

It subsumes here internal control misstatement, although post SOCs, the simplification has some problematic elements to it and certainly the 404 attestation has increased auditor liability. But I'm going to abstract from that problem or that issue, because I want to focus on another point, which is that financial misstatement risk really does depend on both auditing and accounting standards.

Accounting and auditing standards help determine the level of misstatement risk for auditors.

And post-SOCs, auditors do not control either the setting of auditing or accounting standards.

Of course the PCAOB sets auditing standards, and I'm going to talk about the implications of that in a minute.

But here, I would like to note that my concern is that accounting standards can actually facilitate misstatements. This occurs in part because accounting standards can be difficult to audit and even be unauditable, and the next statement, some of my colleagues here, Bob and Peter, probably in particular, we'll part company with, but let me emphasize that there are some of us who find this problem of difficult to audit, unauditability, facilitating misstatements, to be particularly acute as the FASB and international accounting standards boards move more towards market-value based accounting standards.

So that exacerbates the problem here.

Okay. Well, many assume that auditors would not have problems if they just did better audits. But let me illustrate that an auditor can comply with auditing standards, even exceed them, and not eliminate misstatement risk because of client business and misconduct risk.

Client business risk is the risk of loss to the auditor from client declines in performance, client financial distress and client failure.

As noted on this slide, these circumstances occur without misstated financial statements. However, these circumstances do increase the likelihood of misstatement, although it's not the case that clients that suffer financial distress or fail always--that the auditor always gets sues on these clients, but the likelihood of this increases, whether or not the financial statements are misstated.

For example, I have a study that found the Big Eight, slash, Big Six, auditor litigation rate was about 18 percent on large, for a large sample of bankrupt public companies from 1972 to 1992 while the auditor litigation rate is a fraction of that for nonbankrupt public companies.

And then also the dismissal rate for that bankrupt only subset was much higher.

So when I say "bankrupt only," I mean on clients where they were bankrupt but without any misconduct.

So client misconduct risk is the risk of loss to the auditor from management fraud, illegal or unethical acts, excessive perks, shirking and other acts of noncompliance by the client.

I argue in the paper that client misconduct, specifically fraudulent financial reporting, creates the most difficult risk management problem for auditors and for the PCAOB.

Fraudulent financial reporting is why we have SOCs, and unfortunately, the risk of fraudulent financial reporting on large clients with high cap values and/or high debt levels, post-SOCs, remains a critical threat to the value of auditing and the viability of the largest audit firms.

And the paper provides some descriptive data to support this, and I'm going to return to this point several times.

But for now recognize that client business and misconduct risks are among the reasons that the client acceptance retention decisions are important risk management activities for auditors, and client misconduct and business risk are among the reasons that auditors cannot just manage risk by doing better audits.

Complying with accounting and auditing standards only partially protects an auditor.

But having accepted the client, the only way auditors can mitigate misstatement risk is to audit more effectively.

So in the current environment it's not a surprise that auditors would be doing more work, tightening materiality, not waving adjustments of detected misstatements, consulting firm specialists for advice, and making more conservative judgments, all of which certainly increase audit fees.

And instead of supporting these activities, the PCAOB has responded to them as an over-auditing problem, which has only transferred additional risk to the auditors, including business risk.

So business risk is the auditor's need to manage the overall risk to the organization which is defined as the risk of law suits, regulatory actions reputation diminishment, declines in audit firm viability and audit firm failure from all sources and types of services, and this has become more difficult, post-SOCs, I would argue. In the paper I provide a more detailed discussion of how all of these risks that we've just gone through from the auditors' perspective, including business risks, are risks the auditor shares with the PCAOB.

In addition, the PCAOB has to manage its own reputation to maintain confidence in the current regulatory process.

But I would argue, in the long run, the PCAOB cannot do this by undermining confidence in the value of audits and the viability of the firms that audit public companies, which it seems to be doing. And this only diverts attention from what I think is the fundamental problem, is fraudulent financial reporting, and it's the major risk for undermining confidence in auditing, and we haven't focused on that.

SOCs, including section 404, has not eliminated fraudulent financial reporting, pre audit. Even effective audits will not detect on a timely basis all instances of fraudulent financial reporting. So importantly--and the paper provides a little bit more context for this conclusion--but the PCAOB, because they have elected to set auditing standards themselves and not delegate this task to say a reconstituted auditing standards board, or some type of professional expertise organization, as allowed by SOCs, this decision, in conjunction with the PCAOB's broad powers for standards, inspections and enforcement, gives it the responsibility for the residual risk of failing to detect financial misstatements, including fraudulent financial reporting, when all its standards had been followed.

Now, let me turn to the second related thread developed in the paper, and that's one of legal liability and litigation over alleged audit failures.

In the paper I argue that in accounting and auditing cases, the legal system, which includes the regulatory enforcement, so I'm talking about them interchangeably here, does not effectively assess the role of auditor performance versus other factors and circumstances.

In other words, I argue that it doesn't effectively assess the merits of claims and it doesn't effectively determine the worth of claims, that is, relate the merits to auditor sanctions.

I also discuss how trial is not a viable option for auditor defendants, particularly on mega cases claiming multi billion dollar damages, and that this helps drive up settlement amounts.

And I argue that uninsured or uninsurable current and future mega cases undermine the stability of even the largest audit firms, and I provide some data to show that one of the things that characterizes these cases is fraudulent financial reporting.

So let me summarize these threads. Auditor regulation and legal liability are important mechanisms for mitigating, deterring audit failures, and for compensating financial statement users for losses caused by any such failures.

Even so, the current regulatory and legal systems really impose significant risk on audit firms, which the firms are increasingly less likely to be able to bear because of regulatory, legal and market constraints on audit firm risk management activities.

So the key is to find a way to address this problem without losing the deterrence and compensation, okay, but maintaining the value and viability of auditing, and to address this problem I pose the establishment of--here's the new part--the drum roll.

I pose the establishment of what I call an auditor's masters office, and let me describe how an audit master's office might work. It would be under the PCAOB umbrella, because this avoids the need for legislative action to establish it.

It could be established by the PCAOB with SEC approval. It also gives it access, by being under the PCAOB umbrella, gives it access to all necessary data, so it has access to all the confidential data it would need and it has appropriate legal protections around that data.

But the office still needs to be independent of the PCAOB from the standpoint of supervision and control, because this is intended to give it the appropriate objectivity and incentives to evaluate the audit regulator, and I explain the paper that none of the current PCAOB staff functions have the incentives or the objectivity to evaluate the regulator.

So they don't have the incentives or objectivity. They're not doing it and they can't do it either.

The purpose would be to determine whether there was not a failure whenever there are allegations from auditor litigation and regulatory actions involving auditors on SEC registrants. That it would assess auditor compliance with accounting and auditing standards.

And it if determined that there was an audit failure that had occurred, then the office would determine the contribution, if any, to the audit failure by the various components. In other words, there could be deficiencies in auditor performance, there could be deficiencies in audit firm quality control systems and methodologies. But there could also be deficiencies in audit standards.

It could be auditing standards, quality control standards, independent standards, professional conduct, and the PCAOB has responsibility for those. So there could be deficiencies with the audit regulator here.

There could also be deficiencies that contributed to the audit failure in other regulatory processes such as the PCAOB inspections and risks assessment. And then of course there could be deficiencies in accounting standards.

And then finally, the client actions and circumstances could contribute to the failure also.

So the assessment of the contribution to the failure of the various components of it would be part of what the office would do.

And then the use of the assessment would be, they'd be available to the PCAOB to use to improve their standards, inspections and other processes, and it would also be available to an audit firm to use in the legal process.

Now this would have to be voluntary, to avoid violating PCAOB confidentiality requirements.

But it would be a negative signal if the firm did not provide the information. So it'd be a negative signal as to its contents if the firm didn't provide it. And it would really represent friend-of-the-court advice on the merits and worth of plaintiff's claims, and the key thing it would be based on considering the facts and circumstances of the particular case and how that case compared with the body of prior cases.

So are there any precedents for this? And the answer is yes. From outside accounting and auditing, it really captures some of the elements of the National Transportation Safety Board.

