

Chapter 14

Industry Self-Regulation as a Solution to the Reputation Commons Problem: The Case of the New York Clearing House Association

Lori Qingyuan Yue

Paul Ingram

The performance of organizations depends partly on the reputations of their industries. Such reputations are “intangible commons.” Interest in protecting mutual welfare motivates members of an industry to engage in self-regulation. However, the current literature tends to have a pessimistic view of the efficacy of self-regulation in solving the problem of reputational commons. We argue that the obstacles forecasted by such pessimistic reasoning are context-bound and can be overcome if industry self-regulation includes effective sanctions and exclusion strategies. We investigate the case of the New York Clearing House Association, a community-based self-regulatory program, which, by promoting prudence among members, successfully ameliorated the negative spillover effect on market confidence during bank panics. We then identify five conditions that account for the efficacy of this self-regulation. We conclude by

showing how research on institutional solutions to the problem of reputation commons can be extended.

INTRODUCTION

The performance of organizations depends partly on the reputations of their industries. These reputations are “intangible commons” because organizations share both the penalties and rewards associated with the reputations of their industries. Interest in protecting mutual welfare motivates members of an industry to engage in self-regulation. However, current literature tends to hold a pessimistic view of self-regulation’s ability to solve the problem of industry reputational commons. This pessimistic view is rooted in three lines of reasoning: (1) competitive relations within the same industry will undermine the willingness of organizations to cooperate; (2) a collective solution will suffer from opportunism and is thus unlikely to be successful; (3) a collective solution is likely to be exploited by a group of organizations in order to create unfair market competition, which, in turn, will reduce social welfare. Moreover, critics point out that when it comes to solving the problem of reputation commons, self-regulation is likely to serve as a smokescreen since reputation can be improved simply by impressing outsiders without changing the behaviors of organizations. Thus, it is important to investigate whether self-regulation can solve the problem of reputation commons by disciplining the behavior of members effectively. We argue that obstacles forecasted by these pessimistic lines of

reasoning are context-bound and that they can be overcome if industry self-regulation includes effective sanctions and exclusion strategies.

To justify this claim, we first review the literature on industry reputation commons. We argue that reputation exists beyond the level of individual organizations and that the problem of reputation commons originates in the interdependence of outsiders' perception of an organization and that of its peers. All organizations within an industry face sanctions from stakeholders when social expectations are violated. At the same time, all organizations within an industry also enjoy better access to resources when their industry gains cognitive and social political legitimacy. Sharing motivates organizations to cooperate, build a good collective reputation, and protect that reputation from harm. Thus, the emergence of rules and norms to govern the commons is motivated by the self-interested decisions of organizations, as self-regulatory institutions allow organizations to gain the benefits of coordinated activity.

We then examine the case of the New York Clearing House Association (NYCHA), a community-based, self-regulatory program among commercial banking organizations. We show that the effects of negative spillover on market confidence created a reputation commons for banks during times of panic, and that the NYCHA was founded as a collective institutional solution for ameliorating the problem of reputation commons. We have identified five conditions that result in the NYCHA's efficacy in solving the commons problem: (1) previous cooperative experience created a foundation from which self-regulation could take root; (2) a transaction-based mechanism for measuring contributions and consumption offered incentives for good performers to contribute and discouraged poor performers from consuming the common good;

(3) formal mechanisms for inspection, sanction, and exclusion could be enforced to exclude free-riders; (4) a close-knit community further facilitated monitoring and increased the cost of defection; and (5) antitrust legislations and the advance of the state constrained the legitimacy of self-regulation.

We end the chapter by discussing ways to extend research beyond the hurdles that self-regulation must overcome in order to solve the problem of reputation commons. We suggest that future research should examine alternative means of enforcement, such as independent third-party certification, and hybrid forms of regulation that partner with the government. Future research should also test the efficacy of self-regulation by separating the question as to whether industry self-regulations can, in theory, be effective, from legal and political contexts that have inhibited such efforts. Finally, future research should explore the consequence of changes in community structures and information diffusion mechanisms on self-regulation in order to solve reputation commons in new industries.

REPUTATION COMMONS: CONCEPT AND TYPE

Corporate reputation is defined as “observers’ collective judgments of a corporation based on assessments of the financial, social, and environmental impacts attributed to the corporation over time” (Barnett, Jermier, & Lafferty, 2006: 34). In general, reputation is a judgment that is formed through the observation of past behaviors, but also shapes future expectations. Reputation seldom develops in isolation. Since observers can only evaluate the actions of an organization by

