The companies we keep: from legitimacy to reputation in retail investment

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> Nevertheless a certain class of dishonesty, dishonesty magnificent in its proportions, and climbing into high places, has become at the same time so rampant and so splendid that there seems to be reason for fearing that men and women will be taught to feel that dishonesty, if it can become splendid, will cease to be abominable. Trollope ([1883] 1999, p. 354)

These reflections by novelist Trollope were catalysed by the reinstatement in English law of the joint-stock firm—a form of organization that fell into disgrace after the South Sea Company committed history's first known corporate fraud (Harrington, 2013). Trollope feared that the wealth generated by the new crop of limited liability firms would damage the foundations of social life by distorting norms of honor and honesty, just as the South Sea Company had done a century before. While such concerns may seem antiquated, we find them echoed in the work of many contemporary scholars (Partnoy, 2009; see also Macey, 2013).

Surprisingly, few studies have examined public response to unethical or illegal behaviour by firms, despite some research on institutional investors, organized protest groups or shareholder activists (McDonnell and King, 2013). Although a robust research shows that corporations invest heavily in impression management—crafting narratives and 'information subsidies' (Rindova *et al*., 2006) to establish an identity (Zavyalova *et al*., 2012)—the relevant audiences for these messages have generally been construed by scholars as *other organizations*, obscuring the micro-foundations of market activity.

This essay will address the knowledge gap by drawing on evidence from a long-term field study of retail investors—a group known colloquially as 'the investing public' (Harrington, 2008, 2009, 2012*a*). Based on their responses to firms' misconduct before and after the corporate fraud scandals of the twentieth century, this paper will extend current theoretical models by combining the micro level of analysis with considerations of historical context. The latter is particularly important in explaining how the evaluative standards applied to corporations change over time.

Studying retail investors at a particularly tumultuous period allows us to examine the neglected micro level of analysis, but in a way that brings history back in. Although not finance professionals, retail investors are nonetheless bombarded with information about corporate behaviour and identity from the news and advertising, making them an ideal population for a study of public responses to corporate malfeasance. Moreover, they represent a sizeable portion of both economy and society: in the USA, over 51% of adults own stocks, amounting to $5.5 trillion in corporate equities or a quarter of total market capitalization (Harrington, 2012*a*, *b*). These numbers have held steady for over a decade, through numerous corporate fraud scandals, as well as the dot.com bubble, the housing crash and the 2008 financial crisis (Bucks *et al*., 2009).

This paper is based on a data set that includes observations from over 100 retail investors at two points in time: the height of the bull market, spanning 1998 to 1999; and then again in 2004, post-Enron and WorldCom. The evidence shows that when corporate misconduct appears rare or atypical, investment choices are based not only a stock's profit potential but on its ability to enhance the owner's identity by

association. Under these conditions, retail investors also avoid stocks that might reflect badly on them by association, due to illegal or unethical behaviour by issuing firms (Harrington, 2008).

But when corporate misconduct becomes so widespread as to appear 'normal'—the state of affairs to which Trollope alluded—public response undergoes a dramatic shift. When investors believe they have no choice apart from investing in firms engaged in illegal or unethical activity, they adapt by changing their standards of evaluation—a move that simultaneously changes their self-evaluations. They move from a position of judgment over corporations to one of knowing complicity with misconduct.

To account for this shift, this paper will draw on the conceptual distinction between legitimacy and reputation (Deephouse and Carter, 2005). While reputation involves an assessment of relative standing vis-à-vis peers, legitimacy implies comparison with a broader social standard (Suchman, 1995). Thus, an entity's reputation depends on what its peers are doing, but its legitimacy derives from adherence to social norms and expectations. This paper will extend this discussion using concepts from social psychology—particularly power and social identity—and suggest some conditions under which legitimacy or reputation take precedence in evaluations of firms. A key finding is that in the face of widespread corporate misconduct, what changes is not corporate behaviour, but the social meaning of that behaviour.