But there's also precedent from the self-regulatory system. It modifies and extends what was known as the QCIC process. That was the Quality Control Inquiry Committee under the Public Oversight Board.

Now I always thought that this an extraordinary important process. It had some flaws in it. It was part of the Panel on Audit Effectiveness that did an in-depth study of the profession before Sarbanes-Oxley, and one of the issues that we addressed was how the QCIC process could be improved.

But the problem is it's not even clear the process at all is being followed in any way, shape or form by the PCAOB. Maybe some of it's done under registration, inspection and enforcement but there's no transparency to see what, if anything, is occurring here.

So what this proposal does is really modify and redirect, really extend the QCIC process to correct some of the flaws under the self-regulatory system.

And finally, what I was going for here is an incremental change within the existing structure that is feasible.

In the current environment, I doubt whether there is enough, and maybe even any sympathy for legislative action to solve significant structural problems for audit firms or to alter the regulation of auditors.

So I am tempting to craft a feasible solution and at a minimum, I hope that my proposal shines some light on the fundamental problems that need to be addressed to maintain the value of private sector auditing and the viability of the private sector--of the private audit firms that audit public companies, cause as yet we have not had sufficient debate around that.

Thank you very much and I'll turn it over to Peter.

MR.   : Okay. Thank you, Zoe-Vonna. Peter Wallison from AEI is our commenter.

MR. WALLISON: This is really a terrific paper, not only because it recognizes a very significant problem but because it develops what I think is a very practical solution. As I will say when I come to that point, I have some question about whether the agency involved will follow

Zoe-Vonna's suggestions but I do think that she has identified a real problem here and worked hard to find something that might actually work, if there were the right leadership at the PCAOB.

I guess I would simply a little bit the argument that Zoe-Vonna goes through. She is a scholar and therefore would of course follow down all the relevant questions. As I see it, the main problem is auditors cannot detect or discover fraud unless they stumble on it, and as I had always understood accounting, accountants never claimed or allowed the claims to be made that they could discover fraud.

WorldCom I think is a great example of that. Maybe if they had looked at more of the accounting in the WorldCom case, they might have stumbled upon the way WorldCom was treating these leases. But Arthur Andersen's auditors did not. And if it is a fraud, I don't think that there is any way for auditors, or other, gatekeepers, for that matter, to discover a fraud. Frauds are, by definition, concealed, they're hidden, the purpose of a fraud is to put something over on someone and if you're the management and you are in control of the financial statements, and you're halfway clever, you ought to be able to do it, whether or not the gatekeeper involved in this case, auditors, have some kind of conflict of interest.

Now this is not as I see it a perspective that is shared by the public, by the media, or most importantly perhaps--maybe not even most importantly--by the Congress.

Because I think that, in general, it is assumed by those groups that auditors--when a fraud occurs, the auditors should have discovered it, and that in fact is essentially what Congress was saying in adopting Sarbanes-Oxley and the media in its very strong endorsement of Sarbanes-Oxley and the result of this is that on juries, it becomes impossible, I think, for counsel representing audit firms to make the argument that where a fraud has occurred, it was not the fault of their client and that's the point I think that Zoe-Vonna is making so well.

The legal system just does not work anymore to allocate the losses according to the malfunctions when auditors are involved in a case where there has been a fraud. So that auditors now bear a tremendous risk and as Zoe-Vonna points out, many of these risks are so large, that they really can't be adequately insured.

And so we are in some jeopardy, I think, of losing one of more of the Big Four or the final four accounting firms. Right now, as someone mentioned, I think it was Jack, or maybe someone else, too, KPMG was saved by prosecutorial discretion. We can't expect that kind of sympathy from a plaintiff's counsel or from a principal plaintiff such as a Heavsee [ph] who has an accounting firm over a barrel.

I don't think that even the fiduciary responsibilities of such a person would allow him or her to decide that the accounting person involved should be allowed to survive and not pay a multibillion dollar damage, where it is likely that such a suit would be successful in court.

So there is a real possibility, I think, that we could lose one or more of the accounting firms when another major fraud occurs in an environment in which people think that the accounting firm could somehow have prevented it.

So how do we address these risks, and that's where I think Zoe-Vonna's suggestion is so good.

She points out that the PCAOB also shares some of these risks and maybe they could inform people, having the imprimatur of the government, they could go into court or at least allow the accounting firm, the auditing firm to go into court and say, you see, we complied with all of the requirements of an audit and yet there was a fraud, but we did everything that our professional standards required, and that might provide some real practical defense.

Now she has gone one step further, which I think is a very smart refinement, and that is not be PCAOB but a special master of some kind, the audit master I think you call it, which would have that responsibility and would be independent of the PCAOB.

I think that is a very smart idea because the PCAOB, like so many organizations, including the SEC, has fundamentally no courage whatsoever and would never sacrifice themselves for any of the regulated entities, if they can avoid it, and I think this was all demonstrated just a couple of months ago when the SEC and the PCAOB held this roundtable on the cost of 404, and I think this is mentioned in your paper too.

So many companies were complaining about the cost of 404, and so they held a roundtable, they listened to all these complaints and at the end they said, you know, this is the fault of the accountants. They're just dealing with too many details. That kind of decision, if it were really based on a lack of knowledge of what is happening in the accounting industry or accounting profession would be excusable. But it can't be. It's got to be disingenuous. They have to understand that accounting firms must go through this process of extraordinary concern about details because all of these law suits are conducted on the basis of hindsight and if you miss one small detail in the creation of some kind of internal control, and that detail is found by the plaintiff's attorney, and he shows that there is a logical connection between the fact that some form wa snot signed by some subordinate official somewhere down in the company, that could have prevented this fraud, because if the form had been signed, someone along the way would have been able to discover the fraud, thereby drawing some sort of causal connection between the lack of the internal control and the fraud.

The accountants cannot, the auditors cannot avoid that kind of problem and must get down into the details, and so when the PCAOB and the SEC said, well, it's really your fault, it's not our fault for requiring all these things, it's your fault for going further, they have reflected the fact that they are much more interested in maintaining their own reputation as government or quasi-government organizations rather than worrying about the long-term condition of the accounting industry, the auditing industry.

But the idea of creating a separate audit master is really a great one from that perspective, because these were people, presumably, or would be people who would have as their responsibility protecting accounting firms against the kind of liability that we're talking about here, and would have a different attitude toward their role than the PCAOB itself would have.

So I like that idea quite a lot. I want to mention one more way that this issue could be addressed.

In 2003, in November of 2003, the American Assembly held a conference on the future of the accounting industry and there were lots of suggestions at that point about how the accounting industry could be saved from what then seemed to be a cliff it was going over, and one of the very interesting ideas was the suggestion that the certification statement of auditors, that is, the financial statements substantially comply with the generally-accepted accounting principles, applied on a consistent basis over time, or whatever the exact phrase is, is quite misleading, because there are many things, in fact many accounting experts such as Brooklev [ph] point out that most things that go into the preparation of GAAP financials are estimates by the management.

And the auditors can't really assess the quality of those estimates. One that would be obvious would be collectibility of receivables. Management always makes an estimate of the collectibility of receivables and the auditors have very little way to assess whether that is correct or not because the management does have a sense of what is going on in the outside world and the likelihood that the receivables that they have will be good when they are collected over the subsequent year, but that has a very major effect on the earnings.

So the assessment by, or the idea that was suggested at this conference was that the certification statement be changed, so that the things that accountants can actually see and record and vouch for, the vouching element would be such things as cash or items which have an actual market value, or even items that are based on cost less some kind of verifiable depreciation, even though that in itself is a little bit difficult.

But those things that can actually be vouched for, that's what accountants would be responsible for, and for everything else in their certification statement, they would point out that these things are based on estimates by the management and although the estimates look to them as though they could be accurate, the accountants are not responsible for those estimates.

Now that's another way to address the central problem which, as I see it, is that people tend to think that when the accountants certify financial statements, it's a certification of their accuracy, that they are in fact an accurate representation of the real world, whereas they are nothing more than a kind of endorsement of what management ultimately said was happening within the company. And so that's another way, I think, if I can suggest it, that you might approach this issue of attempting to protect accounting firms, auditing firms from the liabilities that they have.

