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I. Introduction

Investors face a difficult task when they value a particular securities investment. Investors typically put money into an investment with the anticipation of taking out even more money sometime into the future. Unlike more tangible investments, a securities investment provides returns only through intangible rights to a company’s cash flows in the form of dividends and rights to assets in liquidation. Having credible information on the nature of these intangible rights as well as on the underlying business of a company then is important for investors seeking to value both the expected return as well as risk. Even with information, investors must have the requisite expertise to assess the information to come up with an informed opinion on the value of a security. Gathering information and assessing the information in turn is costly.

These problems persist after an investment is initially made as investors must decide both how to manage their investment (exercising rights as shareholders for example) and when to sell. Although an important component of share ownership is corporate governance rights, few shareholders actively exercise these rights. The explanation for shareholder passivity is straightforward. The dispersed shareholder body in large, publicly-held corporations (termed “traded firms”) is poorly positioned to engage in effective collective action. It is costly for shareholders to monitor, and the costs of monitoring management or leading a proxy contest typically far outweigh the benefits to an individual shareholder. As a result, shareholder collective actions are rare, even though such actions may benefit shareholders as a group.

The information cost and collective action problems facing dispersed shareholders in large publicly-held corporations create at least two possibilities for opportunism on the part of corporations and insiders. First, corporations may attempt to issue securities at inflated prices, thereby shifting value from new investors toward preexisting shareholders. Second, managers of corporations may take advantage of the inability of investors to monitor the managers’ activities fully, expropriating a portion of a firm’s value for the managers’ own private benefits through large salaries, insider trading, and other forms of self-dealing.¹ The market response to these problems is one of pricing. Investors aware of the possibility of opportunism will be more

¹ For example, Dennis Kozlowski, former CEO of Tyco International, is alleged to have used $1 million of Tyco money to pay for his wife’s 40th-birthday party in Sardinia. See Melissa August et al., Notebook/Milestones, Time, Sept. 30, 2002 at 28.
reluctant to invest and will demand a higher return to compensate them for the risks of self-dealing. In turn, this will reduce the price at which investors are willing to purchase securities.\textsuperscript{2} Where investors cannot distinguish among corporations with varying risks of opportunism, the investors will discount the securities price of all corporations as a group. A classic lemons problem thus arises where corporations that in fact expropriate a lower amount from investors are given the same discount as corporations with higher levels of expropriation, leading the more investor-friendly firms to exit the capital markets.\textsuperscript{3} Fortunately, the securities markets provide a response to the lemon’s problem in the form of securities intermediaries.\textsuperscript{4} Auditors (at least in theory) verify the accuracy of corporate disclosures. Analysts help investors obtain, evaluate and verify information about prospective investments. By reducing the information costs associated with investing, intermediaries reduce the pricing discount and thereby increase the supply of capital available to issuers. Intermediaries also provide services that facilitate shareholder monitoring, including providing advice on proxy contests and technical assistance in the collection of proxies and computation of vote totals. The proxy-advisory firm Institutional Shareholder Services, Inc. (ISS) supplies guidance to institutional investors, recently influencing the shareholder vote to approve the Compaq-Hewlett Packard merger.\textsuperscript{5} The firm Automatic Data Processing (ADP) provides a mechanism enabling shareholders to vote their stock by telephone or over the internet.\textsuperscript{6} By enhancing the effectiveness of shareholder monitoring, intermediary services reduce the risk of management self-dealing.

\textsuperscript{2} See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, Investor Protection and Corporate Valuation (working paper 2000) (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=227583) (reporting evidence that coming from a common law jurisdiction has a statistically significant positive impact on Tobin’s q measure of valuation in support of their hypothesis that legal protections for minority shareholders result in increased valuations for firms); Bernard S. Black, Hasung Jang, and Woochan Kim, Does Corporate Governance Matter?: Evidence from the Korean Market (working paper on file with author) (available at http://www.aicg.org) (providing evidence that a higher level of corporate governance protection for firms listed on the KSE results in a higher Tobin’s Q measure of valuation, among other valuation measures, for firms).


\textsuperscript{4} Indeed, firms themselves benefit from reducing the price discount investors demand of the firms’ securities (at least when the firms are raising capital from the market) and therefore may have an internal incentive to encourage intermediaries. See, e.g., Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 305–07 (1976).

\textsuperscript{5} See Robin Sidel, Pui-Wing Tam, Mylene Mangalindan, ISS Is Put in Spotlight as H-P Claims Victory, WSJ, Mar. 20, 2002, at C20 (stating that ISS’s recommendation in favor of the H-P and Compaq merger “helped bolster H-P’s position in one of the most contentious proxy battles in recent years.”).

The performance of securities intermediaries does not always match this theory, however. Investors in Enron relied at least in part on the auditing services of Arthur Andersen in their assessment of Enron as an investment. Arthur Andersen’s failure to report Enron’s financial status accurately (followed by Arthur Andersen’s alleged destruction of Enron-related auditing documents in the face a widening SEC investigation) resulted in large losses on the part of investors that relied on Arthur Andersen’s auditing role. Securities analysts ignored serious indications of financial problems and continued to recommend Enron as an investment long after the company entered its death spiral. Similarly, Jack Grubman, the premier telecom analyst of the late 1990s, recommended WorldCom (and other telecoms) positively despite a sustained drop in its stock price over 2000-2001. Indeed, the presence of high-reputation intermediaries may lull investors into a false sense of security, causing them to rely on the intermediaries and uncover less information on their own. Once lulled, investors may lose even more money than where the investors enjoyed no securities intermediary-provided protections.

As recent congressional inquiries and media reports have made clear, many of the problems with effective intermediary performance can be traced to conflicts of interest. Firms that audit an issuer’s financial statements also perform lucrative consulting services which compromise auditing independence. Analyst reports are, in many cases, influenced by a brokerage firm’s desire to attract or retain investment banking business. Even shareholder proxy insurgents who offer the promise of intermediation through the introduction of shareholder proposals or the initiation of proxy contests may be motivated more by personal gain than collective shareholder welfare.

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9 See Charles Gasparino and Tom Hamburger, Congress Broadens Probe of Enron Fall To Wall Street Firms, Wall St. J., Mar. 7, 2002, at C1 (reporting Congressional investigation into “analysts who continued to recommend Enron’s stock last fall as the company careened toward bankruptcy”).

10 See Steven Rosenbush, et al., Inside the Telecom Game, Businessweek, Aug. 5, 2002, at 34. See also Charles Gasparino, Citigroup Chief Sanford Weill Will Testify in Salomon Probes, Wall St. J., Oct. 23, 2002 at A1 (reporting that “Grubman, who is cooperating in Mr. Spitzer’s probe, has said he changed his rating [of AT&T] back in 1999 of a hold to the equivalent of a strong buy after what he regarded as nudging from Mr. Weill.”).
The approach toward addressing the problems facing securities market intermediaries has largely consisted of piecemeal efforts to reduce conflicts of interest. In the case of analysts, some have proposed explicitly delinking the compensation of analysts from the investment banking business. Merrill Lynch recently entered into a settlement with the Attorney General of the state of New York effecting a partial separation of these roles. The National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) have also implemented a number of conflict-of-interest rules designed to increase the independence of analysts. In the summer of 2002, President Bush signed the Sarbanes-Oxley Act implementing, among other things, a new five-member auditor oversight board consisting of a majority of non-accounting professionals. The legislation also forbids outside auditors from providing a wide range of consulting services to their client audit firms. Sarbanes-Oxley also requires the SEC to adopt rules to address analyst conflicts of interest.

Elimination of conflicts facing intermediaries is a flawed solution, however. First, someone has to pay for intermediary services, and eliminating conflicts may block an important source of financing. We argue that existing intermediary conflicts have arisen, in large part, because intermediary services are not self supporting. Regulations that force the separation of intermediary services from more lucrative services may reduce the provision of services that cannot be sustained on an independent basis. Second, this effect may exacerbate existing shortages of intermediary services. We argue that some types of intermediation services are

11 The Merrill-Spitzer settlement provides that Merrill Lynch must compensate analysts on factors separate from its investment banking business. See Cheryl Winokur Munk, Merrill Changes Stock-Research Rating Process, Wall St. J., June 10, 2002, at C16. Merrill Lynch also agreed to adopt a new three-tier rating system in addition to paying a $100 million fine as part of its settlement. See id. The Merrill-Spitzer settlement, nevertheless, does not completely separate analysts from investment banking, allowing analysts to receive compensation out of a financial firm’s general revenues (including therefore revenues derived from investment banking). See id.

12 See Randall Smith, New NASD Rule Limits Analysts At “Bake-Offs”, Wall St. J., June 6, 2002, at C1 (noting that the NASD and NYSE’s rules, among other things, would place “a ban on analysts being paid for specific banking deals and disclosure of banking fees in reports” and “limit analysts’ ability to show banking clients the contents of future reports.”). Under the rules, analysts are precluded from “issuing a research report on a company if the analyst has participated in any meeting with the company prior to the time the firm is designated as an underwriter on a new issue.” Id. The SEC adopted the NASD and NYSE proposals on May 10, 2002. See id.

