Conflicts of Interest, Low-Quality Ratings, and Meaningful Reform of Credit and Corporate Governance Ratings

by

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Corporate governance ratings have become an important component of proxy voting and shareholder control. Corporate governance ratings, however, are different from other ratings in that they measure relatively intangible components of corporate performance and are not easily modeled. Furthermore, existing empirial work has not been able to identify robust linkages between corporate governance ratings and value creation within firms; there is little evidence that corporate governance ratings create significant shareholder value or increase the quality of corporate governance practices. We develop a new interpretation of corporate governance ratings that sees ratings as a means of expanding or redistributing the aggregate economic rents that accrue to incentive-conflicted management, institutional investors, and rating agencies, and we argue that this could explain the popularity of corporate governance ratings among institutional investors and managers. If important conflicts of interest lie between institutional investors and their clients, the ultimate investors, then institutional investors may demand meaningless ratings as a means of increasing their rents and avoiding accountability. Because of the market power that can be exercised within the existing manager-rating agency-institutional investor alliances fuelled by those rents, competitive pressures alone will not be sufficient to overturn these bad equilibria. Hence, without appropriate regulatory interventions, the perverse incentives that encourage rent-seeking via low-quality corporate governance ratings will persist.

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I. Introduction

Policymakers and academic critics have identified "conflicts of interest" in the rating industry that have led to poor ratings quality, harming investors who purchase over- or mis-rated investments. We address the question of whether conflicts of interest can arise in the ratings industry without the monopoly benefit conferred by regulatory licenses like those given credit rating agencies that operate as Nationally Recognized Statistical Ratings Organizations (NRSRO). We show that incentive conflicts are apparent in the corporate governance rating industry, despite the lack of a formal regulatory role for the agencies.

Entrenched corporate governance rating agencies that earn large fees for providing low-quality ratings are able to take advantage of the fact that the users of ratings (institutional investors) are conflicted. Ultimately, for the market to reward high-quality ratings, the demand side of the market must care about ratings quality. Otherwise, competition will be muted and low-quality ratings will be tolerated or encouraged. Institutional investors investing on behalf of their clients face imperfect discipline from clients for failing to buy the most useful governance ratings, and may have reasons for preferring low-quality ratings. In that case, conflicts of interest lead institutional investors to demand corporate governance ratings that benefit themselves at the expense of ultimate investors, which can sustain dominant but low-quality rating agencies, and insulate them from competition from new entrants producing better ratings.

Why would institutional investors demand low-quality corporate governance ratings? Institutional investors enjoy private benefits from doing so, which accrue to them rather than to their clients, the ultimate investors. Those private benefits include: (1) avoiding legal liability for their decision making processes when selecting portfolio firms, (2) avoiding accountability to their investors for poor firm performance, and (3) other potential private benefits that institutional investors gain at the expense of stockholders through their alliances with rating agencies.

When institutional investors are more concerned about these private gains that they are about the returns earned by their clients, they will form mutually advantageous implicit alliances with established corporate governance rating firms that pursue rent-seeking strategies and produce noisy (low-quality) governance ratings. Those alliances will undermine competition among governance rating agencies and give artificial market power to dominant rent-seeking rating agencies that produce low-quality ratings, effectively protecting those rating agencies from competition that they would otherwise face from new entrants with better governance rating models.

Given their protected status in such alliances, governance rating agencies will, in turn, be able to exact more rents from the firms they rate (e.g., in the form of requiring those firms to pay for superfluous consulting services about proper corporate governance practices). They also may use their market power to influence decision making at the behest of institutional investors (e.g., by encouraging corporations to meet the demands of those investors that are not value maximizing for stockholders; this is a particular concern in the case of pension funds that represent workers).

The results of this "bad equilibrium" are low-quality corporate governance ratings, rent extraction through rating agency "shakedowns" of public firms, reduced market discipline on public firms' performance, and reduced market discipline on the behavior of institutional investors. This equilibrium serves the interests of institutional investors and governance rating agencies at the expense of ultimate investors.

Without appropriate regulatory interventions the perverse incentives that allow entrenched credit rating agencies and corporate governance rating agencies to dominate their respective industries will persist. Because of the market power in existing industry alliances, competitive pressures alone will not be sufficient to overturn these bad equilibria.

In Section II, we review theoretical arguments about the sources of low-quality ratings, placing corporate governance ratings and credit ratings within the broader context of the literature on ratings quality problems and "conflicts of interest" in the production of ratings. In Section III, we describe empirical evidence on the corporate governance rating industry. Section IV considers appropriate regulatory interventions that could help to restore good equilibria in credit ratings and corporate governance ratings.