considering those of its peers, reputations of organizations are interdependent. A downward social comparison can easily boost one's reputation. Yet standing within a group of dirty peers can hardly make one look clean if observers perceive every organization as one of *the dirty ones*. The thorny interdependence of reputation between an organization and its industry includes both competitive and communal dimensions. [Wade, Swaminathan, and Saxon \(1998\)](#) have observed this interdependence in the brewing industry. According to their study, the passage of prohibition laws in one state resulted in the proliferation of breweries in neighboring states, though too many prohibitions in neighboring areas dampened the number of local breweries because their legitimacy was threatened. The communal view of corporations' reputation argues that the reputation of an organization depends not only on its actions, but also on the reputation of the industry in which it occurs. If organizations depend on collective perceptions of their industry, all of them face sanctions when one severely violates the expectations of stakeholders. Thus, organizational reputation exists beyond the level of individual organizations and has its roots in an interorganizational context ([Barnett & Hoffman, 2008](#)). In this sense, industry reputation is an intangible *commons* ([Barnett & King, 2008](#)).

There are at least three reasons why the reputations of organizations share a communal feature. First of all, organizations within an industry share a reputation because they share similar attributes. Since organizations within the same industry tend to utilize similar resources, employ similar technologies, and adopt similar management practices, the actions of one are often perceived as emblematic of an entire industry. Being tarred by the same brush is not rare. In the case of the recent Gulf oil spill, for example, while the accident was unique to BP, it put all oil

companies under public scrutiny because it “caused consumers to question whether a similar incident could happen to other companies” (Market Strategies International, 2010). As a result, the market index of the reputation of the energy industry plummeted by 25 percent (Market Strategies International, 2010). Second, observers use collective reputations to judge an individual firm due to the problem of information asymmetry. Outsiders may not be equipped with specialized knowledge to distinguish between the behaviors of the industry’s individual members. Even if they are, the cost of making an informed judgment may be prohibitively high, especially when the source of information is distant in terms of geography, culture, and language. As a result of information asymmetry, newcomers to an industry can still bear the stigma of their predecessors long after the latter are gone (Tirole, 1996). Third, an individual organization’s actions can significantly affect the reputation of an entire industry. Research in psychology has shown that salient events caused by certain group members are represented disproportionately in impressions of the group formed by observers because the availability heuristic makes it easier for extremes to be overestimated (Rothbart et al., 1978). As a result, severe accidents and catastrophes caused by an individual organization can have devastating effects on the reputation of an entire industry.

Corporate social responsibility is one instance of an industry-reputation common, as the public has become increasingly concerned about the role of corporations as responsible citizens in society. Besides pursuing profits, corporations are expected to comply with labor, environmental, human rights, or other standards of accountability. Researchers have documented numerous cases in which an entire industry is sanctioned when one or a small group of

organizations violate the expectations of social responsibility. In the chemical industry, all firms were punished by shareholders due to one individual firm's accident (Barnett & King, 2008). In the coffee, athletic shoes, and apparel industries, sweatshops and other unfair labor practices have agitated widespread boycotts by consumers (Malkin, 1996; Hornblower, 2000). In the diamond industry, conflict diamonds mined in African war zones poisoned the glamour linked to the industry and caused drops in sales (Zoellner, 2006). In the early movie industry, the excessive portrayal of sex and violence by some producers drew fire from America's moral guardians, and incurred a crusade that jeopardized the future of this nascent industry (Walsh, 1996).

To be sure, industry reputation commons is not limited to the domain of social responsibility or the shared fate occasioned by shared penalties. A good collective reputation can also lead to shared rewards, such as enlarged growth opportunities or expanded resource space. As a collective perception, reputation is socially constructed and can be enhanced through a legitimation process (Rao, 1994). When organizations' actions are perceived as desirable, proper, and appropriate to the social system of norms and beliefs, they obtain a good reputation, and lead to easier resource access. Consider the necessary legitimation process at the early stage of new industries. Aldrich & Fiol (1994) argue that the essential task of industry pioneers is to construct a favorable reputation for the industry by demonstrating that it is economically viable, cognitively cogent, and morally defensible. In the case of French nouvelle cuisine, for example, endorsement by star chefs ameliorated the pressure of the culinary movement being perceived as abnormal by traditional food critics (Rao, Monin, & Durand, 2005). Similarly, in the case of

American hotels, the founding of the Cornell School of Hotel Administration elevated the image of the hotel industry by presenting it as a profession that attracts talent (Ingram, 1998). When more and more people follow the steps of pioneers, a fledgling industry not only grows in size but gradually achieves a taken-for-granted status. In this constitutive legitimation process, each member contributes by its mere existence.

Another positive effect of sharing an industry reputation is regional industry clusters. The reputation of industry clusters attracts talent and customers from a wide radius. This concentration of talent catalyzes innovations that, in turn, benefit all industry members through the diffusion of learning and knowledge. In the nineteenth century, the reputation of Clyde River as a shipping capital helped shipbuilders in the area secure orders from all over the world (Ingram & Lifschitz, 2006). The fair-trade reputation enjoyed by merchants in Champagne during the Middle Ages helped the region become a trading center in Europe (Milgrom, North, & Weingast, 1990). Similarly, in the modern age, industry clusters such as Silicon Valley function as a magnet that attracts entrepreneurs, scientists, and venture capitalists (Saxenian, 1994).