13 See Sections 101-109, Sarbanes-Oxley Act of 2002. The five-member oversight board tracks an earlier nine-member board proposed by the SEC. See Michael Schroeder, Critics Take Aim at SEC’s Plan for Auditor-Oversight Board, Wall St. J., June 20, 2002, at A2 (noting that “SEC Chairman Harvey Pitt has said the agency plans to unilaterally set up such a board by year's end.”).

14 See Section 201, Sarbanes-Oxley Act of 2002. It is unclear, however, that the new legislation significantly increases the restrictions on auditor consulting services. Notably, in particular, the Act does not prohibit auditors from consulting on tax issues. See id.

persistently in short supply. In particular, although intermediaries presently provide information and technical support, to date they have failed to provide more active services, such as initiating proxy contests.

Why can’t intermediary services be financed through standard market transactions? One reason is a free rider problem. Where shareholders are dispersed, they simply lack individually the full incentive to pay for information and services that benefit the shareholders as a group. Intermediaries may attempt to sell their services to only a subset of investors, but this leads to the possibility that some investors may free-ride off the payments of other investors. In addition, many intermediary services are in the nature of public goods. Information, for example, rapidly leaks into the marketplace, preventing analysts from capturing the full value of their research through sales of information to the investing public.16

Of course, companies themselves may act as collectivizing agents, bearing the cost of services that benefit all shareholders. Companies do this when they disclose information to the entire market (often in the form of mandatory disclosure), obviating the need for individual investors to research the same information.17 Companies do this when they hire an outside auditor to certify the companies’ financial statements. Some companies also hire market research firms to provide reports for investors on the companies. Onetta Inc., a startup fiber-optics company, hired Aberdeen Group to provide a research report (perhaps unsurprisingly positive) on Onetta.18 Companies also help fund the activities of analysts that benefit all shareholders indirectly. Part of the fee paid for investment banking services, for example, goes to compensate the activities of analysts (and therefore explains the relative absence of independent analysts). Similarly, some commentators have argued that managers, prior to the promulgation of Regulation FD which severely curtailed selective disclosures, used such disclosures to subsidize analyst dissemination of information.19

17 See infra Part IV.B.2.a (describing the use of mandatory disclosure to subsidize the research of analysts).
Subsidies from traded firms, however, are precisely what make intermediaries vulnerable to conflicts of interest with the managers of the traded firms. Although companies may work to centralize the interests of all shareholders in funding the activities of securities market intermediaries, the companies face a managerial opportunism problem in how to allocate these funds. In particular, managers are unlikely to allocate funds in ways that maximize the capacity of intermediaries to address opportunism. Rather, managers are likely to fund intermediaries that favor managers. Indeed, management control over the allocation of intermediary financing allows opportunist managers to influence intermediary output of research and other services.

Our central observation is that the problems plaguing securities intermediaries result from a financing dilemma. Absent cross-subsidies or firm financing, the market cannot sustain the optimal level of intermediary activity. The relationship between investment banking and analyst services is an example of such a cross-subsidy. Although it is logical for the firm to serve as a collectivizing agent in financing intermediary services, firm-based financing is subject to a conflict of interest problem so long as managers exercise control over the financing decision.

Understanding the problem facing intermediaries as primarily a financing dilemma leads to the observation that efforts at controlling the conflict of interest problem will ultimately fail unless a separate solution is found for the financing problem. This then leads us to our main proposal. We put forth a new funding arrangement for intermediaries that preserves the central role of corporations in subsidizing the activities of intermediaries for the benefit of shareholders. While retaining corporations as a source of funding, however, we separate the source of funds from the decision of how to allocate the funds. In particular, we outline a shareholder voucher proposal under which shareholders individually are given the ability to direct funding vouchers to the intermediary of their choosing. Voucher financing, of course, is not problem free. Nonetheless, we contend that at least for intermediaries that offer services providing value to a large number of companies and investors concurrently (such as proxy contest insurgents and analysts) without any direct form of financing from traded firms, voucher financing provides a superior alternative to existing financing mechanisms.

Our proposal has several important benefits. First, by looking to the traded firm directly as the source for intermediary funding, the proposal highlights the fact that intermediaries

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20 Other solutions are possible to the problem of managerial opportunism at least in the area of selective disclosures. See, e.g., Choi, supra note 19, at 569-74.
perform a necessary and valuable function that benefits all shareholders collectively. Second, by removing the need for independent sources of intermediary funding, the proposal eliminates the need for cross-subsidization that has resulted in the high level of existing conflicts of interest among intermediaries. Third, by placing control over funding allocation in the hands of investors, the proposal reduces management influence over intermediaries and replaces it with direct accountability to shareholders.

The combination of these effects is likely to affect dramatically the market for intermediary services. We expect a substantial increase in the number of independent intermediaries and, at the same time, a proliferation of new intermediary services for investors. Voucher financing will also complement securities regulations designed to protect investors. Investor protections provided through intermediaries act as a substitute for protections provided through more stringent (and invasive) government regulations. Shoring up the ability of the private market intermediaries to protect investors places less pressure on regulators to increase antifraud penalties and engage in more searching (and costly) enforcement actions. Voucher financing also provides a more flexible and market-driven means of subsidizing intermediaries compared with regulators. Finally, reinforcing the role of intermediaries offers a meaningful mechanism for restoring investor confidence in the securities markets.

The paper proceeds as follows. Part II sets forth the collective problem facing dispersed shareholders. Part III describes the role and function of securities market intermediaries. We describe existing intermediaries, the services they provide, and the structural problems that hinder their ability to fulfill their investor-protection potential fully. Present and proposed legal responses to these structural problems are assessed in Part IV. Part V then sets forth our proposal for creating truly independent intermediaries. Key components of this proposal include

21 For a related argument that securities antifraud liability should take into account alternative market-based mechanisms (which may vary systematically across different size firms), see Stephen J. Choi, Company Registration: Toward a Status-Based Antifraud Regime, 64 U. Chi. L. Rev. 567 (1997).
22 Regulators, for example, may make mistakes. See Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359, 2378-79 (1998) (noting that “[o]ne particularly egregious example of the SEC's problematic disclosure policies will serve to underscore the point that it would be a profound mistake to presume that the SEC gets things right. The SEC prohibited for decades the disclosure of projected earnings. Such information, however, is far more valuable to investors than the accounting information the SEC required, because stock value is a function of future cash flows not historical data. The SEC modified its position in 1979 to permit the disclosure of projections within a safe harbor rule, but even today the agency's approach is still quite guarded when it comes to such disclosures.”). Regulators may also suffer from well-known public choice problems. See Jonathan R. Macey, Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty, 15 Cardozo L. Rev. 909, 924 (1994) (providing a public choice explanation for the SEC’s continued existence despite its obsolescence).
creating an independent source of intermediary funding and allowing shareholders to control this funding. We advocate a voucher system under which corporations subsidize intermediaries but shareholders individually allocate the subsidized corporate funds to the intermediaries of their choice.

II. The Collective Action Problem

The central problem facing shareholders in a publicly-held corporation is one of collective action.\(^{23}\) Dispersed shareholders unable to act collectively enable opportunistic managers to expropriate large private benefits of control.\(^{24}\) This Part discusses the nature of the collective action problem both for individual and institutional investors. The mere existence of a collective action problem, however, does not render shareholders powerless. Indeed, as the Part discusses, institutional investors provide a direct form of intermediation for investors in aggregating their funds in mutual and pension funds. Other intermediaries act to provide information to shareholders or to pursue actions (such as proxy control contests) in the interests of the group of all shareholders.

A. Collective Action Theory

Consider a corporation with only one shareholder. As the residual claimant to the profits (and losses) of the firm, the single shareholder benefits as the corporation does well and correspondingly suffers as the corporation fails to perform. Given her exposure to the ups and downs of the corporate enterprise, the single shareholder will then have an incentive to make expenditures—including expenses to monitor managers or to research whether the firm should undergo a wholesale change in management—to the extent the expenditures increase the overall net return she expects as a shareholder. So where an expenditure of $1,000 will provide the sole shareholder information on whether to hire new management that provides the shareholder an expected benefit of $1,100, the shareholder will undertake the cost.


Now expand the number of shareholders to one thousand, each with at most one percent of the outstanding stock of the corporation. Where shareholders are dispersed, they still benefit (and lose) as the corporation makes profits (or losses). But each individual shareholder receives only a fraction of the profits and losses in proportion to their share ownership. In contrast, any single shareholder that takes it upon herself to expend resources in monitoring management or coordinating with other shareholders to change management will bear a significant fraction (if not all) of the costs alone. Reconsider the example where an expenditure of $1,000 will provide the group of shareholders an expected benefit of $1,100. In this case, a single shareholder that owns only 1% of the outstanding stock will benefit only by $11 and thus will choose not to make an expenditure of $1,000 (despite the benefit to the other shareholders).25

In addition to the general problem of collective action, shareholders also face a rational apathy problem in the context of voting. To the extent a shareholder in a vote believes it unlikely that her vote will be pivotal in the vote then the shareholder will not have any incentive to expend resources in determining how to vote (or even in casting the vote).26 Actions requiring a vote from among dispersed shareholders (including the approval of mergers and the election of directors) therefore face a double problem of collective action in making expenditures that may benefit other shareholders as well as rational apathy in the effectiveness of a vote.