II. Incentive Conflicts that Produce Ratings Inflation or Low-Quality Ratings

Over-rating (or ratings "inflation") in the ratings of securitized subprime mortgage-related debts is commonly cited as a cause of the recent financial crisis. But the discussion about ratings problems sometimes confuses the phenomenon of ratings inflation (changing the scaling of ratings to exaggerate credit quality – for example, by giving a AAA rating to debts that used to receive a AA rating) from the production of low-quality ratings (the employment of ratings methodologies that are based on fundamentally false assumptions about measuring risk, which therefore, have little information content).

The credit crisis occurred *both* because the fundamental methodologies used to measure the risk of the asset or asset pool of the issuer was flawed (the production of "low-quality" ratings) and because rating agencies inflated debt ratings. In fact, while rating inflation has been acknowledged in the industry since at least the mid-1990s,[2] the extreme low-quality ratings methodologies of subprime mortgage-related securitizations did not arise until recently.

The reason ratings inflation could persist without causing significant problems is that inflation may be beneficial to the buy side of the market (institutional investors buying the debts, including banks, insurance companies, pension funds and mutual funds) because rating inflation is a means of regulatory arbitrage. Rating inflation relaxes prudential regulations on buy-side institutional investors in three ways: (1) Inflation allows banks and insurance companies to maintain lower

[2] "The Credit Rating Industry," *Federal Reserve Bank of New York Quarterly Review* 19 (Summer 1994), 1-26.

required equity ratios against the purchased debts. (2) Inflation may fool unsophisticated clients of institutional investors by making it appear that their portfolios are earning higher than normal returns relative to risk. (3) Inflation increases flexibility in portfolio management by removing potential constraints that might restrict the purchase or force the sale of lower-rated debts.

If the methodology for measuring the risk of an asset pool against which rated debts are issued is sound, then inflated ratings on the debts backed by that asset pool can be "adjusted" to recover the correct rating. Hence, rating inflation need not be particularly pernicious.[3]

Low-quality ratings, in contrast, are *never* helpful to investors, since bad methodologies for measuring risk – whether credit risk or corporate governance risk – cannot be "adjusted" by institutional investors to recover the true estimates. Moreover, as the recent credit crisis has demonstrated, when methodological flaws are revealed market confusion over the measurement of risk can result in extreme illiquidity in both primary and secondary markets.

Low-quality ratings, therefore, should not be observed in a world in which agents (that is, institutional investors) are willing and able to establish procedures that perfectly align the incentives of rating agencies with the interests of principals (the ultimate investors). But low-quality ratings do exist. Evidence from the subprime debacle suggests that rating agencies provided low-quality ratings, not just inflated ones. Moreover, as we will show, there is evidence that corporate governance rating agencies also provide low-quality ratings, despite the lack of market protection offered by NRSRO licensing in the corporate governance rating industry.

Low-quality ratings can result from one of two alternative "principal-agent" problems involving three distinct parties: (1) a conflict of interest between "*rating agencies*" and institutional "*intermediaries*" (usually institutional investors, banks, and insurance companies), or (2) a conflict of

[3] It can be argued that credit rating inflation may even benefit ultimate clients (pensioners, stockholders in mutual funds, banks, and insurance companies) in boom states of economy if relaxing regulatory limits improves the performance of the portfolio managed by the institutional investors. Of course, given the risk-adjusted nature of debt yields, investors pay for greater returns in the economic boom with greater losses in the ensuing economic bust.

interest between institutional intermediaries and their clients, the "*ultimate investors"* (pensioners, or stockholders in mutual funds, banks and insurance companies).

We argue that principal-agent problems arising from conflicts of interest on the buy side of the market, between intermediaries and ultimate investors, offer the best explanation for persistent, prevalent low-quality ratings. If institutional investors' incentives were perfectly aligned with the interests of their clients, they would penalize debts that were issued with low-quality ratings by refusing to buy them, or by buying them at a significant discount. Evidence of a "race to the bottom" in ratings shopping in the credit ratings industry shows that institutional investors do not provide such penalties. If they did, the sell side of the market would respond to those competitive pressures by selecting high-quality rating agencies with good methodologies to rate their debts. [4]

In the case of corporate governance ratings, the argument favoring the conflict of interest between institutional investors and their clients as the primary source of low-quality ratings is even stronger. Without investor conflicts, competition would be stronger in the corporate governance rating industry, since competition there is not weakened by the establishment of NRSRO licensing.