COLLECTIVE SOLUTIONS TO REPUTATION

COMMONS

Central to the problem of reputation commons is the interdependence of the reputation of an individual organization and that of its industry. If an individual organization can successfully distinguish itself from the rest of its industry, then no commons problem will arise. However,

with limited resources, an individual firm may not be able to generate enough differences to stand out. Empirical evidence has demonstrated that even industry leaders such as Nike, Gap, and Starbucks are not immune to the backlash against their industries, despite offering superior working conditions than their peers do (Malkin, 1996; Hornblower, 2000). In fact, firms that hold high standards of accountability are more likely to be targeted by social activists, who see responsible firms as soft targets that are likelier to respond to their requests (Barron & Diermeier, 2007). Thus, they prey on these firms to generate momentum for their movements.

If individual firms have limited capacity to solve the problem of reputation commons, it is in the interest of organizations to cooperate, set enforceable standards, and impose a rationalized system to discipline their actions and those of their competitors. The emergence of a self-regulatory institution is motivated by the self-interest of organizations, and incentives to cooperate are grounded in the belief that such an institution will allow organizations to gain the benefits of coordinated activity. This concept of an institution as a “cooperation-for-collective-benefits” (Knight, 1992) is a fundamental argument of both institutional economics (North, 1990) and rational-choice institutionalism (Nee & Ingram, 1998). Industry self-regulation provides a way to solve the problem of reputation commons by providing collective benefits unattainable through the actions of an individual organization. This is also the strategy that Barnett & Hoffman (2008) called “teaming up” with peers.

The difficult fact in protecting reputational commons is that it requires many direct competitors in an industry to cooperate. Organizations that share a common reputation are also those that researchers and practitioners classify as direct competitors. Yu & Lester (2008) find

that reputational spillovers occur among structurally equivalent parties. However, structural equivalence, too, has been used to define competitors because structural equivalents serve as substitutes for each other. Similarly, [Barnett \(2006\)](#) argues that reputation spillover is stronger among homogeneous firms. [Hannan, Polos, & Carroll \(2007\)](#) echo this and claim that a population's legitimacy is directly tied to the degree of similarity among its members. Yet the more similar an organization is to its rivals, the more competitive is their relationship due to overlap in shared resources ([McPherson, 1983](#)). In addition, when competition is localized, staying close to an industrial center means staying close to many competitors. [Sorensen & Audia \(2000\)](#) have shown that proximity to competitors significantly increases the chances of an individual organization's mortality.

The dark shadow of competition is the first obstacle in the formation of a collective solution to industry reputation commons. Competition dampens mutual trust. Without trust, institutional initiators are hesitant to act because they risk placing themselves at a disadvantage if their rivals fail to follow them. Furthermore, other organizations may suspect the intentions of rivals that initiate a regulatory institution and may thus refuse to participate for fear of being trapped in an institution that favors initiators. For example, after the scandal of the El Monte sweatshop in [1995](#), apparel firms in California faced a reputation-commons problem. Some of them attempted to reach out to their primary competitors to establish an anti-sweatshop alliance. But none of these efforts were productive because competitors suspected that they simply constituted another sort of "backroom competition" ([Bartley, 2007](#): 29). In addition to reducing trust, competition also forces organizations to focus on short-term goals such as survival, whereas the improvement

of industry reputation takes time. Organizations, uncertain as to whether they will still be in business the following year, are unwilling to make long-term investments in improving industry reputation.

The second obstacle facing self-regulation lies in the legitimacy of cooperation among competitors. Inherent in the theory of perfect competition is the Darwinian notion that purely competitive markets are good for society because they force firms to reach maximum efficiency. Beyond the calculation of total social welfare, another aspect of the legitimacy of self-regulation involves distributional justice, that is, whether self-regulation serves private at the expense of public interests. Some critics claim that self-regulation is simply a means by which to fend off government regulation. They criticize self-regulation for its weak standards, ineffective enforcement, and secret and mild punishments (Waguespack & Sorenson, 2010). Howard, Nash, & Ehrenfeld (2000) also contend that self-regulation is a smokescreen aimed more at improving public image than at generating real improvement, much as the globe's worst human rights violators are the most likely to sign treaties that protect human rights (Hafner-Burton & Tsutsui, 2005). Supporting such critiques, King & Lenox (2000) report that Responsible Care, a self-regulatory program established after the Bhopal accident in order to mend the reputation of the chemical industry, was incapable of reducing its members' pollution emissions.