B. Institutional Investors

The presence of institutional investors—including mutual funds and pension funds—reduces the collective action and rational apathy problems facing shareholders while introducing a new set of problems specific to institutional investors. Significantly, institutional investors align investor interests while providing a private mechanism for intermediation. Fidelity Investments, for example, takes in a large amount of funds from individual investors.27 Fidelity then provides its investors with at least three services. Fidelity provides aggregation, allowing investors to purchase a diversified portfolio with only a small amount of money. Fidelity provides information services through the employment of its own buy-side analysts to cover the

securities traded in its actively managed funds. And Fidelity provides the potential for collective action by centralizing the process of shareholder voting.

The rise of institutional investors has resulted in a corresponding increase in the concentration of share ownership. For the largest publicly-held firms in the United States, almost 60% of the capital stock is in the hands of institutional investors. An institutional investor with a sizeable stake in a particular firm will have a much greater incentive than a dispersed individual shareholder to make expenditures that will increase the total value of the company. Not only are institutional investors more likely to take individual actions that increase overall share value but the institutional investors often enjoy repeat relationships with both the firms in which they invest as well as with other institutional investors. Institutional investors as a result can coordinate with one another in overcoming collective action problems.

The rise of institutional investors, however, has not proved a panacea for the problems facing dispersed shareholders. Within institutional investors exists an agency problem between money managers and the institutions themselves. Fidelity Investments, for example, employs a number of managers to direct its various actively-managed mutual funds. Each manager, while benefiting somewhat as the fund performs well, does not capture the full benefit of good performance (most of the benefit accrues to the investors of the fund). Moreover, money managers are typically rated against one another on a frequent basis. Thus managers are rewarded primarily for their fund’s performance relative to that of other funds, rather than the fund’s absolute performance.

The rating system for fund managers causes the interests of such managers to diverge from those of fund investors in several ways. First, although many investors are interested in

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31 See Bernard S. Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 UCLA L. Rev. 781, 803 (2001) (noting that a “cottage industry has arisen of consulting firms who verify the money managers’ performance claims, and a related industry that develops performance indexes against which the performance of a money manager with a particular style or investment focus can be measured.”).
32 See generally John E. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277, 1283 (1991) (“The primary explanation for institutional passivity is not overregulation, but the insufficiency of existing incentives to motivate institutional money managers to monitor.”);
long term fund performance (such as those who are investing for retirement), the frequency of evaluations may lead managers to take a short-term focus. Second, the tournament aspect of assessing money manager quality may lead money managers to herd in their investment behavior. Managers face significant risk for investment decisions that depart substantially from the norms, with limited upside potential. Although doing better than the crowd may increase a manager’s compensation marginally, doing worse than other managers may result in the manager being fired. Third, fund managers face considerable pressure to minimize management costs and expenses. Because of free-riding, a fund that engages in shareholder activism will increase returns for its competitors while reducing its own returns by the costs of activism. Lastly, managers of public pension funds face an additional type of pressure, the pressure to further the political goals of their constituents or public officials who exercise control over the funds. As a result, public fund managers may pursue political goals at the expense of the fund investors.

Even absent an agency problem between money managers and their funds, institutional investors often face a conflict-of-interest in their relationships with traded firms. Some institutional investors provide a variety of financial services directly to firms. A financial services firm, for example, may both manage the pension fund of a firm as well as provide the firm with investment banking services. Institutional investors in such a position may shy away from directly challenging the managers of a firm that also hire the institution to provide financial services. More generally, such institutions may avoid a reputation of shareholder activism to...

Edward Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 Geo. L.J. 445, 473 (1991) ("[T]here are precious few incentives for money managers to act in the interests of their principals.").

33 See Martin Lipton and Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. Chi. L. Rev. 187, 206-07 (1991) (“The investment manager trying to outperform the market average in each quarter or each year will always have an incentive to accept, even seek, a short-term premium for a portfolio stock.”). But see Bernard S. Black, Agents Watching Agents: The Promise of Institutional Voice, 39 UCLA L. Rev. 811, 862 (1992) (contending that “[i]nstitutional myopia, however, looms larger in public perception than in reality, and institutional voice should reduce whatever myopia may exist.”).

34 See David S. Scharfstein and Jeremy C. Stein, Herd Behavior and Investment, 80 Am. Econ. Rev. 465 (1990) (providing an economic model under which money managers concerned about their individual reputations choose to herd in their investment decisions with other money managers).


36 See Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 Colum. L. Rev. 795, 801-04 (1993).

37 See Laura Lin, The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence, 90 Nw. U. L. Rev. 898 (1996) (noting that directors with business ties with the traded firm may have “greater incentive to monitor management, in order to protect their own entities’ investment in the company.

11/18/2002
the extent an activist reputation may hurt an institution’s ability to obtain financial services contracts at other firms. Even institutions that do not directly provide financial services may eschew activism in order to maintain good contacts with managers at their various portfolio firms. Such access, at least arguably, may provide the institutions with superior inside information that may be used to boost the individual institutions returns.  

The agency problems, conflicts, and business relationships have, for the most part, led to institutional reluctance to engage in activism. Many institutions that are unhappy with the management of a particular firm simply exit by selling their shares.  

Despite the possibility of exit, institutions may choose not to exit for at least two reasons. First, some institutional investors have such large positions in firms that exit is simply not a feasible option (without incurring a large reduction in the selling price as they exit). Fidelity Investments, for example, owns significant equity stakes in a large number of firms. For a fund such as Fidelity with a large amount of funds in almost all large public corporations, improving present investments through shareholder activism provides the most cost-effective way toward increasing their return. Second, specialized intermediaries in the securities markets offer a

However, [such] directors also may approve managerial actions detrimental to shareholders in order to please management and thus secure their business relationships with the company."

Note, however, that after the promulgation of Regulation FD, restricting the ability of firms to make disclosures of nonpublic material information selectively to certain market participants, the ability of institutions to obtain superior inside information from managers was severely curtailed. See SEC, Selective Disclosures and Insider Trading, supra note 19.

Institutional investors may also face a conflict in dealing with other market intermediaries, utilizing the institutional investors’ size and power to obtain preferential treatment. One example of such treatment includes the disproportionate ability of institutions to participate in hot IPOs. In 2002, the NASD investigated J.P. Morgan Chase & Co. as well as Robertson Stephens unit of FleetBoston Financial Corp, among others, for allocating disproportionately large portions of IPO shares to favored large investors (that typically paid oversized commissions in return). See Randall Smith and Susan Pulliam, Two More Wall Street Firms Are Targeted in Trading Probe, Wall St. J., April 25, 2002 at A1. The NASD’s investigation followed a settlement against Credit Suisse First Boston in January, 2002 for similar IPO allocation abuses. See Susan Pulliam and Randall Smith, CSFB Fines Employees In IPO Case, Wall St. J., Feb. 20, 2002, at C1.

Jack Coffee has argued this point forcefully. See Coffee, supra note 32, at 1318-28.


A search on the Lexis EDGARP database for proxy filings made in 2001, for example, found that Fidelity Investments had beneficial ownership of more than 5% of the common stock of Andrew Corp., Emulux Corp., Swift Energy Co., and SPX Corp., among others.

See Aaron Lucchetti, A Mutual-Fund Giant is Stalking Excessive Pay, Wall St. J., June 12, 2002, at C1 (reporting Fidelity Investment’s increasing activism with regard to excessive CEO compensation and noting that “big investors increasingly don’t like being forced to sell their stakes, a move that can have tax consequences and limits the universe of stocks available to the investors.”).
mechanism for mediating institutional investor activism, reducing the cost of activism and minimizing free rider problems among institutional investors. ISS, for example, provides advice to institutions on how to vote their proxies. At the same time, intermediaries offer a vehicle for shielding the role and reputation of specific institutional investors. Institutional investors may simply point to ISS as the reason for their proxy vote.

Indeed, the rise of institutional investors may provide the necessary concentration of share ownership and expertise for intermediaries to have a useful impact on the securities markets. Anecdotal evidence exists that institutional investors are in fact increasingly becoming more active in their investments. Institutional investors played a key role in the proxy contest over the merger between Hewlett-Packard and Compaq. The voting assistance services ISS provided to institutional investors in evaluating the merger proposal were a substantial factor. Similarly institutional investors are increasingly taking an active part in supervising shareholder litigation through the role of the lead plaintiff.