The fact that competition appears to be very weak in the corporate governance rating industry, despite the absence of licensing or any strong natural monopoly in corporate governance ratings, therefore, suggests that conflicts of interest between institutional investors and their clients are at the heart of the tolerance for low-quality ratings. As noted before, institutional investors enjoy private benefits from low-quality (noisy) ratings (which consist of protection from legal risk, the reduced risk of losing clients for poor performance, and the potential to share in rents extracted from rated firms by the governance rating agencies), all of which accrue to institutional investors at the expense of their clients, the ultimate investors.

[4] Charles Calomiris, "The Debasement of Ratings: What's Wrong and How We Can Fix It," *Economics21.org*, October 26, 2009.

The pursuit of private benefits by institutional investors weakens competition among corporate governance rating agencies and leads to entrenchment among established providers of low-quality ratings in at least three ways: (1) Avoiding *legal liability* for not having pursued an appropriate decision making process when selecting portfolio firms is one private benefit that can drive institutional investors' demands for governance ratings. That consideration will favor entrenched rating firms with dominant market positions, since age and dominance may be valuable characteristics for institutional investors seeking to show due care in relying on experienced and widely used agencies. (2) Institutional investors that seek to *avoid accountability* to ultimate investors for poor performance of their investment choices will favor entrenched agencies for the same reason. (3) Potential *private benefits* that some institutional investors hope to gain at the expense of stockholders will tend to be larger when they form alliances with entrenched rating agencies, since those agencies have more leverage over the firms that they rate. Conflicted institutional investors, therefore, will not tend to reward new entrants with better ratings methodologies, even if employing those new methodologies would result in more accurate ratings of corporate governance.

The central role of investor conflicts to the tolerance for low-quality ratings, however, should not be misconstrued as suggesting that governance rating agencies are passive or unwitting participants in the production of low-quality ratings. Corporate governance rating agencies use their protected status (which results from a lack of buy-side discipline) to actively pursue rent-seeking strategies that maximize the resources that they can extract from the firms they rate (e.g., requiring that firms grant them lucrative consulting contracts in exchange for providing favorable ratings). In turn, the rating agencies can use those rents to further entrench their positions with the buy side by offering additional benefits to institutional investors who ally with them. For example, in addition to "shaking down" rated firms by demanding consulting contracts in exchange for providing favorable ratings, rating agencies may extract non-cash concessions from firms to serve the interests of institutional investors (e.g., employee pension funds).

So far, our discussion of corporate governance ratings has argued that to the extent that there is evidence of persistent, low-quality ratings, it likely reflects a "bad equilibrium" characterized by entrenched rating agencies protected by a lack of effective competition due to the absence of sufficient demand for good ratings by incentive-conflicted institutional investors. We now turn to an overview of the evidence regarding the low quality of corporate governance ratings.

III. The Low Quality of Corporate Governance Ratings

After WorldCom, Enron, and the other turn-of-the-millennium financial scandals, the loose structure of federal/state/exchange and self-regulation of corporate governance that had evolved up to that point was regarded by many as inadequate in limiting the costs of principal-agent conflicts between stockholders and management within U.S. firms. The Sarbanes-Oxley Act of 2002 was one response to this perceived failure, and has since been the subject of considerable academic interest.

Another response, which has received relatively little attention, has been the increasing role of the "corporate governance rating industry." The corporate governance rating industry – composed of governance advisers, governance rating firms, and proxy advisers, sometimes operating as business units of a single company – plays a major role in corporate governance policymaking, and, because of the widespread use of its analysis by institutional investors, effectively acts as a *de facto* corporate governance regulator.[5]

The corporate governance rating industry influences firms through two major channels: reactions by shareholders to voting recommendations and reactions by markets to changes in

[5]. See, for instance, Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 101-141 (2007), 105.; and Robert Daines, Ian Gow, and David Larcker, "Rating the Ratings: How Good are Commercial Governance Ratings?," Electronic copy available at: http://ssrn.com/abstract=1152093.

corporate governance ratings. In practice, the two are related: the proxy firms recommend voting positions in shareholder elections justified by their own corporate governance rating models.

Just as credit rating agencies helped shape structured financial products in the recent credit boom, corporate governance rating agency models are furtively shaping U.S. shareholder voting and corporate governance structures. And just as the depth and duration of today's financial crisis and recession is in large part a result of the need to re-value and re-structure financial instruments based on a new credit rating agency model of credit performance, the need to recalibrate measures of corporate governance quality could be similarly disruptive to management practices and corporate structures.