1. Identity investing

In the wake of the seemingly endless string of corporate and institutional frauds, it may be difficult to recall the optimism surrounding the stock market in the 1990s. This decade transformed investing from an elite activity to one that included more than half of the adult population of the USA (Harrington, 2008). As 'Wall Street became Main Street', there seemed to be 'limitless opportunity' (Krugman, 1998), particularly for the new retail investors.

With their confidence in the integrity of the market intact, investors picked and chose stocks based on social legitimacy. This led to rapid growth in socially responsible mutual funds: investment vehicles whose component stocks are selected based on religious or secular notions of 'desirable, proper, or appropriate' (Suchman, 1995, p. 574) activity. Retail investors tripled the capitalization of these funds within 2 years—from \$529 billion invested in 1997 to \$1.5 trillion in 1999 (Geczy *et al.*, 2003). These preferences of 'the investing public' defied the conventional wisdom in professional finance, which was summed up by one investment manager as 'you can't be in stocks if you're going to ask moral questions' (Hakim, 2001, p. 26). As this comment suggests, within the small world of institutional finance—the environment in which most studies of the impact of corporate

identity and misconduct have been situated—*the social legitimacy of corporate activity has been considered irrelevant*.

For retail investors, however, legitimacy was central to their decisions—as long as they believed that any corporate misconduct was a case of a few 'bad apples' rather than a pervasive problem. Their faith in the integrity of most publicly traded corporations was manifested in selectivity about the kinds of firms with which they wanted to be associated. The process of deciding among the thousands of stocks available started with a financial analysis, screening for sectors and firms most likely to be profitable (Harrington, 2008). That strategy narrowed the field to a handful of possibilities, but was rarely sufficient to provide a decisive solution.

Thus, the initial screening was followed by a second process, which I termed 'identity investing' (Harrington, 2008). This involved assessing the match between a firm's identity and the investor's. Investing is social (Shiller, 1993) in that people talk with their friends, family and neighbours about their portfolios (Katona, 1975). But this *inter*-personal character of investing is matched by an *intra*-personal aspect: retail investors seek congruence between their stock purchases and their social identities. As we know from social identity theory, individuals seek not only to enhance their sense of self, but also to avoid the cognitive dissonance created by activities that conflict with their desired identities (Hogg and Terry, 2000; McKimmie *et al*., 2003).

While none of the individuals I studied articulated a formal policy about 'socially-responsible investing', they wove identity considerations into all of their stock selections. For example, when I asked one woman why she and her friends did not invest in tobacco or petroleum firms, she answered, 'It's just the kind of people they are. They're not interested in supporting those companies'. This identification process applied to the whole spectrum of firms. Thus, I observed individuals analysing Home Depot—a firm involved in the uncontroversial building supply industry—decide against investing in the highly profitable company because they did not wish to be associated with its labour practices:

> *Leonard:* Some women employees have filed a sexual discrimination suit against Home Depot.
>
> *Sid:* Home Depot won't hire women; their ethic is to have staff who are expert in using the products themselves, and they apparently don't think women qualify.
>
> *Leonard*: The firm settled out of court.
>
> *Grant:* Women don't shop there.

> *Troy:* The women employees run the cash registers or work in the design section.

These investors rejected Home Depot based on their assessment of 'corporate citizenship'—the legitimacy of the firm's activities vis-à-vis broader social norms. This was a common theme in the data: even if a firm did nothing blatantly illegal, any ethically distasteful or ambiguously legal activity—'alegal', as Partnoy (2009) puts it—was sufficient grounds for negative evaluation by the investing public in the 1990s.