Institutional investors, therefore, present a large (if imperfect) part of the answer to the collective action problem facing individual investors. Moreover, institutional investors enjoy the ability to directly charge individual investors for their aggregation service through fees. Fidelity’s Magellan mutual fund, for example, charges its investors an expense ratio fee of 0.89% of invested funds to cover its expenses among other fees. Significantly, however, to the extent a single institutional investor does not obtain the entire ownership of a particular traded firm, a collective action problem to some degree will continue to exist among the shareholders of the firm. Legal barriers, moreover, limit the ability of institutional investors to take sizable positions in any one firm. Institutional investors, therefore, present only a partial solution to the collective action problem. Their presence, nonetheless, makes collective action possible (if

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43 Information on Institutional Shareholder Services can be found at http://www.issproxy.com/ (visited Oct. 29, 2002).
44 See supra note 42 (describing Fidelity’s increasing shareholder activism).
45 See Pui-Wing Tam, Investors Continue To Disclose Position On H-P Acquisition, Wall St. J., Mar. 18, 2002, at B4 (detailing the public announcements of a number of institutional investors on their intention to vote on the Hewlett-Packard and Compaq merger).
48 See www.fidelity.com
49 See Roe, supra note 28, at 26-27.
not probable)—particularly with the assistance of other market intermediaries (such as ISS, for example in the proxy advisory area)—in way not feasible for small, individual investors.

In the next Part, we turn to focus on the function of securities intermediaries that work to aggregate the interests of individual and institutional investors. Unlike the relationship between institutional investors and their client investors, such intermediaries often face a financing problem in obtaining compensation from the group of all shareholders that benefit from the services provided through such intermediaries.

III. Securities Market Intermediaries

This Part provides a taxonomy of securities market intermediaries. In particular, we focus on individuals and institutions that play a specific intermediary role—working to collectivize the interests of all investors of a particular traded firm in the market. Using this definition of securities market intermediaries, we discuss how auditors, analysts, proxy insurgents and other market participants function as intermediaries in particular contexts. Moreover, we identify the financing difficulties facing those intermediaries that play a collectivizing role.

Three common principles stand out with respect to the intermediaries we discuss. First, the intermediaries on which we focus serve as collectivizing agents for the shareholders—providing services that benefit shareholders directly or indirectly. Second, intermediaries often look to two sources of funding traceable to traded firms—either direct funding or cross-subsidization provided by alternative services offered by the intermediary or its organization (often sold to the traded firms). Third, the current financing structure of the intermediaries limits their accountability to investors and may give rise of conflicts of interests between managers and shareholders.

A. Securities Analysts

In the current market, the most significant role of securities intermediaries is the collection, evaluation and dissemination of information. Securities analysts, for example, collect information about issuers, the securities they sell, the industries in which they operate, and general market factors. Analysts typically specialize in a particular industry or market segment,
developing expertise that they use to evaluate the information they obtain. Analysts then disseminate the information to the marketplace in the form of reports and recommendations.\textsuperscript{50} Information intermediation enables investors to monitor firms indirectly through market discipline – investors adjust the price at which they are willing to trade securities based on the information provided. Analysts can be divided, as a general matter, into sell-side analysts, who provide information directly to the investing public, and buy-side analysts, who provide information to their employer, typically a mutual fund or other type of institutional investor. In either case, the analyst’s product provides investors with information about securities as investment opportunities.\textsuperscript{51} Because the free-riding problem is greatest for analysts that disseminate information broadly to the market, we focus in particular on sell-side analysts.

The reports of sell-side analysts, which are directed at the investing public, have received the most extensive media attention. Typically, analysts provide general overall ratings or recommendations on specific companies as well as more detailed research reports. The rating systems advise investors whether to buy, sell, or hold the covered securities.\textsuperscript{52} Analyst recommendations are highly influential in investor decisions, and changes in analyst ratings have a substantial effect on stock price.\textsuperscript{53}

Some sell-side analysts profit solely from marketplace transactions, selling their information to investors. Value Line, for example, with a staff of 70 independent analysts, has provided independent investment analysis for decades through its Value Line Investment Survey publication.\textsuperscript{54} Over the past several years, internet-based independent investor advice has appeared. At \url{www.fool.com}, for example, investors may obtain both general investment advice as well as more specific analysis of individual companies.\textsuperscript{55} Similarly, Morningstar Inc. provides thousands of its own independent analyst reports for subscribers at \url{www.morningstar.com}.\textsuperscript{56}

\textsuperscript{50} Investors, for example, may access Merrill Lynch’s research at \url{http://ml.com/researchmarketing/bin/ml_rsch_mkt.asp} (visited on Nov. 3, 2002).
\textsuperscript{51} For a detailed description of analysts and their role in the securities markets see Jill E. Fisch and Hillary A. Sale, The Securities Analyst as Agent: Rethinking the Regulation of Analysts (Working Paper, 2002).
\textsuperscript{52} Merrill Lynch presently employs a three-part rating system, assigning firms to either buy, neutral, or sell categories. See Cheryl Winokur Munk, Merrill Changes Stock-Research Rating Process, Wall St. J., June 10, 2002, at C16. \textbf{[CITE TO NASD AND NYSE REFORMS ON THIS]}
\textsuperscript{53} Cite empirical support.
\textsuperscript{54} Information on Value Line can be found at its web site at \url{www.valueline.com} (visited on June 26, 2002). A one-year online subscription to the Value Line Investment Survey costs $598 (as of June 26, 2002).
\textsuperscript{55} See \url{www.fool.com} (visited on August 5, 2002).
\textsuperscript{56} See \url{www.morningstar.com} (visited on August 5, 2002).
Another entity, gimmecredit.com, specializes in providing bond related research to only institutional investors at a price of $18,000 per year.\(^{57}\)

Despite the presence of these sources, however, the amount of research provided through independent analyst channels is quite limited. One reason is the public good quality of information. Once an analyst’s information has been released to some investors, other investors may learn of the research, either directly from the initial purchasers (who have every incentive to disseminate the information once they have traded based on it), or indirectly through changes in stock price. Put another way, those who pay for research have difficulty in capturing the full value of the information; offers to purchase or sell large blocks of shares, for example, typically result in large countervailing price reactions, undermining the profit from an informational advantage.\(^{58}\) Quality investment research on the other hand is extremely costly. Although analysts bear the full cost of their work, they are therefore unable to capture all the benefits from their research.\(^{59}\) Such independent analysts also typically focus on large capitalization stocks, leaving only investment bank subsidized analysts to cover mid and small-capitalization stocks.\(^{60}\) Moreover, some question exists as to the actual independence of non-investment bank-affiliated analysts.\(^{61}\)

An argument exists, nevertheless, that analysts and others that engage in securities research may already have too great incentives to generate information from a societal


\(^{58}\) CITE EVIDENCE.


\(^{60}\) See Jeremy Kahn, Splitting Up the Street, Fortune, Oct. 28, 2002, at 30, 31 (reporting the belief of David Trone, Prudential’s brokerage stock analyst, that “[i]f research is separated from banking . . . analysts will drop coverage of small companies.”).

\(^{61}\) A recent Wall Street Journal article for example provided the following information related to independent analyst Sanford Bernstein Inc.:

And for all the talk of Bernstein’s independence, data research Thomson First Call notes that Bernstein’s current percentage of “sell” or “strong sell” ratings earlier in October [2002] was just 5.4%, compared with 8.1% for all the research companies on Wall Street; more recently, Salomon’s own percentage has been as high as 27.5%. So Bernstein hasn’t been as tough on stocks in general as the average Wall Street firm, despite the influence of investment banking relationship on the full-service firms.

perspective. Ian Ayres and one of us, have noted that private parties engaged in information research take into account both the cost of such research and the potential private returns from the research (e.g., if the informed trader receives a higher expected return from her trades). 62 Private parties ignore, however, the cost to uninformed traders from their research (and subsequent trades) as well as ancillary impacts from informed trades (including an increase in the accuracy of the stock price of the traded firm). 63 Competition among traders to become the first with an information advantage may further widen the gap between the incentive of private parties and societal welfare, leading to too high levels of securities research.

Responses are possible, nonetheless, to the contention that analysts already provide too high a level of securities research. In particular, research disseminated broadly through a sell-side analyst share properties in common with mandatory disclosure of information inside the traded firm. Mandatory disclosure provides a mechanism for traded firms to both subsidize the production of information on the part of analysts while also reducing the amount of wasteful, duplicative research. 64 Mandatory disclosure from a traded firm, however, is limited to only inside information. Research distributed to the market through a sell-side analyst may perform a similar function with respect to outside information, both providing information to the market while simultaneously undercutting the incentive of active outsider traders to expend often duplicative resources in researching the same information. Put another way, without subsidized sell-side analyst research, an informational vacuum will arise in the market. Dispersed buy-side analysts may then engage in duplicated (and therefore wasteful) research to fill this vacuum. Subsidizing sell-side analysts (distributing information widely to the market) may therefore result in lower aggregate level of expenditures on research. The Ayres and Choi approach combats the over-incentive of outsider traders to engage in securities research through the grant to traded firms of the right to control informed trading in the a traded firm’s own stock. Subsidies to specific sell-side analysts (including our voucher financing proposal elaborated below) provide an alternative route to reduce overinvestment in research on the part of active traders through the provision of free (or low-cost) outside information research to the market as a whole.