Researchers have also expressed concern over the distributional justice of benefits for direct participants of self-regulation. For example, Barnett (forthcoming) finds that large firms exert control over industry communal organizations to advance their own interests rather than those of an entire industry. A related problem is that access to a self-regulation program is controlled by

institutional incumbents who can deploy self-regulation to disadvantage their economic rivals by denying them equal rights of participation.

Besides legitimacy concerns, scholars have also been skeptical of the viability of self-regulation, specifically whether self-regulation can overcome the free-rider problem. The key to providing any common good is to induce contributions or protect it from being exploited by those who do not contribute. At least since the publication of [Mancur Olson's](#) *The Logic of Collective Action* in [1965](#), social scientists have been dubious of the idea that voluntary associations tend to form and take collective action whenever members jointly benefit. The reasoning behind Olson's idea is similar in structure to the dilemma of an n-person game ([Hardin, 1971](#)): if each individual can access benefits of the public good that are funded by others' contributions without payment, then in a finite number of rounds a rational actor will contribute zero. If participation in a private cooperation is voluntary and unenforced by a central authority, then each actor has an incentive to defect from agreements and to free-ride on the efforts of others.

Another concern related to the free-rider problem is the situation of adverse selection. Since organizations with lower levels of performance benefit more from an improvement in industry reputation, they have more incentives to join in coordinated action. Moreover, bad performers may use participation in industry self-regulation to disguise their poor performance. Without effective mechanisms to exclude these bad apples, self-regulation may be downgraded in a way similar to that of the market for lemons ([Akerlof, 1970](#)). [King & Lenox \(2000\)](#) observed the

adverse selection problem in the Responsible Care program and found that firms in heavy pollution sectors were more likely to join the self-regulation program.

These obstacles have recently been re-evaluated through a series of investigations of real-life voluntary associations. Based on her research of private institutions that help pool common resources such as fisheries, forests, and water resources, [Ostrom \(2000\)](#) argued that when a small group of actors makes a credible commitment, engages in effective monitoring, and sanctions against deviations, self-organized cooperative institutions can protect participants' common interests, and the benefits derived from such collective action can spur efforts to create and maintain these private institutions. Can the conditions that Ostrom applied to the governance of physical commons be extended to govern reputation commons?

The depletion of physical commons such as clean water, shared fisheries, and stable climate has a direct impact on the welfare of relevant parties. The conditions of these physical commons can hardly be improved if relevant parties do not reduce water pollution, promote sustainable fisheries, or curb carbon dioxide emissions. However, reputation commons differs from physical commons in that reputation is a set of perceptions that can be decoupled from actual behavior. Thus collective solutions for improving reputation commons can work indirectly by influencing perception without touching the real problem. In support of this view, [Barnett & King \(2008\)](#) have found that rather than acting as a means of disciplining the actions of members, self-regulation deploys impression management practices to forestall industry-wide sanctions. The difference between physical and reputation commons raises the question about the efficacy of self-regulation in solving real problems that concern outside stakeholders. If self-regulation is

simply an effort to manipulate impressions, its efficacy is greatly reduced. It thus remains an important task to investigate whether, and under what conditions, self-regulation can effectively discipline the behavior of participants in solving the problem of reputation commons. We address these problems by illustrating the case of the New York Clearing House Association (NYCHA), an industry self-regulatory institution that solved the problem of reputation commons in the banking industry before the founding of the Federal Reserve.

THE CASE OF THE NEW YORK CLEARING HOUSE ASSOCIATION

Banks are professionally managed. Ordinary depositors cannot easily judge the health of an individual bank. Due to information asymmetry, depositors use information revealed about certain banks to evaluate the soundness of others. As a result, negative investment news about a few banks or some isolated bank failures can damage confidence in a banking market. If depositors worry that their own banks are, or might become, insolvent, they will rush to withdraw their deposits, leading to runs on many banks at the same time. Bank runs can make originally solvent banks fail. To satisfy depositors' demand for cash, these banks may be forced to liquidate their assets in a short time period, often at steep discounts. When discounted assets are inadequate to compensate for debts, a bank becomes insolvent and is likely to fail. Thus, bank runs are contagious, and the problem of reputation commons is at the center of bank panics (Calomiris & Gorton, 1991).

In the US, before deregulation in the late 1970s and early 1980s, banks in most states could only branch within their headquarter state or within the area of their headquarter cities. Localized operation made the effect of reputation spillover especially strong because banks were not diversified geographically. One cooperative arrangement through which banks could unite their actions was the clearing house. The first clearing house in the country was the New York Clearing House Association founded in 1853. Before the Federal Reserve was founded in 1914, there were more than 200 clearing houses in the country. The clearing house was a city-based voluntary association among banks. The function of the clearing house can be broken down into two categories, clearing and regulation (Cannon, 1910). To fulfill the clearing function, the clearing house provided centralized clearing services for its members over notes, drafts, checks, and bills of exchange. To fulfill the regulation function, the clearing house prescribed rules and norms for the control of its members, through which the clearing house ameliorated the problem of reputation commons. It is important to note that the clearing function preceded the regulation function. Cooperation in the clearing process brought bankers together and created a forum in which innovative self-regulation took root.