But as I said at the beginning, I think this is an excellent piece of work because not only have you identified the issue but you have come up I think with a very practical kind of solution that might actually work in the real world.

Thank you.

MR.   : Okay. Before we go to questions, can I ask a couple questions, Zoe-Vonna, of your proposal, just to clarify it.

MS. PALMROSE: Sure.   I was going to respond a couple ways to Peter's but I guess [inaudible].

MR.   : Okay. I just want to be clear. So the first thing is this office that you would create, or the PCAOB would create, you argue it would have the authority to do that now under existing law?

MS. PALMROSE: I would argue that, again, with all due respect to my lawyer colleagues--you know, I'm a kiddy lawyer here--so I would have to defer, if somebody would tell me that's not the case.

MR.   : Okay, but let's assume that--

MS. PALMROSE: I assume it could be done since they have broad powers, under SOCs, that are pretty open-ended.

MR.   : Okay. So let's--

MS. PALMROSE: That's my assumption; yes.

MR.   : So let's assume that you can do that and let me just understand what I think is the purpose of this, and that is you've got a case--well, I guess I have several questions.

The first is do you view this office as providing some kind of decision making or recommendation kind of service to the PCAOB itself on an individual case, or is it only reserved for when somebody is sued, when an accountant is sued and it's the latter?

MS. PALMROSE: It would be the latter. I had in mind, under allegations of audit failure, that would be objective, such as liti--you know--auditors being attached in suits involving public companies or SEC investigations that were going to lead to an enforcement action.

MR. : All right. So if it's an outside action, it's purely then the defendant, which is the auditor, it's purely up to them whether they would then go to this office; right?

MS. PALMROSE: No.

MR. : No?

MS. PALMROSE: No. The office would investigate. It would be--

MR. : In every case?

MS. PALMROSE: Yes; yes.

MR. : In every case there's a law suit, the office would then be triggered?

MS. PALMROSE: Yes. The way it worked under the QCIC was that the firm had to report their litigation or regulatory threats, actions threatened to the QCIC and they would investigate them within--they had to report them within 30 days and they would investigate them quickly.

MR. : Okay. Now I invoke my lawyer friends. All right.

MR. : [inaudible].

MR. : Yeah. Oh, come on, Barry!

So this is like an official expert witness, all right, but it has to have some standing in a private law suit or an enforcement action, and the question is how does it get standing to--no. How does it get its views before the court?

MR. : Defense can call them. Defense can call them as an expert witness. That's not the problem.

MR. : Okay.

MR. : The defense will certainly want to put on any expert witness who can say there was no failure here.

MR. : But they don't know, they won't know, or will it issue a report? It'll issue reports, that everybody will know?

MS. PALMROSE: No. It will issue reports that are available to the audit firm, so the audit firm will know what the report says.

MR. : Oh, okay.

MS. PALMROSE: And the PCAOB will know what it says. But remember, everything under the PCAOB is subject to confidentiality requirements. So anything external would have to be done voluntarily by the firm.

MR. : Okay.

MS. PALMROSE: So the firm would have the option to file it with the court and if they didn't, I mean if this was--

MR. : There'd be an adverse inference if they didn't file?

MS. PALMROSE: Yes; yes.

MR. : Okay; all right. Jack, you were probably going to interject with--

MR. COFFEE: I'm not opposed to the idea of there being an expert witness. What it'll do of course if you'll waive all the privilege. The moment you put this into evidence, everything else that's back there in the Picaboo files is going to be able to be brought in by the plaintiff, and the question is how much does this really impact on litigation.

I would ask you this cause even if I agree with all your premises, thought everything was beyond the legal system's capacity, you're going to get one expert witness on the defendant's side, perhaps a quite persuasive, plausible witness, but in trials, one more witness doesn't always make the difference.

The judge is going to be in control and he may be looking at a large fraud and have his own suspicions.

If you ask most of the people in the industry, the general counsels of the Big Four, I think they would much prefer to have something like a ceiling on damages to this possibility of a little bit more evidence that could go into the trial process.

There is some real prospect in Europe today that there could be a ceiling on damages. That at least solves what I think the industry perceives as a problem. It's the huge mega verdict.

MS. PALMROSE: Yes.

MR. COFFEE: Because if you just have a ceiling on damages, you can insure everything under the damages. If you don't have a ceiling on damages, there's still this prospect of a $2 billion recovery that could kill any firm and what you've done is you've tipped the balance of evidence by adding one more expert witness.

The plaintiff may call the professor of accounting from Harvard, Yale and Stanford to say this was bad and I'm not sure the jury knows who to put more weight on.

MS. PALMROSE: Well, hopefully it would develop a reputation, first of all, as an expert, that would carry more weight. But I agree with you. I--

MR. COFFEE: The jury? Juries know nothing.

MS. PALMROSE: I understand that, but it would be--again it's the expectation of what the jury would think because, in all honesty, juries aren't hearing anything now anyway. So we've had, under the--as a piece of data for people who didn't get a chance to read the paper, since the '95 reform act, in all these class actions, securities class actions there have been four trials. Four of them have gone to trial and two of them involved audited defendants that went to trial.

So out of these thousands of cases, that's what we have so far. So it's really the expectation that you want to building here and it's the expectation of the reputation effects with the court. But let me just speak to--I was trying to come up with something feasible because, one, I'm really concerned about damage caps in the sense that I don't know that they provide the appropriate deterrence. So I wanted to keep in place the deterrence mechanism here.

I disagree with Peter in the sense that I don't think it's the case that auditors just stumble on fraud.

I actually think that there is a performance issue, I think there's a standard issue, but I think there's--all the characteristics that I outlined on the slide are ones that will contribute to why it there was a failure to detect it, and what I think is missing is someone who has the expertise to sort through those on the individual case by case basis.

So that's why I was trying to come up with a mechanism that brought the expertise to the table in an objective way, that recognized all the other people who weren't at the bar, that had, you know, contributed to it. And the PCAOB isn't going to get sued but yet they were a contributor probably in terms of their standards.

So trying to get everybody lined up here in a way that is feasible, and the other thing that this body would have is some expertise in terms of what's realistic in the way of compensable damages.

For example, KPMG, it's true that you can say that the firm be saved but they're under deferred prosecution, so anything that happens in the next, what is it? 18 months, will be used against them, and plus at the cost of half a billion dollars essentially which some say was the upper limit that they could have paid and survived on a financial, and that's under what's happening in terms of fees generated under SOCs or under 404.

So it happens to be a point in time when the resources might be available and may not be representative.

So it's trying to work its way--you know--what I'm trying to do is work my way through all of those problems and come up with something that's feasible, that doesn't undermine the deterrence and compensation aspects.

MR. COFFEE: I think lawyers would tell you is you may have bought too much into the legal system because I don't think that it would end the unwillingness of the defendant to go to trial, that it has one more, even an authoritative witness. You just don't know how the jury will respond.

They may say that's a government bureaucrat. I'm going to ignore it.

MS. PALMROSE: I understand that risk and I understand the risk also from the general counsel's standpoint that it's putting all your eggs, in some sense, in one basket. There is that risk.

But it seems to me that there are possibilities here for developing a reputation for reasonableness and expertise that both are missing from the process at this point in time and I'm just trying to come up with a way of getting them. I'm also trying to come up with a way of getting the regulatory structure to have constant improvement too, which I think is missing from this current regulatory structure.

MR. WALLISON [?]: [inaudible]. I just wanted to make a comment, and that is I think that the important thing here is that it adds, this proposal adds tremendously to the bargaining power of the accountant with the plaintiff's counsel in a civil class action suit, and the fact that a government type agency, a quasi-government agency that is theoretically the regulator of all auditing, with no ax to grind, might say that the accounting firm did everything that can reasonably be expected under the circumstances, is a very powerful argument, and what it would do is at least reduce the settlement amount. It might also result in more trials because the auditors then may feel comfortable enough to go to trial.