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62 See Ayres and Choi.
63 See id.
64 CITE COFFEE (1984).
Not surprisingly, analysts represent a significant cost center for large financial firms. While financial firms must pay for a variety of costs associated with analysts, including significantly compensation for the analysts themselves, the firms typically are unable to recoup these costs through fees to end-user investors. Prior to the SEC’s deregulation of fixed commissions in 1975, brokers were able to charge relatively high commission fees to institutional and individual investors. Elevated fees, in turn, allowed financial firms to subsidize the research activities of analysts. Significantly, because analyst compensation ultimately derived from investor-customers of a financial firm’s brokerage arm, analysts had at least some incentives to provide objective research valuable to investors. A firm’s ability to provide high quality recommendations generated client relationships which, in turn, led to commission revenue when those investor-clients traded.

After 1975, a shift occurred in the source for analyst compensation within financial firms. Without excess brokerage commissions, firms turned to investment banking revenues as a source of financing for analysts. Ultimately, the source of analyst financing therefore shifted from investors toward traded firms (paying for investment banking services). Over the 1990s (and particularly toward the late 1990s), analyst compensation rose steadily in tandem with higher investment banking revenues. Analyst contracts often contained clauses explicitly tying compensation to the contribution the specific analyst made in obtaining investment banking

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67 See Moss et. al, supra note 65.
68 Mary Meeker of Morgan Stanley, for example, earned $15 million in 1999, compensation “directly linked to her ability to secure investment-banking fees for the firm.” Colleen DeBaise and Nick Wingfield, Morgan Stanley Tech Star Sued on Bullish Calls, Wall St. J., Aug. 2, 2001, at C1. In 1999, Morgan Stanley pulled in approximately $100 million in fees from helping to underwrite IPOs of internet companies. See Charles Gasparino and Randall Smith, Wall Street Scores in ’99; Now for the Big Bonus Round, Wall St. J., Dec. 9, 1999 at C1. See also Patrick McGeehan and Anita Raghavan, Wall Street Investment Banks, Traders May See Year-End Bonuses Leap 30%, Wall St. J., Dec. 3., 1997 at C1 (reporting that “[a]s the securities industry wraps up its most profitable year, firms are expected to dole out the biggest year-end bonuses ever . . . with some highly coveted merger-and-acquisition bankers and research analysts having their payouts almost doubled….”).

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business. Significantly, without the subsidy from traded firms, many analysts operating today may simply close shop.

Subsidization of analysts is not, per se, problematic. In theory, the traded firm is a potential collectivizing agent, internalizing the interests of its entire group of investors. If an issuer expends resources on the development and dissemination of information, investors benefit without the free-riding problem, because the cost is borne proportionately by all shareholders. Moreover, for certain types of information—including inside information—the corporation not only represents an ideal collectivizing agent but also the lowest-cost source of information.

The problem with relying on firms to subsidize analyst production of information is that control over such subsidies is vested in management. Managers, however, may have objectives other than maximizing the ability of analysts to evaluate the firm fairly. The separation of ownership and control and the resulting divergence between the interests of shareholders and those of managers creates the potential that managers will use their control over subsidies for analysts to maximize their private gains. Managers typically benefit, for example, from high levels of analyst optimism, which allow managers to maximize their compensation and reputation. As a result, managers may discriminate among analysts, selectively providing support only to those analysts that support management.

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69 See Charles Gasparino, Analysts’ Contracts Link Pay to Deal Work, Wall St. J., May 6, 2002, at C1 (reviewing analyst compensation contracts from CSFB and Donaldson, Lufkin & Jenrette and reporting that in one contract “the analyst is offered 1% to 3% of ‘the firm’s net profit per transaction . . . with a cap of $250,000’ for investment-banking deals he helps bring in.” and that in another contract an analyst is provided with “‘banking related compensation’”.). See also Charles Gasparino, Latest Fuel in Analyst Probe: ‘Bonus’ Memos, Wall St. J., May 30, 2002, at C1 (reporting that “[f]or years, research analysts at many Wall Street firms have written self-evaluations at bonus time to trumpet their roles in helping to win lucrative stock-and-bond underwriting and merger business.”).

At least two explanations exist for this linkage between analysts and investment banking. First, economies of scale may exist. To the extent a firm provides investment banking services for a traded firm, it will gain knowledge and expertise related to valuing that particular firm’s securities. Second, the linkage between analysts and investment banks allows traded firms to indirectly subsidize the research of analysts through higher fees for investment banks. Indeed, evidence exists that a direct relationship exists between obtaining analyst coverage and providing a financial firm investment banking business. See infra text accompanying notes 73-74 (describing Piper Jaffray’s tactics toward Antigenics).

70 In proposing Regulation FD, the SEC voiced just such a concern. The SEC contended that firms may use selective disclosures to bribe analysts to provide better-than-warranted recommendations for stock in the firms. See Selective Disclosure and Insider Trading, Exchange Act Release Nos. 33-7787, 34-42259, 64 Fed. Reg. 72590, 72592 (Dec. 28, 1999). For an argument that less restrictive means are possible to allow selective disclosures while curtailing managerial opportunism see Choi, supra note 19.
At worst, analysts may then become corrupt and eschew unfavorable reports of companies contributing large payments to the analysts’ own accounts. Analyst recommendations may then become more a tool for selling securities than an objective evaluation. In turn, the financial firms may value the analyst’s work based on its success at generated investment banking business, rather than the accuracy of its analysis. Managers may direct investment banking business only to financial firms where the analysts recommend the traded firm’s securities highly, perhaps more highly than warranted. Evidence exists that financial services firms routinely use analyst coverage as a carrot to induce firms to hire the intermediary for investment banking services. U.S. Bancorp Piper Jaffray, for example, allegedly dropped coverage of Antigenics, a biotechnology company, right after Antigenics chose another investment bank to help with a seasoned public offering of stock. Piper Jaffray also ceased providing market maker services for Antigenics stock.

Company-subsidized financing for analysts may also crowd out independent analysts in the market to the extent investors are unable to distinguish those analysts that operate completely independently of management and analysts that are indirectly subsidized by management. Investors, for example, are less likely to pay for Value Line reports when they are able to obtain research reports from Merrill Lynch and other brokerage firms (receiving an indirect subsidy from companies through their investment banking divisions) for a much lower price if not for free.

71 The Wall Street Journal, for example, reported that Jack Grubman, a former prominent telecom analyst at Salomon Smith Barney (part of Citigroup) in defending against NASD charges argued that Citigroup “wouldn’t let [Grubman] change his stance on the telecom company because it was a banking client.” See Charles Gasparino et al., Wild Card: Citigroup Now Has New Worry: What Grubman Will Say, Wall St. J. Oct. 10, 2002, at A1. The Wall Street Journal in the same article also reported that Citigroup placed pressure on Grubman not to paint AT&T, an eventual investment banking client of Salomon Smith Barney, in a negative light. See id.

Claims of analyst corruption are not unique to Salomon Smith Barney and Merrill Lynch. See Susanne Craig, Massachusetts Claims CSFB Stock Reports Led Investors Astray, Wall St. J., Oct. 22, 2002, at C1 (reporting that allegations made by Massachusetts state securities regulators that CSFB’s investment banking department exerted “undue influence over the firm’s research department”).

72 Certainly higher banking revenues contribute to higher analyst compensation. See, e.g., Charles Gasparino, Spitzer Staff Gathers Salomon E-Mails Criticizing Grubman, Wall St. J., July 16, 2002 at C1 (quoting analyst Jack Grubman as saying: “My compensation is a function of many factors…One of those factors is banking revenues to the firm.”). Analyst firms, nevertheless, have denied tying analyst compensation directly to investment banking fees. See id. But see supra note 69 (citing evidence of explicit contractual ties between analyst compensation and investment banking revenue).


74 See id. Market makers provide liquidity for a particular stock, holding themselves out as continuously willing to sell (at a specified bid price) and purchase (at a specified ask price) the stock.
In response partially to the conflicts facing analysts, several new intermediary driven information services have also recently appeared in the market. Standard and Poor’s (S&P), for example, recently launched a new corporate governance rating service. Unlike most analysts, S&P plans to obtain financing from covered traded firms, charging up to $100,000. Questions exist, however, whether S&P’s reliance on financing directly from traded firms may lead to a similar conflict of interest.

B. Auditors

Analysts are not the only information intermediaries. Other intermediaries provide information to investors and the marketplace. Federal law requires public corporations to have their financial statements reviewed and certified by an independent accounting firm. The auditor issues a financial report certifying that the financial statements have been prepared in accordance with Generally Accepted Accounting Principles (GAAP).