Corporate governance ratings appear to exhibit persistently low quality. Despite the boom in corporate governance research, there is no convincing evidence of the ability of corporate governance ratings to successfully distinguish firms that perform poorly from those that perform well. Indeed, recent academic literature has questioned whether corporate governance ratings are of any value.

The first academic research in the field suggested that some corporate governance ratings could possibly predict firm performance. For example, Spellman and Watson (2009) found that GovernanceMetrics International's GMI rating was correlated with past firm performance and had the ability to predict future firm performance with some degree of accuracy.[6] Similarly, Gompers, Ishii, and Metrick (2003) found that the ratings of ISS (the rating agency with a dominant market share) were correlated with firm and shareholder performance.[7] Brown and Caylor (2004)

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[6]. G. Kevin Spellman & Robert Watson, GMI Ratings and Corporate Performance: 2003 to 2008, Working Paper, Jan. 2009, at 9.

[7]. Paul Gompers, Joy Ishii, & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107-155 (2003), 144.

corroborated that result in a separate analysis.[8] Brown and Caylor (2004), also found that high ISS CGQ scores are associated with higher current stock returns, higher accounting returns, lower volatility, and higher dividends. Brown and Caylor (2006) also suggest there exists a favorable relationship between Tobin's Q and an index created from 51 governance variables collected by ISS (and identified as important elements of ISS ratings).[9]

While some of that research was independent, some (e.g., Brown and Caylor 2004) was sponsored by corporate governance rating agencies, and thus, must be greeted with some healthy skepticism. GovernanceMetrics International has also sponsored research to show the relevance of its ratings methodology.

Recent independent research contradicts many of the findings of prior studies. For example, Daines, Gow, and Larcker (2008) conduct statistical analyses of four ratings: ISS's CGQ, GovernanceMetrics's GMI, The Corporate Library's TCL, and Audit Integrity's Accounting and Governance Risk (AGR) metric. Daines et al. find that, with the possible exception of the AGR, "governance ratings have either limited or no success in predicting firm performance or other outcomes of interest to shareholders."[10] They also find little correlation among the ratings, a result they suggest indicates either that the ratings measure different corporate governance metrics or that there is significant measurement error in the metrics.[11]

Additional research indicates that the inability of corporate ratings to consistently predict performance is rooted in the design of the ratings metrics themselves. Koehn and Ueng (2005) find the poor performance of ISS corporate governance ratings in predicting earnings quality

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8. *See* Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Performance, White Paper, Dec. 7, 2004.

9. Id.; Brown, L. D., Caylor M. L., 2006. Corporate governance and firm valuation. Journal of Accounting and Public Policy 25, 409–434.

10. Robert Daines, Ian Gow, & David Larcker, Rating the Ratings: How Good Are Commercial Governance Ratings?, Working Paper, June 26, 2008, at 29.

11. Id., at 4.

unsurprising. ISS board governance metrics include, amongst other factors, director independence, board size, board attendance, board diversity, etc.; Koehn and Ueng conclude that, "with so many factors incorporated into a single governance score, the corporate board rating contains a lot of statistical noise. As a result, statistically significant factors may be cancelled out by less relevant statistically insignificant but inversely correlated factors."[12] Moreover, Koehn and Ueng suggest that ISS's individual governance metrics may be grossly misspecified. For example, though prior research has demonstrated that age restrictions on board members are largely irrelevant to performance, "ISS simply opts to ignore this possibility when it forces the model to include a positive relationship between governance and director age limits."[13]

Gillan, Hartzell and Starks (2003) take the notion of flawed governance metrics a step further, and demonstrate that industry-wide factors, including competitive environment, information environment, investment opportunities, and product uniqueness have a greater impact on governance structures than the traditional inputs to rating agencies' corporate governance metrics.[14] Industry characteristics and common economic factors across firms better explain governance structures *and* firm choices than indices focused on board composition, charter provisions, bylaws, and other traditional corporate governance rating inputs. Gillan, Hartzell and Starks conclude that "industry factors contribute most of the explainable variation in overall governance structure and appear to dominate time effects and firm effects."[15] In summary, Gillan, Hartzell and Starks' research suggests that there is no one optimal governance structure and that a vast multitude of factors – most of them fundamental to the business opportunities facing the firm and others

[12]. Daryl Koehn and Joe Ueng. Evaluating the Evaluators: Should Investors Trust Corporate GovernanceMetrics Ratings? Journal of Management and Governance (2005), 125.