They don't now because what they're afraid of is that the juries will simply not understand what they are being confronted with but when they hear a specialist from the government side of things saying that the accounting firm did all right, that's probably going to be a very powerful argument, even though there is this professor from, maybe even from Columbia, who says that it's not--

MS. PALMROSE: Most likely from Columbia.

MR. WALLISON: --satisfactory. That's right; it could well be from Columbia.

MS. PALMROSE: So it responds, in some ways, to Jack's concern, but in other ways, his concern is a real one certainly. Can I just add one more thing on one of Peter's comments in terms of the estimate proposal. I have seen obviously and read about this proposal where you'd bifurcate the financial statements into sort of hard numbers versus soft numbers, and the auditor would express an opinion on the hard numbers but not an opinion on the soft numbers.

I find that an extremely problematic route to take, one, even as an academic who's done restatement work and tried to sort through whether restatements involved hard numbers or soft numbers. It's very difficult to sort them into those baskets. So it's far more problematic than you would think to go through the financial statements and try to figure out, oh, which ones.

And, frankly, the estimates can be handled--I would actually--I don't know why the schedule 2--there's what's called schedule 2 in the 10K that gives, is supposed to give the valuation account information, the beginning balance and the flows and the ending balance. So you have essentially the debits, credits, and the beginning and ending balance, which is an extremely informative schedule.

If you're doing fundamental analysis, you like to use that schedule. It's a way of showing some light on what happened through those big estimate accounts which are getting the focus of attention on this and it's a very easy solution to providing more disclosure around estimates, which issuers have not done, and the SEC has not brought them, you know, to the table or forced their feet to the fire, whatever the analogy is, to do that.

So it seems to me that there are other ways of dealing with the estimate problem that would recognize and allow the market to make their own assessments of the judgments and estimates that go into, you know, sort a second-guess and then do the estimates provided by management without getting into this very problematic morass of figuring out what are hard numbers and what are soft numbers and start bifurcating the financial statement.

Users want, I mean they do want a number. They have to know it's not accurate. If you want a number, it's going to be precise but not accurate, and having said that, they still need a number.

You know, so having these financial statements with ranges or having them bifurcated into estimates and others, I just find--I'd never seen them put in play in a way that made any sense to me. So that's the problem with that proposal.

MR. PARTNOY: Frank Partnoy. With respect to the proposal, there are a number of precedents for court-appointed experts. They're typically in cases where there's a bench trial, not a jury trial, so the tax court is one prominent example, and I think the reason for that is I very much agree with Professor Coffee on this one. I think the thinking is that from a jury's perspective, there just isn't that much difference between a quasi-government expert and, you know, that's one factor that weighs in, but you could get an expert who used to work for the entity, you know, who just stepped down and is now a professor, and from the jury's perspective, I think the thinking anyway is it's not such a big deal.

But there is a precedent anyway, from a bench trial perspective, and I think the tax court, if you wanted something to look to the tax court would be an example. I want to just briefly.

This is fascinating to me because it seems like we're ships passing in the night with respect to some of the fundamental issues associated with this conference and those are what does it mean to be a gatekeeper and what does fraud mean, and it seems to me that part of the gatekeeper function has to be to detect fraud.

I mean, fraud is--we're talking about material misstatements when we're talking about fraud, or omissions, where there's a duty to speak, and one of the interesting questions I think has come out of this is who are the gatekeepers for fraud.

There are various levels of fraud. We started off today with Japan where you might think that auditors are being paid relatively low-level fees and they're not being expected to find much fraud.

They might contribute slightly, so that there would be some material misstatement or maybe not a material misstatement, some misstatement that would have occurred and now it's not going to occur because the Japanese auditor found it. In the U.S. we have--we think that the auditors are finding some misstatements, that's part of the function, and Zoe-Vonna, you said that unauditability facilitates misstatements.

And so there's clearly a line where the cost-benefit associated with an audit no longer makes sense. But I don't think that line is fraud.

It goes to the question of what you're buying when you're buying an audit. People are paying a lot of money for these audits and we're not thinking that they'll detect every fraud, they won't detect everything, but they'll detect something; right? And so I think that one question I have after this discussion is who is the gatekeeper for fraud.

The auditors are saying we don't detect fraud and the credit rating agencies say, oh, we don't detect fraud, and the analysts don't detect fraud.

So fraud is something that we think, based on Professor Coffee's analysis of who a gatekeeper is, we have institutions out there that should be playing this function and it sounds to me like everyone's saying this is not me, it's someone else. So who are the gatekeepers for whatever level of fraud we're talking about?

MR.   : One answer is that it's certainly ex post, I mean--

MR.   : About the--

MR.   : Yeah.

MR.   : [inaudible]. Go ahead.

MR.   : Fraud is not misstatement. Fraud--at least I have never considered it that. I mean, there are misstatements that are inadvertent but frauds are deliberate efforts to deceive, and when you have a deliberate effort to deceive, as you did in WorldCom and as you did in Enron, there, I think a management that is intending to deceive is very likely to get away with it.

And so what we do to deal with that, as we always have done, is prosecute the wrongdoers after the fact, ex post. The problem with Sarbanes-Oxley, more than anything else, is that it assumes that you can prevent fraud, ex ante, with certain kinds of procedures and what it really is doing is imposing on all companies, all public companies, all kinds of costs on that assumption, when, in fact, of all public companies as we now know, there will only be handful of frauds.

So we are making a big mistake by attempting--or giving people the impression that there are gatekeepers who can prevent fraud, when frauds are relatively rare. When they occur, they get a lot of attention but they're relatively rare and what we ought to do is just prosecute the wrongdoers.

MR.   : Can I say one quick thing. It's absolutely the case that mental state is a part of fraud but you used probabalistic language when talking about which frauds can be detected and so i think it's an interesting question. Is everyone in agreement here that gatekeepers can never detect fraud and that we shouldn't think that they're in the business of detecting fraud, given whatever mental state requirement you think there is?

Or is it the case that there's some other line drawn--obviously, we're going to rely on ex post enforcement, right? but is there a role for the gatekeepers with respect to fraud.

MR.   : Why don't we let Leslie weigh in and then we'll go back.

MS.   : I just had a question for clarification.

MR.   : Is it still on fraud?

MS.   : Yes. Leslie Boni. Just a quick question. I've heard Jack Coffee talk about income smoothing and at lunchtime when you showed corporate managers, big incentive in the last five-ten years, my option value go up, if I could smooth income a little bit, if I could get another--

MR. COFFEE: Spike it rather than smooth it.

MS. : Yeah. One person's spike, another person smoothing. Would that be fraud?

MR. COFFEE: Today, it could be--the SEC would say--and there are some currently pending cases where the SEC would say that that kind of deliberate, quote, earnings management could be fraudulent.

It's very hard to define the line between legal and illegal earnings management, something can be done, some timing decisions are appropriate.

I think you'd also find that the SEC would say there was a 404 control problem that you were able to do this.

MS. : And if in fact this is fraud, then are we talking about just a few companies or was this pretty common--

MR. COFFEE: Well, just restatements. You had 12 percent of all listed companies at the top of the market. Is that a few or is that a significant number? I think it's probably enough to affect investor confidence and if our goal is to lessen the cost to capital, we've got to deal with the prospect of reduced investor confidence cause it increases the cost of capital.

MS.   : In terms of the statistics on restatements--

MR.   : [inaudible]. Is your mike on?

MS.   : In terms of the statistics on restatements, we found that about 20 percent of them would involve what we would have objective evidence, either on the part of the issuer, saying, ah, fraud, sorry, and/or other objective evidence like criminal indictments or SEC enforcement actions. About 20 percent of them, actually a little bit less than that, involved fraudulent--

MR. COFFEE: That's underreporting cause you're saying clear evidence of fraud which is not easy to find.

MS.   : Sure; sure. But then some would say that it's biased if you include SEC enforcement actions because not all of them are true frauds and the SEC is bringing them and it's easier to settle them and get out of it than it is to fight it. So we're biased on both ends.