Auditors typically receive compensation directly from the audited firm. Johnson & Johnson paid $9 million to PricewaterhouseCoopers for auditing services in 2001, for example. Although the traded firm’s payment for auditing services helps to collectivize the interests of all investors in ensuring the accuracy of financial disclosure, as with analysts, the financing of auditing services creates the potential for conflicts of interest. Traditionally managers have exercised substantial control over the selection of auditors, leading to the risk that managers would choose auditors with a pro-management bias. Although shareholders often have the nominal ability in most publicly-held corporations to approve (or disapprove) management’s selection of auditors, the voting mechanism typically does not offer shareholders the opportunity

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76 See id. (noting S&P’s claim that “its access to company insiders and internal documents will make for a more nuanced rating.”).
77 See id. Proponents, nonetheless, argue that institutional investors will pressure companies both to obtain a S&P corporate governance ranking and to publicize the ranking. See id.
78 Many SEC filing documents, including public offering registration statements and periodic information filings, required audited financial statements. For an overview of the role of auditors under federal securities regulation see Thomas Lee Hazen, Law of Securities Regulation, 2 Law Sec. Reg. § 9.6 (4th ed.).
79 See id.
80 See Cassell Bryan-Low, Auditors Still Perform Nonaudit Services, Wall St. J., April 3, 2002, at C1
81 Sarbanes-Oxley may address this problem by vesting the audit committee with greater authority to control the selection and compensation of the firm’s auditors. See Section 202, Sarbanes-Oxley Act. Traded firms also must disclose when they change their auditor in a filing with the SEC. See Item 4, Form 8-K.
to select an auditor different from the managers’ choice. Management control of the proxy mechanism coupled with the collective action and rational apathy problems facing shareholders make the vote a mere formality.

At the same time, auditors have increased their supply of other business activities to audit clients, generating additional conflicts of interest. In many cases the fees for non-audit related services substantially exceed the fees for auditing work. In 2001, for example, Johnson & Johnson also paid $57.8 million to PricewaterhouseCoopers for non-audit services, including several million dollars for design work related to Johnson & Johnson’s financial information systems. Prior to Enron’s collapse, Arthur Anderson provided not only auditing services, but also a range of consulting work for Enron. Tax and information technology consulting services, in particular, have become highly profitable.

The financial importance of consulting services to accounting firms and the ability on the part of managers to dangle other revenue sources for auditing firms may lead auditors to compromise the quality of their audits. In particular, managers unable to eliminate quickly and easily an auditor without making public disclosure may instead use a reduction in their purchase of non-audit consulting services as a disciplining device, punishing auditors that do not take a pro-management point of view. Competition among auditors to obtain business from managers, in turn, may lead auditors to accept a reduced auditing fee in the hopes of obtaining other service business from managers. Moreover, auditors that do provide solely auditing services may still face influence from firm managers. To the extent an auditing-only firm faces

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82 See Klaus Eppler and R. Bruce Steinert, Jr., Drafting the Proxy Statement, 1286 PLI/Corp 737, 767 (2002) (“Since the 1930s it has been customary to have shareholders vote to approve the selection of the auditors although in most cases there is no legal requirement for such approval.”).
83 Some companies have moved, in fact, to eliminate the shareholder approval requirement for auditors. See id. at 767.
84 A 2002 survey of Chicago firms found that firms, on the average, paid consulting fees to their auditors that were three times as large as the audit fees. See Janet Kidd Stewart & Andrew Countryman, Local Audit Conflicts Add Up: Consulting Deals, Hiring Practices in Question, Chi. Trib., Feb. 24, 2002, at C-1.
85 See Bryan-Low, supra note 80, at A1.
86 See Deborah Solomon, After Enron, a Push to Limit Accountants to...Accounting, Wall St. J., Jan 25, 2002, at C1 (reporting that “[i]n Enron’s case, the Houston company paid Arthur Andersen LLP $25 million for its audit and $27 million for nonauditing work, including tax-related and consulting services, in 2000, the last year for which figures are publicly available.”)
87 Jeff Gordon voices a similar idea in a recent article on Enron. See Gordon, supra note 7, at 1237-38. (discussing the possibility that firms may employ auditors for non-audit related consulting services in order to give firms a low-visibility method of sanctioning auditors (e.g., by terminating such consulting services) that go against the wishes for firm management).
the possibility of termination at the hands of managers, the auditing-only firm (dependent entirely on its auditing income) will face pressure to adopt a pro-management viewpoint.*88

In addition, a firm that provides consulting services gains a stake in the transactions that it has structured, and subsequently may lack the independence to subject those transactions to rigorous auditing scrutiny.**89 Importantly, investors are poorly placed to discipline auditors for poor quality work. Although investors may eventually penalize the traded firm’s stock price by selling, this reaction may not occur until long after the fact, when the deficiencies of the auditor’s work have come to light. Auditors, of course, may care about their long-term reputations with investors. Individual (and decentralized) decisionmakers within an auditor, nevertheless, may not fully take into account the value of reputation, sacrificing reputation in return for a more direct personal profit (through higher revenues from clients seeking to engage in aggressive accounting for example).*90

C. Proxy Advisory Services

Intermediaries also provide information related directly to shareholder monitoring. Proxy advisors, for example, analyze director performance, shareholder proposals and election contests, and provide shareholders with guidance as to how to vote.

The largest and most influential independent proxy adviser is Independent Shareholder Services (ISS).*91 ISS provides information and analysis to help institutional investors understand the financial implications of proxy proposals and to cast informed votes. Run as a fee-based service with 950 clients worldwide, ISS prepares detailed reports analyzing the proxy issues for approximately 20,000 shareholder meetings per year.*92 Reports include an analysis of the issues subject to shareholder vote, voting recommendations and explanations of the reasons behind the ISS position. ISS also offers a mechanism through which institutions can outsource the voting process to ISS. Through this program, institutions delegate the physical part of voting – receipt

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*88 Nonetheless, an issuer must make a report to the SEC in the event an auditor resigns, is dismissed, or declines to stand for re-election. See Securities Exchange Act Form 8-K, Item 4.
*89 *Cite to Example?*
*90 See, e.g., Gordon, supra note 7, at 1239 (noting that “the compensation of the Houston partners was significantly tied to their client billings both for auditing services and for consulting services. Enron might have been a relatively small client for Andersen, the firm, but it was the largest client for its Houston office, and, for the Enron relationship partners, perhaps their only significant client.”).
*91 Information on ISS’s services can be found at [www.isstf.com](http://www.isstf.com) (visited on June 25, 2002).
of ballots, share reconciliation, casting votes, and recordkeeping – to ISS, which casts the vote according to ISS’s voting guidelines or its client’s customized instructions. 93 For these services, ISS charges its institutional investor clients annual fees that range from a few thousand dollars to hundreds of thousands of dollars. 94

A number of other firms also provide proxy advisory services or otherwise collect governance data for the purpose of providing information to facilitate shareholder monitoring. The Counsel of Institutional Investors (CII), for example, describes its objective as to “encourage member funds, as major shareholders, to take an active role in protecting plan assets and to help members increase return on their investments as part of their fiduciary obligations.” 95 Toward this end CII collects and publishes a variety of governance data on publicly traded firms. In particular, CII actively monitors submissions and results of shareholder initiatives. Included on its web site is information on the text of submitted shareholder proposals and the resulting shareholder votes. 96 Significantly, CII does more than collect and disseminate information. In cases in which a company has failed to respond to a majority shareholder vote in favor of a resolution, CII sends the issuer a letter inquiring as to the company’s intentions. The issuers’ responses are posted on CII’s website. 97 Although some of CII’s information is publicly available, CII is member-financed, and its full range of services is available to members only. 98 Voting membership is open to public and corporate pension funds, at an annual cost of $1.30 per $1 million in assets, but no less than $3,000 and no more than $30,000. 99 The CII also has Educational Sponsors, which include issuers, mutual funds, and even law firms with annual dues ranging from $7,000 to $10,000. 100

A few other organizations provide similar services to that of ISS on a smaller scale. Two of the better known are the Investor Responsibility Research Center (IRRC) and Davis Global

94 See Top Stories: Health Care, Bloomberg News, Nov. 3, 2000 (stating ISS client fees start at $14,500). See also Paul Taylor, HP-Compaq vote to test adviser’s influence, Fin. Times, Mar. 8, 2002 (quoting Jamie Heard, ISS chief executive, as stating that ISS annual subscriptions range from “a few thousand dollars to well into six figures”).
97 See id.
98 For information on obtaining membership to CII see http://www.cii.org/membership.asp (visited on Oct. 29, 2002).
100 See id.
Advisors. IRRC provides proxy search, agency voting service, proxy monitoring, and proxy
guidelines through consulting services and customized software.\textsuperscript{101} Services are provided on a
subscription basis. Davis Global Advisors monitors corporate governance developments, assists
institutions in drafting governance guidelines and provides advice on governance monitoring.\textsuperscript{102}

Despite the presence of firms providing proxy advisory services, not all shareholders
contract for such services. Some investors may continue to believe (rationally) that their vote
has little chance of being pivotal and therefore find investment in deciding how to vote
wasteful.\textsuperscript{103} Other investors may simply choose to free ride on the efforts of investors that do
choose to pay for the advice of proxy advisory services. Due to public reporting of ISS’s
positions and the ability of institutional investors to communicate with each other, an institution
need not subscribe in order to obtain ISS’s voting recommendations. Few individual investors,
as well, pay for advice on how to vote on various proxy issue proposals and control contests.\textsuperscript{104}