[13]. Id., at 121.

[14]. Stuart L. Gillan, Jay C. Hartzell, and Laura T. Starks. Explaining Corporate Governance: Board, Bylaws, and Charter Provisions. Working Paper Series, WP 2003-03, John L. Weinberg Center for Corporate Governance, University of Delaware (2003), 28.

[15]. Id. at 2.

completely idiosyncratic to management personality – determine firm performance. Hence, the lack of predictive power associated with corporate governance ratings is rooted in the base inputs to the metrics themselves: the models are just not very good and they product low-quality ratings, as a result.

Bhagat, Bolton, and Romano (2007) similarly conclude that existing corporate governance ratings do not accurately predict performance, showing that there is no single best measure of performance that is adequate to make informed decisions regarding firm quality.[16] In fact, they find that one variable – outside directors' stock ownership – by itself outperforms leading academic indices.[17] But they go further, criticizing what they see as commercial misuse of academic methodologies.[18]

Other authors similarly suggest that, rather than simply being ineffective, corporate governance ratings may even have *adverse* effects on firm performance. Rose (2007) argues that one-size-fits all governance ratings that are often unproven can have adverse impacts on significant shareholder decisions.[19]

Even worse, Koehn and Ueng (2005) state that firms are often pressured to obtain corporate governance ratings from high-profile firms such as ISS and GovernanceMetrics International, even though the governance rating metrics championed by these firms are "not good indicators of either the quality of a firm's earnings or of its ethics,"[20] and may in fact be *negatively* correlated with annual

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16. Sanjai Bhagat, Brian Bolton, & Roberta Romano, The Promise and Peril of Corporate Governance Indices, Yale Law School Working Paper No. 89/2007, Oct. 2007, at 67.

17. Id.

18. Id., at 4.

19. Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 101-141 (2007), 105.

20. Daryl Koehn and Joe Ueng. Evaluating the Evaluators: Should Investors Trust Corporate GovernanceMetrics Ratings? Journal of Management and Governance (2005), 111.

stock appreciation and ethics scores.[21] In this regard, corporate governance ratings could be harming both the firms pressured to obtain them and the investors who rely on them.

Why would institutional investors or other intermediaries purchase noisy and unreliable ratings that are harmful to corporate performance?[22] As we pointed out before, institutional shareholders (investors) may purchase the ratings as protection against future legal claims that they have invested or voted unwisely and thereby breached their fiduciary duties to their clients, or as protection against departures by dissatisfied investors. Institutional investors may prefer noisy low-quality ratings because low-quality ratings make it harder to hold them accountable for poor decision making or poor outcomes associated with those investment decisions. Institutional investors can point to the fact that investments that turned out ex post to have bad returns had high corporate governance scores beforehand, thus absolving themselves from blame (which is analogous to the "plausible deniability" equilibrium for credit ratings described in Calomiris 2009).[23]

In the case of corporate governance ratings another potential contributing influence on low-quality ratings is the rent-seeking behavior of entrenched rating agencies, who may be using their protected status to "shake down" firms that receive ratings. As we noted, this can also attract institutional investors to the rating agency, further insulating the rating agency from competition,

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[21]. Id., at 124.

[22] Not everyone is convinced by the evidence of low-quality corporate governance ratings. Daines, Gow, & Larcker (2008), contend that the apparent weakness of corporate governance ratings may reflect the fact that outside researchers do not have the "right" model for estimating the impact of firm governance or the "right" measure of firm performance. Ratings firms object that, given the right model specification (which they, of course, possess), their ratings are significant and informative. We do not find that a very convincing argument. If ratings firms really had unique knowledge of the right model, then they could demonstrate (through the economic value of investment decisions made on the basis of their model's forecasts) the value of their model by showing its value as an investment tool, just as stock market analysts can be judged on the basis of the profitability of following their investment advice.

[23] There is another potential explanation for the facts that ratings are demanded by institutional investors despite their lack of value. There may be legitimate reasons for institutional investors to purchase rating agency products other than the desire to access the ratings. Among the popular explanations that have yet to be tested is the hypothesis that investors buy the ratings simply to obtain the underlying data. The data on firm takeover defenses, CEO compensation, or board membership can be costly to collect for a large sample of firms and the commercial rating firms might be a cost-effective source for these data.

especially if those rents can be shared with institutional investors, for instance through lower prices for their ratings.