The problem is that it is this blurry area, we have this earnings management research that's a whole big literature but no one distinguished between what's really non GAAP and what's GAAP. So there are things that are allowed under GAAP and the SEC can do all the posturing it wants in terms of saying they're going to come down hard on earnings management but essentially they can't do it unless it's non-GAAP financial reporting, and there's a lot of blurriness in it, blurriness around estimates and judgments, blurriness around choices, and the fact is if you look at these high, abnormal accrual portfolios on either side, you find that the frauds in them are very low, you know, single digit, maybe thirty at the most out of, I think in the paper I have like 6700 public companies and it turns out, ex post, either somewhere between five or thirty, depending on the portfolio, have objective evidence of fraud.

So it's the fact that ex post plaintiffs can't tolerate that the fraud was in their investment and it's problematic when you have really high cap values. I mean, you lost a lot of market cap with a revelation. So it's those two problems that we're sort of trying to get our arms around here.

MR. : Let me just interject this. All right. So back to Frank's question about, you know, ex ante versus ex post detection or fraud and so forth.

So I come from an antitrust world and I'm thinking an analogy. All right. The antitrust laws say instead of saying it's against the law to have fraud, they say don't price fix.

Okay. Now we don't have the equivalent of PCAOB or anything else like that to go out and, you know, scrutinize whether people are price fixing. We have the interrorem effect after the fact that when you are a price fixer we throw you in jail.

[Start tape No. 4A.]

MR. : [in progress] about to go to jail and God knows how many people from Enron are going to go to jail. So, you know, after the fact, the most cost-effective thing to do is throw a few people in jail and scare the hell out of people, and rather than have a 20- or $30 billion apparatus every year, set up trying to detect fraud before it happens. I mean, that's an open question.

MR. : Yeah. In fact the reason is that it's so difficult to determine what is fraud.

MR. : In advance.

MR. : In advance. And even after it's occurred, you have to have a trial, very frequently. So my problem was--if I can just respond to Frank's point--that is that we are predicating a liability system, we're allowing the idea to become generally accepted, that someone is supposed to stop fraud, some gatekeeper is responsible for this, and at least as I define fraud--maybe this may have been an exceptionally narrow definition--but if a management wants to defraud, as the WorldCom management apparently did, and a few others, they can do it, and if we're going to hold someone else responsible for it, or create a vast system to prevent it from happening, we are only protecting the shareholders of the very few companies where that will happen at the cost of everybody else, and the much more sensible way to do it is simply, after the fact, to have a trial and determine who, in fact, had the intention of deceiving.

MR. : [inaudible--comment off-mike].

MR. : I just think that that goes a little bit too far. There's a deterrent value to this. I mean, people go through red lights and we've discovered that you put up cameras and you're taking pictures of millions of people who don't go through the red light, you've got all the costs, but you do deter and you do catch some.

Part of these rules will make it easier to prosecute frauds. You won't be as able to do as some of these guys have. I didn't know it was going on; right? Because you're establishing an internal procedure that they have to certify. So in the future, they can't make the argument they didn't know, and if people believe that there's a big apparatus there, they're unlike--one of the reasons that there's not more fraud in the American corporate system, I think, is a belief that there's a lot of internal checks. It's a basically honest--you go to other countries, this is very, very common in some of the countries I deal with. That you would say an enormous proportion of the committee engage in fraud, internally, because there are known to be no internal checks.

So I think you've got to take both of those into account.

MR.   : [off-mike comment.]

MR.   : [off-mike comment.]

MR. DODD: This is Ronald Dodd. I didn't know there were noneconomist--nonlawyer and economist response to this, and I was just kind of going to follow up on what Barry was saying, and that looking not only at the role of deterrents from criminal prohibitions but also look at other gatekeepers and what they do. We have banks that are examined to try to prevent fraud. We have auditors that are required for public companies and the purpose of the examinations--and the auditors are, to one hand, produce useful market information so we can better price assets. But one collateral benefit of that is to also have some standards by which they perform, in which they should detect fraud, and they should be required to report it, if detected.

That doesn't mean they're going to prevent all fraud. It doesn't mean they can prevent all fraud. But if they're going to engage in these activities for the purpose of public capital raising, then you might as well also have them have a standard for detecting and reporting the fraud. It seems like an important collateral benefit and as Mr. Coffee argued very well earlier, this is going to reduce the cost of capital in our capital markets. It's going to attract investors from abroad as well as at home, and it seems a very odd thing to do, to me, to punt this responsibility and this collateral benefit of all these examinations and auditings that are occurring.

MR. : A quick answer, peter, and then we'll go to Art.

MR. WALLISON: Well, it actually doesn't reduce the cost of capital. It increases the cost of capital because you're imposing unnecessary costs. If you just prosecute people after the fact, then you achieve everything you would ordinarily have achieved, but if you try to put in expensive processes beforehand, you increase the cost of companies and reduce their earnings, and increase, thus, their cost of capital. So I just don't see that argument.

MR. : What if part of this big increase in cost occurred with an increasing, complicated structures of these firms? If you have a simple firm, your auditing costs are probably small and simple. If you're going to set up a firm with a lot of special purpose entities, that auditors have to, you know, go down the rabbit hole to discover the origins of, then maybe that's just what was previously an unaccounted for cost, in a sense, but now you're bringing it back on the books, of trying to set up these complicated structures, cause that's one explanation for why auditing costs have gone up, is that the structure of the firms and they ways they're conducting business can be much more complicated.

And in a sense, if you're going to do all that and use SPEs, then why shouldn't there be a more adequate assessment of the social cost of these entities, because they're otherwise creating a lot of nontransparency and a lot of difficulty, by investors, in trying to ascertain where the credit risk is, the legitimacy of the earnings, the legitimacy of the revenue, and this sort of brings that back where it ought to be.

MR. : Yes, as a nonaccountant--

MR. : Art [inaudible].

MR. : Art Walmarth [?] again. With some caution, because I'm a nonaccountant, I raise two points which I think, you know, complicate the whole issue of auditing standards today and make more difficult a lot of the issues we're talking about, because there's a real move--and Professor Palmrose mentioned this--there's a real move toward market value based accounting, and Enron was partly a story about how market value based accounting was absolutely manipulated, you know, to create the fraud that happened there.

And so market value based accounting requires all kinds of judgments based upon, allegedly, all kinds of complicated financial models about what something is worth today, even though you can't point to any cost basis for what you're alleging as the market value.

The other trend, which we see, is this rejection of rules-based accounting and what seems to be a broad movement toward adopting principles-based accounting, which would adopt, apparently, very broad statements of principle, like, well, you should disclose all materially-important matters, and not specify all the rules that go into figuring out what materiality means.

And so it seems to me that if these trends continue, we're going to get more difficult and complicated judgments about did the internal management people exercise informed nonfraudulent judgments and did the external auditors exercise, you know, prudent, diligent oversight in figuring out whether these market-valued based or principle-based disclosures were appropriate.

So I think these problems, unfortunately, are going to get more complicated, not less, and I think we need to be careful about both trends.

MR. LITAN: Jack, actually, before you raise your hand and talk--this is Bob Litan--can I ask you a question in the course of which you can answer and provide your own comment, and that is, do you share Zoe-Vonna's premise, from her paper, which basically says--and correct me if I'm wrong, Zoe-Vonna--but the premise of your paper is there may be unintended consequences of all this activity, and that accountants may be subject to, you know, enormous, you know, catastrophic risk from their point of view, and what her proposal is designed to do is at least try to limit that risk in a sensible way. All right.

Do you share her premise, that maybe there's an unintended consequence, that we have this danger, and if so, what would you do about it?

MR. COFFEE: Of course I've already the view that there should be a cap on liability, so we don't have a market failure and drive firms two, three or four. Frank and I disagree on where the cap should be. My cap is lower than his cap as I see it. But in any event, I think that we don't want to drive a firm out of business. I think the only purpose of liability is not compensation but is deterrence.

Personal service firms. These are partners. There's never enough capital in an accounting firm to pay real compensation on the scale of a major failure. Therefore, focus on what you can do, which is deterrence. I think you can get that by using some multiple of what the audit fee was or the total compensation from that auditor.