These decisions were not necessarily high-minded or moral. Typically, they were guided by identity considerations: the kinds of companies these individuals wished to keep. For instance, the same men who rejected Home Depot also refused to buy stock in La-Z-Boy—a maker of reclining chairs—because of the firm's image as a brand for the working class. This decision-making pattern was repeated with other stocks and other investors, suggesting that their assessments of firms' legitimacy were not only connected to general social norms, but more specific notions of appropriateness for *the kind of people they were*, or aspired to be (Harrington, 2008). Some 5 years later, however, this legitimacy-oriented decision process was supplanted by one that foregrounded reputation.

2. Unindicted co-conspirators

If, as Deephouse and Carter (2005); (see also Suchman, 1995) have written, legitimacy is assessed relative to broader social norms, what happens when mass violations of social norms take place? When it becomes obvious that misconduct is systemic, rather than the work of a few 'bad apples?' One consequence is a radical restructuring of the terms on which firms are evaluated. Following the accounting fraud scandals of the early twenty-first century, if retail investors had continued to screen firms based on legitimacy, they would have found that very few made the cut. Some corporations, to be sure, continued to be aligned with social norms, but were not necessarily profitable enough to provide for retirement savings and investors' other major financial goals (Harrington, 2012*a*, *b*). Lacking the power to transform the firms themselves, retail investors instead changed their frame of reference. Specifically, they shifted from assessing firms in terms of a broad standard of social appropriateness or legitimacy to viewing them in terms of reputation relative to their corporate peers.

Owing to their economic dependence on the stock market (Harrington, 2008), evidence of widespread corporate malfeasance did *not* lead these investors to withdraw from the market. Some of them simply did nothing, ceasing to buy *or* sell stocks. As one woman in my study put it, 'I have no idea what to do now that we know you can't trust anything firms tell you'. For the others, the investment task

shifted from picking the best stock (the one offering the greatest profit and identity enhancement) to one of picking the least-bad apples from a rotten barrel.

In fact by 2004, participants who had not previously expressed any reservations about the integrity of corporate behaviour began claiming that they had known all along that corporate fraud was commonplace. For example, one woman in my study said 'My experience in the work word taught me that business people cheat all the time, so the scandals didn't come as a surprise'. Another individual claimed

> I knew there was cheating going on in the whole market . . . And the scandals haven't damaged my trust in the system because I never trusted it to begin with. So some people got special deals from mutual fund managers—so what? I work at [a major defense contractor]: we see special deals all the time!

In other words: everyone does it. As the sociological literature on accounts (Orbuch, 1997) indicates, shifting the standard of evaluation from absolute to relative comparisons is a standard mode of damage control. What is surprising here is to find retail investors rationalizing corporate behaviour in this way. Why would investors make excuses for firms?

Power can motivate individuals to shift their standards of evaluation. Abandonment of the legitimacy standard for assessing corporate conduct can be interpreted as symptomatic of the power imbalance between corporations and retail investors (Harrington, 2013). These individuals wielded genuine power through the hundreds of millions of dollars they poured into the market every month. This economic clout translated into the explosive growth of socially responsible investment funds, which continues even in the aftermath of the 2008 financial crisis (Cortez *et al*., 2012). But when faced with an array of choices that *all* looked bad from an ethical or social identity point of view, retail investors lacked the defining resource of situational power—the ability to walk away (French and Raven, 1959; see also Hirschman, 1970). For so many of these individuals, the weakened social safety net in the USA left them with no alternative but to own stocks and hope for the best. As several in the study put it, using identical wording, 'Where else are we going to put our money? In the mattress'? One woman summed up this perspective by remarking, 'I can't afford to leave [the market]. . .I have to make my money back'. Such observations suggest the following empirically testable proposition:

> *Proposition 1*: If X is dependent upon Y, then evidence of misconduct by Y will lead X to shift from legitimacy to reputation as an evaluative standard.

Ongoing engagement with a system known to be corrupt is likely to have consequences for the identities of individuals involved. Since avoidance of cognitive dissonance is a major force in social identity processes (McKimmie *et al*., 2003),

continued participation in a stock market tainted by corporate malfeasance created a problem for investors: by associating themselves with cheaters, they were threatening their own identities as good people. This necessitated a shift in the alignment of identities between retail investors and firms. Where once they could be choosy about the kinds of companies they kept, they now had to take what they could get and revise their self-evaluations accordingly.