Early in its operation, the clearing house adopted a strategy of pooling the reserves of members. Pooling was not popular, however, because more conservatively managed banks had no rewards to contribute to this reserve pool, while opportunistic banks were allowed to pursue high-risk and high-return operations. From the 1870s on, the clearing house abandoned the practice of pooling reserves and adopted transaction-based loan certificates. Once a bank panic struck, member banks could borrow loan certificates from the clearing house and use them in

place of currency in the clearing process. They could thus inflate the adequacy of cash that they needed to satisfy depositors' demands. These loan certificates were interest-based, and borrowing banks paid lending banks interest rates ranging from 6 to 10 percent—high enough to encourage reserve-abundant banks to share their bounty and to discourage reserve-deficient banks from borrowing more frequently than when absolutely necessary. In this way, the clearing house provided a selective incentive for banks to contribute to collective solvency, and to refrain from threatening that solvency. Serving as a credit intermediary, the clearing house enabled a more efficient use of resources during panics, when banks hoarded money.

Was the clearing house an effective regulatory institution? [Yue, Luo, & Ingram \(2009\)](#) have studied the efficacy of the New York Clearing House Association—the largest clearing house in the nation—in reducing the failure rate and operational risk of member banks. They found that the NYCHA reduced the failure rate of member banks by 56 percent after controlling the endogeneity of self-selection in membership. Moreover, they found that NYCHA member banks were relatively prudent and avoided highly risky operations. [Yue, Luo, & Ingram \(2009\)](#) also show that the NYCHA was successful in imposing self-regulation and organizing cooperative arrangements. What, however, was the welfare implication? As [Yue, Luo, & Ingram \(2009\)](#) demonstrate, survival benefits did not remain solely with NYCHA members but spread to all Manhattan commercial banks. The overall failure rate of this population during the regulation of the NYCHA was significantly lower than in the previous period, which had had no private regulation. Moreover, the overall failure rate of this population under the regulation of the NYCHA was no higher than that under the government regulation after [1914](#). Although the

NYCHA only rescued its members, its efforts at dampening waves of bank panics stabilized the market and allowed the whole bank population to flourish. The number of commercial banks located in Manhattan increased from 51 in 1853, when the NYCHA was founded, to about 100 in 1913, when the NYCHA ceased to regulate the market. More impressively, the total assets of these banks grew 1,400 percent during this period. Contrary to what antitrust proponents might predict, under the regulation of the NYCHA, New York developed into the most competitive and vibrant banking market in the country. It is hard to exaggerate the role that the NYCHA played, and in an era without a central bank, the NYCHA was regarded as “a most important and beneficial part in the general economic health of the nation” (Gilpin & Wallace, 1905: 5).

The success of the NYCHA in mitigating panics was a result of the system of loan certificates, and, most importantly, of the monitoring and sanctioning regime that backed the system. First of all, the clearing house provided *club goods*, accessible only to clearing house members. Key to the provision of club goods was that free-riders had to be excluded from the club (Potoski & Prakash, 2009). The clearing house had a special committee in charge of member admission. In addition, new members had to be approved by the majority of existing members. The clearing house also adopted an exclusion strategy. Banks that refused to share the burden of other members during a financial crisis were suspended from the privileges of the clearing house or were even expelled (Cannon, 1910). Second, to prevent the moral hazard problem, the clearing house required banks to keep a high level of reserves (Hammond, 1957). The clearing house closely monitored the balance sheets of member banks and required them to report their condition every week. Moreover, the clearing house had the authority to audit

members' books at any moment, which it could do in response to rumors about the state of a particular member.

Third, as a form of local self-regulation, the clearing house was relatively small, but its modest size made close monitoring feasible and coordination relatively easy. Due to prohibitions on bank branching, banks were locally based. Even the largest clearing houses, such as the NYCHA, maintained a size of 50–60 members during the years they regulated the market. Moreover, a shared market made mutual monitoring relatively easy. [Gorton & Mulleaux \(1987\)](#) argue that monitoring within the clearing house was especially effective because member banks had the specialized knowledge to value each other's assets.

Fourth, besides formal strategies, the embeddedness of the clearing house in a close-knit community also offered informal mechanisms for excluding free-riders. Geographical proximity facilitated the diffusion of information and increased the stake of sanctions. Within a small geographical region, monitoring was strong because information could easily be transferred and defectors easily identified. Moreover, actors were less likely to defect because the stake of losing various types of connections was too high. Geographical proximity also facilitated social interactions between community members. Bankers within such dense community networks faced strong peer pressure to act responsibly. Informal constraints thus significantly reduced the cost of coordination within the clearing house.