Given the earlier analysis about institutional activism,\textsuperscript{105} one might wonder why any
institutional investors are willing to provide existing levels for funding for proxy advisory
services. The answer may come, in part, from the ERISA requirements that pension funds vote
stockholdings in their beneficiaries’ interests.\textsuperscript{106} Subscribing to a proxy advisory service and
voting in accordance with its recommendations is a relatively low cost and safe way to meet
these requirements. Accordingly, ERISA indirectly sustains a minimal level of intermediary
proxy advisory activity. Institutions that subscribe for the sole purpose of meeting their legal
obligations as fiduciaries, however, may be less apt to demand accountability from ISS.\textsuperscript{107}

Perhaps because of the underfunding of proxy advisory intermediaries (relative to their
contribution to shareholder welfare), the market for proxy advisors does not seem able to support

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\textsuperscript{101} Information on IRRC can be found at \url{http://www.irrc.com}(visited on Oct. 29, 2002).
\textsuperscript{102} Information on Davis Global Advisors can be found at \url{http://www.davisglobal.com}(visited on Oct. 29, 2002).
\textsuperscript{103} See supra note 26 (citing to sources describing the rational apathy problem).
\textsuperscript{104} Institutional Shareholder Services, for example, gears specific services to corporations and to
institutional investors. No such services are tailored for individual services. See \url{http://www.issproxy.com/services/}
(visited on Oct. 29, 2002).
\textsuperscript{105} See supra Part II.B.
codified at 29 C.F.R. § 2509.94-2 (1999)) (encouraging pension funds to exercise their voting rights in the best
interests of fund beneficiaries); See also Letter from Alan D. Lebowitz, Dep. Ass. Secretary, Labor Dep’t, to
Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc. (Feb. 23, 1988), reprinted in BNA Pension
Rep., Feb. 29, 1988, at 391 (asserting that “with respect to proxy voting . . . an investment manager or other
responsible fiduciary must keep accurate records as to the voting of proxies”);
\textsuperscript{107} See supra note 106 and accompanying text.
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extensive competition. Within the last several years, ISS has absorbed two of its main competitors, Fairvest Corporation which is the leading provider to institutional investors of Canadian corporate governance research and related services, and Proxy Monitor, the second leading proxy services firm, which was merged with ISS in July 2001.\footnote{See Robin Sidel, After This Deal, Is Anyone Left to Give Advice?, Wall St. J., July 26, 2001 at C1.} Limited competition leads to two problems. First, the high cost of proxy advisory services makes them largely unavailable to individual investors.\footnote{Recently shareholder proposals introduced at a few companies have sought to have the company hire a proxy advisor, with corporate funds, for the benefit of all shareholders. See, e.g., The Gillette Company, 2001 SEC No-Act. LEXIS 175 (Feb. 1, 2001) (rejecting arguments that shareholder proposal requesting board to hire an independent proxy advisory firm can be excluded from issuer’s proxy statement).} Second, the virtual monopoly provides services like ISS with a tremendous amount of power.\footnote{See, e.g., Tom Johnson, Proxy Analysts Take Spotlight in Merger, Houston Chron., Mar. 5, 2002 (describing power wielded by ISS in mergers and proxy contests).} Recently, for example, the NYSE introduced proposed rules that would require shareholder approval of all executive stock option plans and, in addition, eliminate the authority of brokers to vote on such plans without explicit shareholder instructions. If these rules are adopted, approval of stock option plans will essentially depend on the vote of institutional investors. ISS’s influence over this vote indirectly provides ISS with the ability to influence executive compensation across all NYSE-listed firms.\footnote{Interestingly, ISS recommended that shareholders vote against a proposal requesting the board of directors to hire an independent shareholder advisory firm. See Letter from Mark Latham to Shirley Westcott dated March 22, 2000 (avail. at \url{http://www.corpmon.com/ResponseToISS.htm} quoting from ISS recommendation).}

Although the services provided by these intermediaries are not extensive, they appear to be reliable.\footnote{See id. (describing ISS as “the only independent U.S. firm providing investors with advice on merger and shareholder contests”).} Nonetheless, one potential risk is that proxy advisory firms may be subject to conflicts of interest that are not fully disclosed to the investing public. In the Compaq-HP merger, for example, one commentator, a securities analyst, raised allegations of such conflicts with respect to ISS.\footnote{Cite. [Jill—I couldn’t find this?].} SEC filings reveal that a substantial percentage of ISS is owned by venture capital firm Warburg Pincus, that Warburg is a general partner of ISS and that three Warburg partners sit on the eight member ISS board of directors.\footnote{Cite. [Jill—I couldn’t find this?].} Significantly, Warburg Pincus had been involved in a number of business deals with HP.\footnote{Cite. [Jill—I couldn’t find this?].} Another substantial owner of ISS is Hermes, an asset management firm that manages four of the seven largest UK pension
plans. The analyst alleged that Hermes’ position with respect to the merger may have been influenced by its customer relationships and the prospect of future asset management fees.\textsuperscript{116}

Similarly, because ISS generates substantial revenues from the services that it provides to institutional investors, which include corporate pension funds and other institutions with Wall Street loyalties, ISS may face constraints on its ability to criticize management decisionmaking. Indeed, ISS is able to sell its services most profitably to non-activist institutions that prefer to delegate their proxy decisionmaking to a third party. In addition, ISS offers consulting services to corporations for the purpose of assisting corporate management in drafting corporate governance proposals, poison pills and executive compensation plans.\textsuperscript{117} The sale of these services would be threatened if ISS were to appear too critical of corporate management.

\section*{D. Shareholder Activism}

Shareholders may also act as collectivizing intermediaries themselves. Institutional investors and insurgent groups may provide monitoring services by disseminating information to their fellow shareholders or take a more activist role, such as submitting a shareholder proposal or mounting a proxy contest.\textsuperscript{118} Of course shareholders often act out of conflicted motives – seeking to generate private gains rather than to promote general shareholder welfare.\textsuperscript{119} Nonetheless, in those instances where their actions in fact serve the interests of shareholders generally, shareholders are properly considered intermediaries.

Shareholders may increase investor welfare simply by providing information. Several large institutional investors, for example, including CalPERS and TIAA-CREF, have begun publicly announcing their proxy voting decisions and the reasons for those decisions.\textsuperscript{120} These announcements reduce the information and monitoring costs to other shareholders of casting an informed vote. In addition, shareholders are currently the exclusive source of more activist

\textsuperscript{116}Cite. [Jill—I couldn’t find this?].

\textsuperscript{117}For more information on ISS’s services for corporation see http://www.issproxy.com/services/corporate/index.html (visited on Nov. 4, 2002).

\textsuperscript{118}Shareholders may also provide monitoring services by initiating or supervising shareholder litigation.

\textsuperscript{119}See, e.g., Bebchuk and Kahan, supra note 23, at 1091-96 (discussing various ways shareholder proxy insurgents’ private interests may cause them to deviate from the socially optimal decision on pursuing a proxy contest).

\textsuperscript{120}For examples of public announcements of voting intentions in the Hewlett-Packard and Compaq merger vote see Tam, supra note 45, at B4. See also Securities Exchange Act of 1934 Rule 14a-1(1)(2)(iv) (excluding public announcements by shareholders on how they intend to vote, including public speeches and press releases from the definition of a proxy solicitation).
services. An individual shareholder that chooses to launch a proxy contest to change the board of directors or that proposes a shareholder initiative designed to increase shareholder welfare acts in the collective best interest of all investors in the firm. A shareholder activist that calls for improved corporate governance policies acts as a collectivizing agent. Even a large institutional investor that uses its ownership position to pressure management informally benefits all investors in the firm. Indeed, empirical studies demonstrate a correlation between some institutional activism and higher overall share returns, suggesting that institutions are providing value to the entire shareholder class.\footnote{121}

In most cases, shareholder activism is not funded directly by either investors or the traded firm. Although the laws of most states allow the corporation to subsidize voluntarily a challenger’s proxy expenses, as a practical matter, reimbursement is only available if the challenger mounts an election contest and the contest is successful in changing control of the board.\footnote{122} Reimbursement may, in some cases, also require shareholder approval.\footnote{123}

In theory, intermediaries could attempt to sell activist services to investors in the market. However, the free riding problem is even larger for shareholder activism than for the provision of information research. When they sell information, intermediaries are at least able to provide a greater advantage to those investors that receive the information first. Investors with an informational advantage are able to profit from trades based on the information before others in the market learn of the information. In the case of actions taken on behalf of all investors, on the other hand, investors that refuse to pay are just as well off as investors that pay for such actions. Investors that do not pay for the services of a proxy contest insurgent benefit from the change in management to the same extent as investors that do pay for such services (in proportion to their share holdings). To the extent investors are dispersed and ignore the benefit of their actions on other investors, such investors will have a large incentive simply to free ride off the efforts of an intermediary rather than purchase the intermediary’s services.