A 2008 policy briefing sponsored by the Millstein Center for Corporate Governance and Performance at the Yale School of Management suggested that firms such as the RiskMetrics Group, which provide voting advice to institutional investors while also providing structural governance advice to the firms, allow companies purchasing governance guidance through the corporate governance rating agency's consulting arms "to 'game' the system, whereby less potentially disruptive voting recommendations are given to investors if the company of interest is also a client of the corporate governance rating agency's consulting services."[24] Alarmingly, even institutional investors and proxy voting advisors involved in the Millstein Center's research roundtable admitted "that they believed various corporations assume that signing up for RiskMetrics' consulting provides an advantage in how the firm assesses their governance."[25]

As a result, some policymakers have already raised concerns over those potential conflicts of interest, especially with respect to firms that exhibit *per se* evidence of conflicts of interest or those whose proxy advice and governance ratings have proved unreliable.[26] In 2006, former Rep. Baker argued that "conflicts of interest and a lack of competition in the industry could lead firms to provide biased advice."[27] A 2007 study undertaken by the Government Accountability Office confirmed the potential for important conflicts of interest in the industry.[28]

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24. "Policy Briefing No.3: Voting Integrity-Practices for Investors and the Global Proxy Advisory Industry." Millstein Center for Corporate Governance and Performance, Yale School of Management, 2009, 9.

25. Id.

26. *See* Kaja Whitehouse, *U.S. Legislator Seeks Report on Corporate Vote Consultants*, DOW JONES NEWSWIRES, Oct. 5, 2006, http://www.djnewswires.com.

27. Id.

28. United States Government Accountability Office, Report to Congressional Requesters: CORPORATE SHAREHOLDER MEETINGS, Issues Relating to Firms That Advise Institutional Investors on Proxy Voting, GAO-07-765, June 2007.

The GAO study and other commentators also noted that the conflicts of interest that affect such a powerful influence over corporate governance structures is wielded by a handful of firms that currently dominate the corporate governance ratings industry. There are, in total, about six firms that comprise the corporate governance industry, including RiskMetrics Group's Institutional Shareholder Services division (ISS); GovernanceMetrics International; The Corporate Library; Glass, Lewis & Co.; Proxy Governance, Inc.; and Morningstar, Egan-Jones and S&P.

Of those firms, ISS is by far the industry leader. ISS alone is said to control a third or more of the shareholder votes in the U.S.[29] ISS has over 1,700 institutional clients, with assets under management exceeding $25 trillion, relying on its ratings.[30] ISS claims to advise "24 of the top 25" and "81 of the top 100" mutual funds, all "25 of the top 25" asset managers, and "17 of the top 25" public pension funds.[31]

Since most of the firms dominating the industry are privately held or parts of much larger firms, financial evidence of conflicts of interest is difficult to disentangle. While the RiskMetrics Group, the only public corporate governance rating firm, provides some information that information suggests a significant potential for important conflicts of interest.[32]

Partially reflecting the results of the 2007 GAO study which identified conflicts of interest in the industry and that study's reliance on the RiskMetrics Group for information on the industry, the RiskMetrics Group formally admitted that a potential conflict of interest arises from the fact that it sells consulting services to corporate clients and ratings services to institutions. [33] As a result, ISS

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[29]. Dean Starkman, A Proxy Adviser's Two Sides: Some Question Work of ISS for Companies It Scrutinizes, WASH. POST, Jan. 23, 2006, at D1 (citing a statement by Susan E. Wolf, vice president at Schering-Plough Corp. and chairman of the Soc'y of Corporate Sec'ys and Governance Prof'ls).

[30]. *See* INST. S'HOLDER SERVS., THE BUSINESS OF CORPORATE GOVERNANCE IS GLOBAL, http://www.issproxy.com/pdf/Locations.pdf

[31]. Id.

[32]. Whether that information is representative of other firms is uncertain.

[33] The Corporate Library states that it does not provide advisory services to a firm that it currently rates (although that could just mean it only rates firms that have previously retained it for consulting and already conformed to its requests

created a separate subsidiary, ISS Corporate Services, which manages most corporate governance advisement and consulting. The RiskMetrics Group also writes into its contracts with ISS Corporate Services that the purchasing of services from ISS Corporate Services will not influence either corporate ratings or proxy recommendations.[34] Still, some 14.2 percent of ISS's $119.2 million annual revenues in 2007 and 11.1 percent of their $141.8 million annual revenues in 2008 (about $13.2 million and $20.1 million, respectively) came from *non*-recurring business, which is the category reported by ISS Business Services.[35] Of course, more revenues may come from services classified under other categories not reported to the public, but we cannot know for sure.