It is useful to compare the clearing house with Responsible Care, an industry self-regulation program aimed at solving the problem of reputation commons in the modern chemical industry. In terms of formal control, the clearing house had a set of inspection, sanction, and exclusion

strategies to control risk-taking activities among its members. As King & Leonx (2000) have pointed out, however, the Responsible Care program is unable to expel any of its members who fail to meet the standards and has only limited power to monitor members' implementation of the codes. In addition, the Responsible Care program does not inspect members' adherence but relies on their self-reporting. Having no "iron fist," this program is, not surprisingly, more attractive to bad performers and has no effect disciplining the behaviors of its members. In terms of informal control, industry self-regulation can create a code of responsible behavior to discipline members by forming and diffusing norms within the moral community of organizational peers. However, the formation of norms requires community-wide consensus, while the diffusion of norms requires dense networks. A small close-knit community did exist among commercial banks in Manhattan in the 1800s, but is obviously absent in many modern industries. Instead, a modern industry, such as the chemical industry, is composed of multinational corporations, the operations of which are globally dispersed. It is nearly impossible for these corporations to monitor each other. Finally, if members cannot identify with a moral community, informal coercion simply does not work.

If the clearing house was so successful, why did it eventually fail? The internal operation of the clearing house never really failed. Before the panic of 1907, the NYCHA issued loan certificates eight times and not a dollar was lost (Gilpin & Wallace, 1905). For the clearing houses in the rest of the US, "the losses from all the various note issues, spurious and otherwise, *were negligible!* The only loss reported in any of the accounts here considered was \$170,000 in

Philadelphia in 1890 out of an issue of 9.7 million—1.8 percent of that total” (Timberlake, 1993: 210; italics in original).

To understand the final episode of the clearing house as a private regulation program, we must take into account changes in economic and political contexts. From the end of the 1890s on, more and more trust companies, originally chartered to manage the wealth of the affluent, began to compete with banks in the deposit and loan market. Market competition intensified the rivalry between banks and trust companies, and trust companies were excluded from the NYCHA. During the panic of 1907, the NYCHA—as a self-regulation program for banks—refused to extend assistance to trust companies. This deepened the market crisis significantly. The serious consequences of the panic revealed the limitations of the NYCHA as a market regulator and created political opportunities for other social and political interest groups to initiate banking regulation reform.

The political environment also changed. The clearing house as industry self-regulation flourished in an era of laissez-faire. Before the founding of the Federal Reserve, the government supplied few institutional solutions to bank panics. The clearing house was founded in the Era of Free Banking (1837–1862). During this time, states were the sole authority to charter and regulate banks. The Michigan Act passed in 1837 automatized the chartering of banks, reduced state supervision, and created shakier banks. Relaxed regulation caused market chaos; the average lifespan of a bank in this era was five years; about half of the banks failed—a third because they could not redeem their notes. Many banks in this era earned the reputation of being *wildcat banks*. Although the National Banking Act of 1863 created a system of national banks

that required higher standards of reserves than state banks, the government still offered no solution to the problem of reputation spillovers during panics. The rise of clearing houses was the banking industry's spontaneous response to the need for restoring market confidence and constructing an ordered market. Instead of being founded to fend off public regulation, the clearing house played an important role in filling the institutional vacuum created by the government.

The legitimacy of the clearing house in regulating the market was not challenged until the 1890s, especially after loan certificates of small denomination were circulated in place of currency during panics. The debate focused on whether loan certificates were loans or currency. Populists accused the clearing house of issuing illegal money and infringing the authority of the federal government. By 1907, a large portion of the clearing house issues had become recognizably illegal (Timberlake, 1993). Seeking to restrain big business and perceiving the institutions designed by business as serving their own interests, the progressive movement advanced the state as a legitimate market regulator allegedly for egalitarian reasons. The creation of the Federal Reserve in 1914 marked the end of the era of the clearing house as a regulator of commercial banks.

Despite its limitation in regulating an entire market, the NYCHA does prove that self-regulation can solve the problem of reputation commons by disciplining the behavior of organizations effectively. We have identified five conditions critical to the clearing house's success. First, cooperation within the non-regulatory function of clearing created a foundation in which self-regulation took root. Previous cooperation had enabled banks to leave the shadow of

competition and explore opportunities that protected their common interests. Second, interest-bearing loan certificates created a transaction-based mechanism that encouraged contribution and discouraged opportunism. Third, the clearing house adopted a set of formal strategies based on inspection, sanction, and exclusion to prevent banks from taking high risks. Fourth, a close-knit community further facilitated monitoring and increased the cost of defection. Such a social structure also formed a moral community that encouraged banks to act responsibly. Fifth, the economic and political atmosphere outside the clearing house constrained the legitimacy of self-regulation. While the institutional vacuum left by the government provided fertile ground for self-regulation to flourish, the subsequent advance of progressive legislation legitimized the state rather than private actors as regulator.