Through retrospective sense-making and revisionist history, participants in this study altered their standards of self-evaluation from one of personal honour or integrity to one of street-wise intelligence. Thus, one man I interviewed in 2004 said of his engagement with the stock market in the 1990s, 'I knew it was a sham back then. I was just riding it as long as I could'. Similarly, a woman in the study said, 'We sort of knew the books were cooked; I kind of saw it coming'. Though they could no longer credibly claim to be honest investors, they could at least claim to be smart. Given that 'there is no crime in the cynical American calendar more humiliating than to be a sucker' (Lerner, 1949, p. 300), it is perhaps not surprising to find retail investors—unable to exit the stock market, but still trying to maintain some congruence in their social identities—describing themselves as 'greedy' and as 'money whores'. These identities made them accomplices, rather than victims.

Ultimately, the corporate fraud scandals of the early twenty-first century catalysed *two* shifts in the standards of evaluation: one for firms, and the other for investors. The anecdotes extracted from my study suggest that evaluators—whether investors, consumers or other stakeholders—see *themselves* differently when they move from a legitimacy standard to a reputational standard in their assessment of firms. Linking the work of Deephouse and Carter (2005) to the literature on identity in social psychology, we can derive the following proposition:

> *Proposition 2*: If X alters its evaluation of Y from the legitimacy standard to the reputation standard, a corresponding shift will occur in X's self-evaluation.

There is as yet insufficient evidence to specify the direction of this shift in self-evaluation. While it seems likely—based on the data presented here—that the shift would be negative, this is a question that future research should explore in other contexts.

Finally, this essay suggests the need for research that takes account of broad patterns in corporate activity. Though most research in this vein has focused on single organizations or incidents (e.g. McNamara *et al.*, 2002), the evidence presented here—along with the historical record (Harrington, 2013)—indicates that public response to corporate misconduct is strongly influenced by historical context. By shaping the standards against which they are evaluated, this context affects firms' survival in the marketplace; Deephouse and Carter (2005) implied as much

about the commercial banks they studied. This suggests a final proposition for empirical testing

> *Proposition 3*: When a large group of organizations lose legitimacy, reputation increases in significance so that being less well-regarded than others can threaten a firm's continued existence.

3. Conclusions

This paper extends the theoretical distinction between legitimacy and reputation by linking it to social psychological theories of power and identity. Consistent with recent work on the overall decline of sanctions for corporate misconduct (Macey, 2013), the evidence from retail investors suggests that even when firms lose legitimacy, they experience few financial consequences for that loss—*as long as they maintain a reputation no worse than their peers.* Meaningful penalties for corporate misconduct, the kind likely to evoke behavioural change, can only be meted out by other organizations, specifically 'those that exercise coercive power or mobilize other social actors' (Deephouse and Carter, 2005, p. 351). Lacking that power, retail investors changed what they *could* control: their evaluative standards for firms, and their own social identities.

For the investing public, the weight of corporate reputation relative to legitimacy has probably increased since 2004, when the last of the data discussed in this paper were gathered. The global financial crisis of 2008 certainly did nothing to restore public faith in firms. If anything, the absence of meaningful sanctions for illegal or illegitimate behaviour (Macey, 2013) has only solidified the impression that corporate misconduct is the 'new normal'. Or, as Trollope put it, 'dishonesty magnificent in its proportions, and climbing into high places' seems to have made assessment of firms' legitimacy vis-à-vis absolute standards of social acceptability increasingly irrelevant. What remains are considerations of reputation—a relativism that would have horrified Trollope, but is perhaps better suited to an era in which the pragmatics of the market have colonized the life-world (Habermas, 1985).

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