Revenue and operating information for other ratings firms is even less accessible.[36] GovernanceMetrics International is a privately held firm and does not report financial or operational information publicly.

In summary, empirical research indicates that corporate governance rating firms' models are noisy and may be useless. Corporate governance rating agencies seem to be earning fees for offering no meaningful guidance in their proxy advisory service.[37] The fact that institutional investors willingly demand corporate governance ratings suggests that low-quality ratings are a consequence

for restructuring). United States Government Accountability Office, Report to Congressional Requesters: CORPORATE SHAREHOLDER MEETINGS, Issues Relating to Firms That Advise Institutional Investors on Proxy Voting, GAO-07-765, June 2007.

34. RISKMETRICS GROUP, ANNUAL REPORT 2008 (2008), at 16.

35. Id., at 37.

36 As noted above, the GAO report focuses almost exclusively on ISS/RiskMetrics, the only firm for which there exists sufficient information with which to make even the most rudimentary assertions about the industry and potential conflicts.

37 Two caveats, however, are in order. First, there may be legitimate reasons for institutional investors to purchase rating agency products other than the desire to access the ratings. Among the popular explanations that have yet to be tested is the hypothesis that investors buy the ratings simply to obtain the underlying data. The data on firm takeover defenses, CEO compensation, or board membership can be costly to collect for a large sample of firms and the commercial rating firms might be a cost-effective source for these data. Second, Daines, Gow, & Larcker (2008), contend that the apparent weakness of corporate governance ratings reflects the fact that outside researchers do not have the "right" model for estimating the impact of firm governance or the "right" measure of firm performance. Ratings firms object that, given the right model specification (which they, of course, possess), their ratings are significant and informative. That is not a very convincing argument. If ratings firms really had unique knowledge of the right model, then they could demonstrate (through the economic value of investment decisions made on the basis of their model's forecasts) the value of their model by showing its value as an investment tool, just as stock market analysts can be judged on the basis of the profitability of following their investment advice.

either of the incentive conflict between rating agencies and investors (where, in theory, low quality could be driven by hard-to-observe ratings quality and monopoly power by rating agencies), or of the incentive conflict between investors and clients (where low-quality ratings are used by institutional investors to avoid accountability or to share in the rents extracted by rating agencies).

In our view, the principal-agent conflict between institutional investors and clients is more likely to be important. The alternative conflict story (which revolves around rating agency "shirking"), depends upon two assumptions: (1) the difficulty in assessing ratings quality, and (2) an exogenously conferred monopoly over the ratings process. Neither of those assumptions is plausible in the case of corporate governance ratings. First, empirical evidence has done a reasonably good job showing that ratings quality is low, suggesting that, in fact, we can observe the ex ante low quality of ratings. Second, unlike NRSRO credit rating agencies, corporate governance rating agencies enjoy only very limited monopoly privileges. Market power does not flow from either a government license or a natural monopoly over information; rather, to maintain their market power, corporate governance rating agencies depend on the low demand for high-quality ratings from institutional investors, which they can magnify by offering private benefits to institutional investors, supported by the rent extracted via consulting contracts and other holdup schemes.

IV. Meaningful Reform

Our review of debt ratings and corporate governance ratings suggests that the primary source of the problems of low-quality ratings and ratings inflation is the principal-agent problem between institutional investors and their clients. Market forces left to their own devices will not solve these problems; absent some intervention to shift incentives, institutional investors will continue to demand such ratings, and rating agencies will continue to produce them willingly at high profit.

What interventions could improve the performance of credit and corporate governance ratings? It is useful to consider potential policy interventions in the two ratings industries separately.

Proposed credit rating agency reforms that would try to empower institutional investors more (by having them pay rating agency fees, or by having them participate in rating agencies' corporate governance or modeling) would be counterproductive and unlikely to eliminate ratings inflation or improve ratings quality. Increasing the number of NRSROs is laudable, but if the conflict between investors and clients is the problem, increased competition will have no effect. Furthermore, proposals to eliminate NRSRO status entirely are problematic. First, this is unrealistic as a short-term reform, given the extreme dependence of regulation (e.g., the Basel II standards) on NRSRO credit ratings). Furthermore, the elimination of NRSRO status in and of itself likely would not solve the problem of low-quality and inflated credit ratings. The apparent entrenchment of corporate governance ratings shows that eliminating the use of credit ratings for regulatory purposes would not overcome the problem of low-quality ratings, although it likely would remove much of the incentive for ratings inflation.