What I would tell you, where I really want to disagree with some of the discussion here, is I think there is significant division within the accounting profession as to what the auditor's responsibility is for fraud detection.

Since something called the Treadway Commission, 20 year ago, followed by the Council of Sponsoring Organizations, which are self-regulatory bodies, there is one school of thought that accounting has to move in the direction of accepting a greater responsibility for fraud detection.

This can be debated but that is one school of thought.

Section 404 is essentially an ex ante attempt to do something to reduce the probability of fraud by putting in internal controls. Passed the Congress almost unanimously. I don't think you can ignore it and say this will be removed.

I think there are ways that internal controls can work. We keep using the WorldCom example. I agree, no auditor could have detected that, ex post, but Scott Sullivan made a top-down adjustments of 100s of millions of dollars. Had there been appropriate internal controls, he could not have done that.

So there are ways that a new system could have prevented WorldCom or at least reduced the prospect of WorldCom style frauds.

MS. PALMROSE: I just have to slightly disagree. I actually think that--first of all, 404, I have problems with because there was no voluntary demand for these services before the fact.

In other words, you didn't see companies voluntarily signalling the quality of their internal controls through attestation at all. It was zero, essentially. And the problem with using that mechanism to solve this problem is that fraudulent financial reporting involves management override.

So it's overriding of controls. So what you have to do is have a control system that is really strong to prevent override of controls, and that's a very hard problem. In fact I've worked on several task forces that have tried to, you know, address that problem, and actually put a little bit more responsibility on the audit committees who least want it, but nonetheless, that's basically what you have is the audit committee and the auditor for addressing the risk of management override.

And so that's the problem. It's given the public this notion that somehow if you have good internal controls, we've solved the fraudulent financial reporting problem, when you haven't at all. So I agree with Peter on that one.

MR. : [off-mike comment.]

MS. PALMROSE: Oh, just thank you very much and I really appreciate the comments and the interaction on this issue, cause I think we all agree that there is an issue here and it's just best how to get your arms around it in a feasible way. So thank you.

MR. LITAN: Thank you. I thought that was a very stimulating paper.

[Applause.]

MR. LITAN: We'll take a 10-minute break and then we'll have, stock analysts are up next.

[Break.]

MR. LITAN: If we can get started.

[Introductions are not on audio.] [Most of tape side A is blank until near the end the following:]

MR. LITAN: That was great. George, let's give you a mike.

MR. PERRY: Well, I liked this paper and enjoyed reading it. Leslie addressed a lot of useful and interesting topics and she provides a lot of evidence on the perform of sell side analysts. Since I had no priors at all about what the data would show, the results were all news to me. So what more can you ask for from a paper?

I won't talk about setup that Leslie uses cause she's described it very well just now. She works with data for the individual firm's recommendations and then, in particular, tries to see what changes she can detect before and answer the settlement.

She's got a lot of results and I want to comment on just a few of them. I'll refer to just a pre and post, that means pre and post global settlement, and I'll call them high, low and medium. I'll call them buy, hold and sell instead, since that's what I'm used to, and I'll say that somewhere along the line anyhow.

Well, averaging across firms in her first table, she shows a substantial reduction in sell recommendations in the post years, along with little change in the buys, and on the face of it this isn't what you might expect if, as Leslie correctly says, the concern was that analysts had been guilty of pumping up stocks for their investment bankers in the pre-war years. In the pre--

MR. : Pre war!

MR. PERRY: In the pre years. I'll make that mistake again. But I think a count of individual firms' behaviors gives a somewhat different picture and I did take a look at that, cause I mean, maybe some firms are misbehaving, some firms weren't, so the averages may conceal something.

What I found in looking at individual firms were that analysts at seven of the ten firms reduced their buys by a noticeable amount, which is consistent with the concerns that the paper described and may provide some evidence that behavior was changed.

Of course, I mean, this kind a change, reducing the number of buys, could reflect changed opinions about the overall market rather than an end to bias in the recommendations. But if that's true, then the patter, over time, of the buy recommendations are hardly evidence of good market timing since they reduce their buys at the wrong time.

Table one also provides a measure of how recommendations for individual stocks cluster around firms. I don't think that Leslie talked about that in her presentation but it's in the paper and it's an interesting idea.

The measure tells how many of the ten firms share the same recommendation, buy, sell or hold for any individual stock.

As I said, I think there's an interesting question to investigate, and Leslie finds a small increase in cluster, on average, in the period, in the post period, and that's a result that holds across individual firms.

But if I understand correctly, the measure combined two things. How many firms cover the stock and how much those firms agree.

For example, a cluster value of three, which is kind of the neighborhood of the average that she shows us, a cluster value of three for a buy could mean that the three firms cover the stock and all agree that it's a buy. Or it could mean that ten firms cover that stock but seven of them have a sell or a hold recommendation and so only three have a buy, and those are two very different stories in my mind.

I'd be interested in knowing, if we're going to do this cluster business, both how many firms cover a stock for larger caps, presumably most, and for small caps, perhaps only a couple, and among those who do cover it, what percent agree, which I would take as a rough measure of herding. Either or both these measures might have changed per and post, and it might be interesting to know whether they have.

Now tables 3 and 4 present the most intriguing and puzzling results in the paper and to keep it brief, I want to refer only to table 4 where the results are based on valuated recommendations. There are two striking results here.

First, the buy recommendations outperform the S&P index in every year, surely a sign that clients are being well-served. And second, the sell recommendations outperform the buys in all year but one, surely a sign that clients should look elsewhere for their advice.

Those I think are the two interesting things. Comparing the pre and post years, the buy recommendations do relatively worse in the post years measured against either the S&P or the sell recommendations.

Now what to make of these results, and here I've got a table. Do you know how to punch that up, Barry. Oh, that's it; it's up. Okay. So What to make of these results. Now Leslie suggests that the good performance against the S&P may be explained by a preponderance of small cap stocks in the recommendations and the greater risk investors take on when they buy such stocks.

And she reports that regressions using various measures of risk support that sensible thought. Well, to further explore this and some of the other table 4 results, I put together the table which is projected on the screen, that compares the analyst performance with two indexes, which give more weight to small cap stocks than the S&P 500 does. That's the Wilshire 5000 index, which is meant to be something which has big and small stocks, more or less appropriately weighted as I understand it.

And the second one, the S&P small cap 600 index, which is confined to small cap stocks, in my table, Leslie's data converted, by the way, to annual rather than monthly returns. Same number but it's much more exciting to make the comparisons on the basis that we're all accustomed to which is annual rates of return.

MR.   : [inaudible].

MR. PERRY: I don't get excited about 2 percent a month but I get carried away by 24 percent a year. And also, I omit 2002 when comparing the pre and post performance periods, which is the last two columns on the right. Since regulatory changes were instituted during 2002, if I put them in the pre period, it wouldn't qualitatively change any of the comparison results.

Now a few points are worth highlighting from this little table.

[Start tape side 4B.]

One is that the performance of buys relative to sells deteriorates sharply in the post-war years. I have a copy of this table that I can actually read but in the pre years, the buys outperform the sells by 1.1 percent a year, and in the post years, they underperform the sells by 10.4 percent a year.

So the underperformance of the buys, it really is concentrated in that second period.

That was one--let me see, where have I gone in reading off this table? Now what explanation could there be for this? One that occurred to me is that the stocks that interested investment bankers were in fact stocks that were worth investing in, and in the pre years, their forced entry on to the buy lists overcame relatively poor stocking by analysts, which was subsequently exposed in the post years when we got their own best views of the issue.

That's a cynical interpretation, cynical about the analysts' capacities, but it's consistent with the story that we're trying to examine and trying to change.

But now this explanation really doesn't address the biggest surprise in the data. The Wilshire 5000 index should resemble the universe from which recommendations were drawn, yet when we compare in the bottom, in the bottom bunch of numbers, the bottom panel, the sell recommendations strongly outperformed the Wilshire index in both the pre and post years. That's the sell recommendations, and in the pre years they outperformed the Wilshire by 19 percent a year average, and the post period by 10.4 percent a year average. That's the sell recommendations.