These conditions also set up boundaries for self-regulation to discipline the behavior of members effectively. For example, one limitation of the clearing house was that when the scale of the economy exceeded the boundaries of local communities, the means of exerting control were weakened. In this respect, the success of local clearing houses stood in sharp contrast to the failure of the emergence of a nationwide clearing house. Another limitation that arises when applying clearing house principles to modern industry self-regulation is the barrier set up by antitrust laws. Below we discuss ways to extend research beyond the constraints of self-regulation's efficacy in solving the problem of reputation commons.

IMPLICATIONS AND DIRECTIONS FOR FUTURE STUDY

Our review has two goals. One is to point out that a firm's reputation is affected by factors beyond its control. The interdependence of organization and industry reputations creates a challenging problem of commons. The other is to suggest that given the communal nature of industry reputation commons, collective strategies such as industry self-regulation provide a solution to reputation commons. The case of the clearing house clearly illustrates that the reputation of an individual organization depends on that of its residing industry, and that under certain conditions self-regulation can be organized effectively to discipline industry peers' behaviors. We list the literature reviewed in this chapter regarding the concept and management of industry reputation commons in [the summary table at the end of the chapter](#).

Regarding our first goal, the current literature can be expanded in at least three ways. First, despite growing scholarly interest in corporate reputation, most research has treated organizations as autonomous entities and ignored their mutual dependence. Future research should pay more attention to the externality between organizations and, in their analysis of organizational outcomes, take into account the commons problem. Second, the current literature on reputation commons has focused mostly on the negative interdependence between organizations. Future research should look more carefully at positive externality between organizations. As our review of the literature reveals, organizations can also benefit from the positive reputation attributed to their peers' legitimation efforts or to the effect of industry

clustering. In fact, a good industry reputation can serve as a unique competitive advantage for an industry as well as for its members. It may be fruitful for future researchers to reveal how organizations create and maintain their positive industry reputation. Finally, future research can also benefit from investigating how the boundaries of reputation commons are defined. Organizations can be grouped by means other than industries. They can be grouped by geographies or other common features. Within each group or category, there are subgroups and subcategories. The interdependence of organizational reputation degenerates with the expansion of category scope. Thus effective definitions of the borders of reputation commons have important implications for the success of collective mobilization aimed at addressing problems of commons. In addition, different audiences may pick up different cognitive cues when defining a category. Future research on reputation commons should address questions such as who are the key stakeholders and from whose perspective is corporate reputation addressed.

Regarding our second goal—how to resolve the problem of reputation commons—we suggest that in order to discipline the behavior of members effectively, any self-regulation program has to be equipped with an “iron fist” that allows it to monitor and sanction. But modern antitrust laws prevent self-regulation from directly controlling and sanctioning the behavior of members. Future research should explore alternative means that self-regulation could adopt to resolve the problem of reputation commons. One direction to take is to put intra-industry efforts such as the NYCHA in context with third-party-led private regulation, of which a typical form is certification. Non-governmental organizations (NGOs) codify standards of action and certify organizations’ adherence to these standards through independent inspections. An early example

of such third-party certification is the Motion Picture Association of America (MPAA), which solved the reputation commons in the movie industry by certifying films according to five different categories. In the last few decades, concerns over corporate social responsibility such as sweatshops, child labor, blood diamonds, food safety, environmental sustainability, and other issues have spurred the foundation of dozens of non-governmental certification institutes (Bartley, 2007).

Certification is essentially a signaling strategy. By conferring certification, certifiers endorse a signal that those who are certified are superior to others who are unable or uninterested in obtaining certification. But certification is limited in its ability to sanction, and thus it may be a weak solution for reputation commons. When norms are breached, a certifier's response is often limited to withdrawing or downgrading certification. This type of sanctioning has limited power because outsiders may or may not observe the change of signal. Another issue that adds to the weak sanction is fragmentation within the field of certifiers themselves. Field fragmentation makes it difficult for outsiders to follow any single certifiers closely. Moreover, the proliferation of certifiers and the differentiation strategies they pursue enable opportunistic organizations to shop for certifiers. Competition within the field of certifiers speaks to another problem that arises from relying on a third party to regulate, namely, how to motivate those independent regulators who do not have a direct interest in the results of regulation. When certifiers adopt a for-profit model, competition may lead regulatory standards and enforcement to evolve along a different trajectory. When facing conflicts of interest, certifiers intentionally create ambiguities in evaluating categories (Fleischer, 2009). Similarly, when certifiers begin to receive payment for

their work, it is difficult for them to remain impartial while issuing certification, as was the case with bond-rating agencies in the recent subprime mortgage crisis (Lucchetti, Ng, & Hitt, 2010). Future research should investigate how to motivate independent third parties and how to protect their reputation (see also Gilad and Yogev, Chapter 24, this volume).