Ratings reform of all types *must make it profitable for rating agencies to issue high-quality, non-inflated ratings*, notwithstanding the demand for low-quality or inflated ratings by institutional investors. This can only be accomplished through the following two regulatory interventions: (1) objectification of the meaning of ratings, and (2) linking the fees earned (or penalties paid) by rating agencies to objective measures of their performance.

The objectification of credit ratings could be achieved by requiring all NRSROs to formally and transparently link letter grades to specific numerical estimates of the probability of default and the expected loss given default. Once they have done so, then regulators can specify regulatory limits and capital requirements that are linked to estimated probabilities of default and losses given default (which have concrete meaning), rather than vaguely defined letter grades. Then, for example, if an

NRSRO's ratings for a particular product (say, CDOs) were found to be persistently inflated over a sufficiently long period of time then that NRSRO would face a penalty, like a "clawback" of the fees the agency has already earned on that product or losing its NRSRO status for a brief period of time.

In the case of corporate governance ratings, the pernicious demand for low-quality ratings does not lead to ratings inflation, but rather to noisy signals that avoid identifying either strong or weak companies. Thus, the penalty function to properly incentivize corporate governance rating agencies would focus on penalizing ratings *inaccuracy*, not just ratings inflation.

While, in theory, the idea of objectifying and penalizing low-quality corporate governance ratings has appeal, in practice, there are significant obstacles to developing a means of doing so. First, the academic literature on corporate governance is far from achieving consensus on a feasible approach for measuring accuracy. Thus, a penalty structure that would reward good ratings and punish bad ones seems not to be immediately feasible. Unlike credit ratings (which measure the objective fact of default and loss), corporate governance translates into long-term performance, which is difficult to measure. Furthermore, the literature on predictors of default has been an active area of research for decades, while corporate governance quality is a relatively new field.

Second, since corporate governance rating agencies are not acting as NRSROs and have no formal regulatory function in the financial system, the corporate governance rating industry is not obliged to meet *any* degree of accuracy under current law. Thus, before we could consider penalizing corporate governance rating agencies we would have to license them.

In our view, to the extent that the Securities and Exchange Commission relies increasingly on corporate governance ratings as a means by which institutional investors can meet their fiduciary duties to vote shares in a manner reflecting the best interests of the ultimate investors (the individual claimants behind the pension and mutual funds, as well as insurance companies and banks), the corporate governance rating agencies that sell information to meet those fiduciary duties should have a regulatory obligation that requires them to maintain some degree of accuracy. Hence, to the extent that the industry's role as a corporate governance regulator becomes formalized, appropriate penalty structures – such as the objectively applied clawback provisions envisioned above – should be developed. If in the fullness of time the industry cannot demonstrate a convincing value relationship between corporate governance and firm performance, the ultimate penalty function – preventing meaningless corporate governance rating-based proxy advice from being used to meet institutional investor fiduciary duties – may have to be imposed.

It cannot be denied that corporate governance rating agencies play a significant role in proxy recommendations. Those powers give corporate governance rating agencies significant ability to extract rents from the firms that they rate, and currently governance rating agencies are not subject to any disclosure requirements or business practice standards regarding these conflicts of interest. Thus, under current laws and regulations, abuses of power by corporate governance rating agencies due to conflicts of interest are not observed, defined, or prevented. While such holdup games exerted against large companies are well-known (like ACORN's infamous actions to extract money from merging banks in exchange for agreeing not to oppose their mergers) historically these sorts of activities have largely escaped regulatory or legal interventions and when intervention has been attempted (for instance, the sunshine provisions for community activist organizations proposed under Gramm-Leach-Bliley), entrenched institutions (such as ACORN) fight hard to suppress reform.

At a *minimum*, therefore, the SEC should immediately require disclosure of all potential conflicts, and should develop standards that would prohibit egregious conflicts of interest between rating agencies and the firms that they rate. Furthermore, in the interest of mitigating rent seeking behavior, institutional investors should have to disclose all of their points of contact or alliance with the rating agencies, and these conflicts of interest should also be the subject of SEC standards.

In summary, real meaningful policy alternatives to the seeming conundrums of ratings industry conflicts of interest do exist. Those alternatives, however, require seeing properly what gives rise to the conflicts of interest among all the industry participants, including ratings agencies, institutional investor intermediaries, and the ultimate investors, and structuring incentive compatible industry arrangements to lead to the desired policy objectives.