And the puzzle deepens if we look at the comparison with the small cap index. I say deepens because we know that larger caps were sort of covered by all firms and were part of the track record of the analysts that we're comparing with.

So the sell recommendations outperformed the small cap index in both the pre and the post years by less than they outperformed the Wilshire but they outperformed an index consisting entirely of small caps.

So the idea that this performance can be explained by a lotta small caps in the recommendations, and this is a value-weighted measure that I'm using, table 4, just doesn't seem to explain. It's a plausible explanation but it doesn't come close to actually explaining what it is we're looking at.

Now the only conjecture that I can come up with for this result is awfully cynical. Leslie's data comes from IBES, which gets them from the individual firms. The result is so strange that it's hard to believe that the data aren't somehow corrupted. Is it possible that when a rating goes bad, coverage is dropped before the reporting period, so that you never sort of observe the sort of outlier bad news? Or is there some other way that big mistakes go unreported in the IBES data?

Whatever it is, it certainly makes me very suspicious of how accurately those data are reported. And if that's true, then some of the recommendations that Leslie offers, which is that the regulators just use this data and provide the information that we'd all like to have as investors, may just not be reliable enough to, you know, to be worth bothering with.

Finally, let me just turn to a thought about what most concerns investors and regulators, and it was of course that firms with investment banking ties pushed certain stocks on their customers, a practice that surely existed and that concentrated on larger stocks, which is where the money was.

These stocks are in the average figures for everything that was recommended but their performance would be better detected it we could just focus on larger stocks.

Even better, it might be useful if we could focus on just the stocks of large cap firms, that have made use of investment banking.

With a lot of work, I assume that could be done with this data set, though it raises the problem of where to assign a stock whose market value changes sharply. You know, many firms grew from small cap to large cap during the boom and quite a few went from large cap to no cap after the bubble burst.

So off the top a my head, I guess if I had to do this I'd include a stock in a larger category when it got there and then keep it there for some period, say, perhaps half a year after it got small again, just to reflect the actual behavior that we're trying to identify and see whether it's changed.

In any case, if it were possible to analyze one of these subsets of the data, it might bring a sharper focus on the influence of investment banking on analysts' recommendations and evidence of different behavior in the pre and post analysis would suggest that the separation of investment banking from stock recommending accomplished its purpose, at least for now.

But, you know, I hasten to add that one can always ask for more, and the suggestions about a subset of the data might be very difficult and perhaps impossible to actually accomplish with these data.

Leslie's work, using all the data, provide a useful first look at this issue, and even if the analysts' data prove to have some upward bias, even if that sort a my suspicion that they just can't be true, or can't be unbiased is so, so long as that bias is always present, it need not detract from the comparison of pre and post performance that this paper provides.

MR. LITAN: Okay. Anybody want to weigh in?

MS. BONI: This is Leslie Boni. I'd like to thank you for your comments. Let me try to clarify a couple points. First, thank you for the careful read and for your thoughts.

First, you mentioned the clustering. I absolutely agree. It would be helpful to the paper to standardize or adjust for conditional on how many firms covered and what percentage were on the same side. The other thing I guess I would suggest might help for that would be let's take the case I mention in the paper, where AT&T, everybody knows AT&T is thinking about issuing $30 billion worth of bonds. And suppose all ten firms want to go after that business.

We might find that for that one stock, for a three month period, they all moved to their strongest buy, and by looking at 850 stocks, on average, we wouldn't see that result. So it could be that we need an even better measure or a finer measure to take a look, and there are some academic papers that have tried to take a look at that. It's tricky cause you have to compile the underwriting data for an issue [?]. I agree. To get at that question would really need some good work.

As far as trying to reconcile the small cap stock results and what implications that might have for whether this data is correct or not, and I apologize if I didn't make this clear enough in the paper. The regression that is run to examine risk factors, it's not just for small cap stock risk. It also takes a look at what we call beta, or just how volatile price is. It takes a look at, relative to a market index, so there are four factors. There's the small cap that you look at, there's the beta risk, there's book-to-market value.

So that tries to take a look at what some people call value versus glamour stocks, and certainly during the tech bubble, there was a heck of a move to cover what would be called glamour stocks or low book to market stocks. So that risk is in there. And then there's a fourth risk which people say is momentum.

And so there's a French model that identifies portfolios forms of those, that have those four different factors, we run the regression, so small cap stock is one risk but then there are the other factors as well, and didn't report those results, but it could be useful to go ahead and highlight the differences in how the highest versus lowest recommendations load on those factors, because it's not all small cap stock risk.

So that might be a little bit where it's hard to reproduce that by looking at an index and not taking a look at the actual regression results, if I understand what you were doing, to try to look at small cap.

MR. PERRY: Yeah. I guess I just took a poor man's approach to seeing whether, you know, the small cap bias was what we're looking at.

I don't know the regression you're talking about, but what did it do? It managed to explain, say, the performance of the buy recommendations. Just for example, you took the buy recommendations, you stuck all these factors on the right-hand side and you tried to see--

MR. BONI: Then we did a time series regression, so we took at look at--say you had taken a small cap risk, a beta risk, and so you had four types of risk, not just the fact that you were testing a small cap, and--

MR. PERRY: So you've got four guys trying to explain the left-hand variable.

MS. BONI: Right. And for the highest recommendations portfolios and the lowest recommendation portfolios, for three of the four types of risk, for the small cap, book to market, and for the beta, the recommendation portfolio is high or low, were pretty similar in how they loaded.

They all took on more risk, similar risk, and the real difference came down to the fourth factor which was momentum, and that's the idea that's pretty well-documented for the last ten years, that if you just have a strategy where you buy stocks that have been going up for the last six months and you simultaneously short sell stocks that have been going down, you can make, on average, a percent, a percent and a half per month, which I know won't excite you but that's 12 to 18 percent per year--

MR. PERRY: No, that's what--

[Simultaneous conversation.]

MR. PERRY: That's what excites me; right.

MS. BONI: So it turns on this has been documented by some other researchers, that what analysts have tended to do is they load up. They make their strong recommendation stocks, they go ahead and they use that information sometimes, they say, well, stock's been going up, I'm going to go ahead and upgrade it. So they try to piggyback by taking more--you know, that's documented--

MR. PERRY: But that discriminated, if I understand you, between the buy and the sell. That helped explain the better performance of the sell group.

MS. BONI: And what happened is although--

[Simultaneous conversation.]

MR. PERRY: The sell group used more momentum?

MS. BONI: Actually, they used less momentum--

MR. PERRY: Less momentum.

MS. BONI: --and what it turned out is in the period we're looking at, it turns out momentum was not a good thing, although historically it had been a good thing. It turns out it wasn't a good thing--

MR. PERRY: It sure wasn't in March of 2000. But the problem with this still, as an explanation, that is, if our alternatives are the data must be biased or we can explain it by these things, that regression's always going to explain it, isn't it? Forget the buy versus sell comparison. You're always going to end up explaining it, aren't you? and you're going--

MS. BONI: Sure.

MR. PERRY: --to find that you loaded up on these risk factors. But that still doesn't tell us whether it's extraordinary because you're always--maybe I misunderstand the exercise but it seems like you're always going to fit it, the error is going to have a mean of zero.

So you're going to discover that--

MS. BONI: Well, an alternative--

MR. PERRY: The best I can do is to believe that one of these factors explained it, and they are going to pick up some more weight.

MS. BONI: Well, an alternative would have been we--a result that we didn't get was that analysts recommended that you guy stocks that had lower risk, lower nonrisk factors. In other words, they put you in stocks that, on average, had the same kind of these risks that you would have gotten if you just invested in the S&P 500. In fact they put you in lower risk stocks. But that wasn't the case. Or perhaps the high recommendation stocks had different risk levels, and you expect a higher return for risk. So that's what we were looking for and I apologize, if I didn't explain--

MR. PERRY: No; no. Quite all right.

MR. LITAN: All right. This is Bob Litan. I have a question. All right. So at 40,000 feet--this is what your paper screams out to me. All right. Sell side analysts are basically worthless, and if anything, we ought to not--

MR.   : It's not to them.