The other direction that researchers have taken is towards a hybrid form of public and private institutions in which private regulators produce the standards of regulation but outsource enforcement to the government. In the nuclear industry in the US, the Institute of Nuclear Power Operations (INPO), a trade association, sponsors industry standards, and a state-run regulatory body, the Nuclear Regulatory Commission (NRC), enforces these standards. Rees (1994) found confirmative evidence of the efficacy of this type of hybrid form. While it raises questions about the blurriness of the boundary between public and private regulation, it does touch on one key issue concerning the success of regulation: an effective regulator must have good knowledge of an industry. Along this line of reasoning, researchers can also explore other ways in which public and private regulations can be connected.

The trend of globalization in recent decades offers new opportunities for studying industry self-governance as a solution for reputation commons. One reason is that antitrust laws may have limited application within the global market. An obvious case of this is the US antitrust law which does not apply to any activities of American companies that affect only foreign markets. The other reason is that the increased flow of capital across national borders creates a demand for global regulatory schemes that transcend the sovereignty of any single nation. However, international conflicts add barriers to intergovernmental agreements and consequently afford

private actors with unique opportunities to act as institutional entrepreneurs (Bartley, 2007).

Researchers have noted that transnational regulatory programs have emerged in manufacturing and natural resource-extracting industries to manage reputation problems in environmental protection and labor disputes.

Finally, advances in information technology have profoundly changed the way people communicate and have seeded various new forms of communities. When the boundaries of online communities move beyond the constraint of geography, the expanded space offers opportunities for organizing self-regulation in new domains. In addition, information technology industries offer new opportunities for investigating collective solutions for reputation commons. For example, the popularity of online social media has created a US\$23 billion-a-year online-advertising industry that tracks consumers' web-surfing habits for ad targeting. But this industry is fiercely attacked by advocates of consumer privacy. To protect the reputation of the industry as well as to ward off potential public regulations, a coalition representing advertisers and Internet companies released a set of voluntary guidelines in July 2009, calling for voluntary disclosure of tracking and data use. Without an enforcement authority, this coalition encourages adherence only through peer pressure and the threat of public exposure (Steel, 2010). Future research should investigate whether advances in monitoring technology in cyberspace and amplified public exposure due to networking online can deter opportunism.

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Summary Table. Literature Review of the Concept and Management of Industry Reputation Commons

Reference	Key Constructs & Findings
Barnett & Hoffman (2008)	This article argues that organizations’ reputations and performance are not solely determined by their individual behaviors but also by

	interorganizational dependence.
Barnett & King (2008)	This article develops the key definition of reputation commons to describe the interdependence in organizational reputation. Organizations in an industry share sanctions thanks to shared reputation.
Wade, Swaminathan, & Saxon (1998)	There are both competitive and communal interdependences between an organization's reputation and that of its peers.
Bartley (2007); Barnett & King (2008); Malkin, (1996); Hornblower (2000); Zoellner (2006); Walsh (1996)	These articles study industry reputation commons in the domain of corporate social responsibility. The violation of social accountability by an individual organization can result in penalties for an entire industry.
Aldrich & Fiol (1994); Rao, Monin, & Durand (2005); Ingram (1998);	These articles study industry reputation commons in the domain of legitimation. There are three types of legitimation: cognitive legitimation, social-political legitimation, and constitutive legitimation. A good reputation helps all organizations within an industry to acquire resources.
Ingram & Lifschitz (2006); Milgrom, North, & Weingast (1990); Saxenian (1994)	These articles study industry reputation commons in the domain of industry clusters and regional advantage. Good reputation of an industry cluster benefits all organizations by attracting talent and customers from a wide radius.

<p>Barnett (2006); Ingram & Yue (2008)</p>	<p>These articles study the collective strategy that firms can adopt to enhance their competitive positions through cooperation with their industry peers. These articles suggest that collective strategy can serve as a means of managing the communal problems, such as reputation commons, that face an entire industry.</p>
<p>Ostrom (1990); Ostrom (2000)</p>	<p>Ostrom's work shatters the belief that government regulation or pure market transaction (i.e., property rights) is the only solution to the problem of commons. Ostrom proposes that self-regulation programs can serve as a viable alternative.</p>
<p>Potoski & Prakash (2009)</p>	<p>This article proposes private clubs as a solution to the problem of commons. Clubs can mitigate the reputation commons problem by conferring a signaling benefit to firms and allowing their stakeholders to reward them for producing the social externality that club membership requires.</p>