MR. LITAN: Yeah. Well, we ought to not do what they tell us to do, or whatever. Certainly, we ought to buy their low recommendations. And to George, these results are so incredible, that maybe he worries about the quality of the data.

So I want to ask you: What do you say about this?

MS. BONI: I think the SEC could, instead of relying--if your concern is the IDES [?] data--

MR. LITAN: Yeah.

MS. BONI: They could easily take the recommendations, LIFBE [?], just like they'd take for compliance purposes, LIFBE from the New York stock exchange, and the Nasdaq for stock prices. They could simply--it'd be pretty easy to just require that any time there's a recommendation change, it goes in electronic dump [inaudible] the brokerage firm to an SEC database.

MR. LITAN: Okay, but in any event--

MR. PERRY: And with a fair price attached to it, and so forth. I mean, they're going to actually do all this data processing.

MS. BONI: Well, the SEC has--

MR. PERRY: You know, mines of data.

MS. BONI: --[inaudible] of closing prices every day, so they could just put it in. It'd be pretty easy to take the direct feed.

MR. LITAN: This is Bob again. let me ask George. But regardless of what you believe about the quality of the data, do you agree that Leslie's recommendations at least make sense?

MR. PERRY: Sure.

MR. LITAN: Yeah. And in fact if your data are right of course the--

MR.   : [inaudible].

MR. LITAN: Because--well, basically--

MR.   : It's called--

[Simultaneous conversation.]

MR. LITAN: It would show these guys are worthless, which of course, why, they would go nuts, they would go nuts at forced disclosure. But it would make transparent for all the world to see that these guys don't add any value. Right?

MR.   : Well, what if he collects historical information on a group of people who have no value?

MR. LITAN: Well, because this would make it transparent.

MR. : I know a homeless guy out there--

[Laughter.]

MR. PERRY: Oh, no, no, no. No. Come on, Barry. If you need to demonstrate it, I just think that institutionally it'd be very hard to say we're going to prove that recommendations from brokerage firms are useless. The SEC, just somehow, isn't going to go quite that far.

MR. LITAN: But the NASD could do something like this. Well, I mean--

MS. BONI: I don't know. I guess I'd look at mutual fund reporting, and they're required to report.

MR. LITAN: Yes; they are. Historical performance.

MS. BONI: Yes.

MR. LITAN: Yes.

MS. BONI: And it doesn't seem like a stretch if they're already asking that they report individually, stock by stock, historical price performance. It's not asking that much to say every month, take a look at your [inaudible].

MR. LITAN: I mean, this seems to be a lot more productive than what Eliot Spitzer forced on the industry of this complicated system and funding all this other independent research and so forth.

MS. BONI: Well, I think there's $84 million of investor education money that could--I mean, I don't think it would cost that much to--here's an investor education Web site. Here's a staff. Pick your firm.

MR. LITAN: Yes. Did you want to--

MR. : I want to try a slightly different 40,000 foot explanation and see if this works. I'm not sure that it does. But I liked this paper a lot, the results are quite provocative, and I'm wondering if sell side analysts are like Yale Law School.

This is one you might appreciate. Basically, getting on the list, you know, getting in is the value, and they do a really bad job of grading once you're in, and so once you're in the group of stocks that are being rated, that has some value. But it's like, you know, the C students are the ones who make all the money, is the sort of joke here.

So is there any credibility to that at all, is one question. And then the second one, I'd love to hear, given that you've looked at how the nomenclature of the ratings has changed over time, is this an exercise in the power of euphemism? They're changing to all these different, outperform and all these different things. I'm just curious of your sort of qualitative explanation of what you think about the move from relatively simple categories to this much longer list of categories.

MS. BONI: Well, they've tried to go the other way. They've tried to go to getting them toward simple buy, sell and hold.

MR.   : Well, I know that you do that in the paper but we've got--

MS. BONI: Post-settlement, the firms have renamed to, of course toward narrower definitions--

MR.   : Well, but a lot of these firms now--so maybe I'm wrong--but a lot of these firms now have continued to use very subtle gradations of overweight this and not overweight that, and pure market perform and--

MS. BONI: Well, I share your sort of--you look at the data and you say I'm stymied. You're so stymied, you're thinking the IBES data must be corrupt. I'm stymied, thinking how can they keep issuing recommendations, cause they must be looking at this inside the firm, and I'm stymied because apparently they're issuing them because somebody's asking them for them, I guess. So I'm--

MR.   : Just on this question of corruption, clarify one thing, cause the paper was a little bit short in this. It's self-reporting but you have a footnote or something that says once you start reporting IBES, you're supposed to continue reporting--

MS. BONI: It's my understanding--

MR.   : But you don't go to jail; right?

MS. BONI: No, no, no. It's just my understanding that they don't self-select, that they--what they do is--what happens is the reason that IBES has the data historically is because real-time institutional investors subscribe to IBES as a way to get the information about recommendations, and so Goldman Sachs doesn't know in advance whether this recommendation is going to do well or poorly. Right. They issue a recommendation, and once it's out there, IBES holds on to it.

MR.   : Yeah. But I drop something, I drop coverage on something.

MS. BONI: It's still in the IBES database and it records it as stopped, it's no longer covered.

MR.   : But that last month, you know, when the stock blows up on me, okay, the stock blows up, and I say oh, drop this thing. So at that point it's not in the data bank. It's such a small technical question, that maybe nobody knows the answer.

MS. BONI: No, I do, actually. The firm would issue to its clients--"Hey, stop coverage."

MR.   : Right.

MS. BONI: And that's a lot of times what they'll do. They'll say it's under review.

MR.   : Right; yeah. "We're stopping coverage; right.

MS. BONI: At that point it gets issued as a stock and IBES picks it up and they create a separate data set that we read, that says firm such and such stopped coverage. At that point we go ahead and we say okay, that's it, that's the last month you would have--at that point, if you had bought it, you now sell it.

MR.   : So you record, but you record--so they stop coverage on May 20th.

MS. BONI: That's right.

[Simultaneous conversation.]

MR.   : On your May 30th--

MS. BONI: That's right. We'll have--

MR.   : --you will record the May 30th price--

MS. BONI: That's right.

MR.   : --as being the performance for that stock.

MS. BONI: That's right.

MR.   : All right. Okay. So--

MS. BONI: If they got it right by ten days, we've cheated them.

MR.   : No; no. But--

MS. BONI: Yeah. But that's right; that's right.

MR.   : Well, we know they get it wrong, so--

MS. BONI: Chances are they'll stop coverage after it went down the first 20 days of May, but people probably had something [inaudible].

MR. LITAN: Any other comment? Yes, Art; back there.

MR. WALMARTH: Yes. Art Walmarth again. I have one comment. You know, Chuck Prince decided that he was going to split up the brokering function from the asset management function, which I thought was a very significant move, sort of saying I can't manage these conflicts anymore.

Does your paper really say that Chuck Prince is right and that basically, you know, brokers ought to be over here and asset managers ought to be over here?

MS. BONI: Did he say we're going to shut down the sell side research?

MR. WALMARTH: I'm sorry?

MS. BONI: Did he say I'm going to shut down the sell side research?

MR. WALMARTH: Well, the question would be do you think that having gotten rid of the brokering function, which creates a lot of the conflict, and really, okay, now you're the asset manager and you really want just to tell your people what to do, do you think that the sell side research should be better or do you think these people are just stupid? Or are you--

MS. BONI: I think if we reported the numbers every month, we could see that. Right? We could--if they had to report them that way, we could tell, and until I do, we can't answer it.

MR. WALMARTH: I think that'd be a very interesting sort of--a "straw in the wind" so to speak. Now we actually have the market, a major market player deciding to split these functions which have been, you know, fused together by most everybody except for Vanguard for a long time.

It always seems to me that Vanguard would seem to have consistently the best performance, has always rigorously, you know, separated these functions. They haven't seen themselves as, you know, broker dealer salesmen in the way that most other big firms have been.

MR. PERRY: Okay. We'll just assume that that's the last comment. I want to thank you. This was a fascinating paper.

MS. BONI: And thank you, George.

MR. PERRY: This was great.

[Applause.]

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