Instead, activism is largely self-financed. Some shareholders receive a return for their activities through an increase in the value of their own shares. The successful bidder in a tender

\footnote{121}Cite – [Jill do you have cites on this?].
\footnote{122}See Bebchuk and Kahan, supra note 23, at 1106 (noting that “companies generally pay all the expenses for the reelection campaign of incumbents, but reimburse challengers only if they gain control over the board of directors.”).
\footnote{123}See id. at 1109 (discussing the need for successful proxy insurgents to obtain shareholder approval before receiving reimbursement of expenses). See also Steinberg v. Adams, 90 F. Supp. 604, 608 (S.D.N.Y. 1950); Rosenfeld v. Fairchild Engine & Airplane Corp. 309 N.Y. 168, 173, 128 N.E.2d 291, 293 (1955).
offer, for example, is rewarded in part to the extent it is able to increase share value, raising the value of all shares in the company (including the bidder’s own pre-bid block of shares). Large institutional investors that put pressure on management to raise share value also benefit as their share holdings increase in value. Despite the possibility of benefiting through share ownership, a shareholder that owns less than 100% of the outstanding equity necessarily only captures a fraction of the total benefit from their actions.

Shareholder activists may also benefit from private non-share-related gains. The successful bidder in a tender offer may receive a return to the extent that it buys control for less than fair value or to the extent that it subsequently uses control to expropriate value from remaining public shareholders or other corporate constituencies. Shareholder gadflies may reap personal value from the attention associated with the sponsorship of proxy proposals. In the context of proxy issue proposals, evidence exists that unions and charitable organizations may sponsor proposals to generate publicity for causes in which they specifically have a stake or to gain bargaining leverage over management. Because private gains may be in tension with or even come at the direct expense of shareholder welfare, they produce conflicts of interest that make them undesirable as a source of intermediary funding.

Shareholder activism, therefore, presents a dual problem. Where shareholders are acting in the best interests of all shareholders in pursuing, for example, a proxy contest, they are under-compensated to the extent they own only a fraction of the outstanding shares. Bebchuk and Kahan have noted that this under-compensation may lead to a suboptimally low level of shareholder activism. In contrast, shareholder activists that pursue an action against a traded firm to increase the activists’ own private benefits may have too great an incentive to engage in such actions relative to the best interests of the group of all shareholders.

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124 Few bidders, however, have pre-bid toehold stakes. Arturo Bris presents evidence from a sample of tender offers in the United States from 1985 to 1998 that only 3.2% of the bidders had a prior toehold stake. See Arturo Bris, When Do Bidders Purchase a Toehold? (Sept. 2001), at http://faculty.som.yale.edu/~ab364/toehold.PDF (visited on Oct. 29, 2002).

125 Cite to example?


127 See Bebchuk and Kahan, supra note 23, at 1093 (“entry decisions might be skewed because contestants do not internalize the full change in company value. Rather, any change in company value will accrue to a contestant only to the extent that she owns stock of the company.”).

128 See id. at 1094-95 (noting that divergence between private costs and social costs may lead to too high levels of shareholder activism from the perspective of social optimality).
In response to this dual problem, Bebchuk and Kahan have argued for an intermediate level of reimbursement (providing neither full nor zero levels of reimbursement of expenses).\textsuperscript{129} They propose mandatory subsidies based on shareholder support for the challenge.\textsuperscript{130} This subsidy, although politically impractical, shares some common ground with our financing proposal in that shareholders, by voting in favor of the challenger’s proposal, are able to approve firm-based subsidization of the challenger’s actions. The Bebchuk and Kahan solution, however, links shareholder decision about financing with the decision on the merits of the proposal (to the extent more meritorious proposals typically receive a higher fraction of the votes).\textsuperscript{131} This approach limits subsidization for proposals that increase firm value indirectly. The publicity from a losing contest (particularly one that obtains a large fraction of the votes), for example, may spur managers to make changes in the governance of the firm. As well, a losing contest may raise awareness among shareholders, raising the probability that a subsequent contest will be successful. At the same time, under Bebchuk and Kahan’s approach, shareholders cannot withhold financing without rejecting a proposal, preventing them from holding a meritorious challenger accountable for pursuing a contest in an inefficient manner, for example.

E. Administrative Services

Intermediaries also provide technical assistance that facilitates shareholder exercise of their governance rights. The most visible example of this type of intermediary is Automatic Data Processing (ADP).\textsuperscript{132} ADP administers the distribution of proxy solicitation material and the collection of voting instructions for virtually all U.S. securities that are held in street name.\textsuperscript{133

\begin{footnotes}
\item[129]See id. at 1111 (noting that “if challengers are fully reimbursed, many undesirable challenges will be initiated”). See also id. at 1113 (noting that “as the level of reimbursement falls, the average quality of the contestants who as a result decide not to enter rises. At some point, further decreases in the level of reimbursement become undesirable—when entry by those contestants who as a result decide not to enter would have been desirable.”). Bebchuk and Kahan, however, note that even higher quality contestants may not necessarily be desirable from the shareholders’ perspective. See id. at 1115. They provided limited empirical evidence, nonetheless, to support their claim that some intermediate level of reimbursement for proxy contestants would be optimal. See id. at 1115-16.
\item[130]See id. at 1118-22.
\item[131]See id.
\item[132]Information on ADP can be found at http://www.adp.com (visited on Oct. 29, 2002).
\end{footnotes}
Banks and brokers who hold stock as nominees hire ADP. Securities Exchange Act Rule 14b-1 requires nominee holders, such as brokers, to take various steps to provide proxy material to beneficial owners and to obtain voting instructions from those owners. ADP then acts as the agent for banks and brokers in distributing required information in connection with the shareholder voting process. In addition, ADP has developed a range of mechanisms that facilitate shareholder voting. Through the ADP process, shareholders can vote by mail, by telephone, and even over the internet. ADP then aggregates shareholder voting instructions and delivers them directly to the issuer. The costs of ADP’s services are borne by traded firms. Under a pilot program established in 1997, NYSE Rules 451 and 465 provide that the issuer is required to pay the costs associated with this proxy solicitation according to a set fee schedule, which has been approved by the SEC.

With respect to financing, ADP is an interesting subject for analysis. ADP receives fees for its services directly from traded firms. Nonetheless, because the fee schedule for ADP’s distribution of proxy material is determined by regulation, it is difficult to determine the relationship between ADP’s fees and the cost of its services. ADP’s fees can be substantial; in 2001, for example, ADP’s fee for distribution services in connection with the proxy fight between Computer Associates International and Ranger Governance Ltd. Amounted to $1.33 million, plus postage. In commenting on the SEC Releases approving the rate schedules,

Reimbursement Release) (reporting that ADP currently distributes close to 100% of the proxies sent to beneficial owners holding in street name).

See Securities Exchange Act Rule 14b-1. Rule 14b-1 states that: “The broker or dealer shall, upon receipt of the proxy, other proxy soliciting material, information statement, and/or annual reports to security holders, forward such materials to its customers who are beneficial owners of the registrant’s securities no later than five business days after the receipt of the proxy material, information statement or annual reports.” See Rule 14b-1(b)(2). NYSE Rule 451 expands upon this obligation by requiring member firms, upon receiving proxy solicitation material, to forward that information to beneficial owners together with a signed proxy or a request for voting instructions. See NYSE Rule 451.


See Paul Schreiber, The Fight for Computer Associates; In the Middle of Big Battle; ADP unit plays major role behind the scenes, Newsday, Aug. 27, 2001, at C14.
several commentators have questioned the fee rates. Commentators have observed, for example, that ADP charges firms a premium for electronic distribution of proxy material even though such distribution is less costly.\textsuperscript{140} Similarly, ADP is able to reduce its costs through the use of bulk mail discounts, but those discounts are not fully passed on to traded firms.\textsuperscript{141} The fee structure is particularly problematic in light of ADP’s monopoly, which eliminates the potential for its rates to be subjected to a market test.\textsuperscript{142}

Problems with the ADP structure may arise, in part, from the fact that, although ADP provides services for the benefit of traded firms and shareholders, ADP is not accountable to either group. Banks and brokers, who hold securities as nominees, make the decision to retain ADP as an intermediary for technical assistance in connection with shareholder voting (but importantly do not pay ADP’s fees). Traded firms in particular have criticized the structure for depriving them of control over the process of distributing proxy materials to shareholders.\textsuperscript{143} Indeed, ADP’s monopoly hold on the market may be due, in part, to the fact that ADP rebates part of its fees (obtained from traded firms) to banks and brokers instead of the traded firms.\textsuperscript{144} The rebates constitute a percentage of the issuer-paid fee for ADP’s services. Public reports indicate that these broker rebates can amount to as a much as 37\% of the fee paid by a traded firm.\textsuperscript{145}

The mechanism through which ADP is retained limits its accountability to both traded firms and investors, neither of which have a role in the decision to hire ADP or in the assessment of its rates and services. Importantly, ADP exercises substantial control over the manner in which it transmits information to shareholders and over the voting mechanisms that it provides. Traded firms and investors have, from time to time, identified problems with the manner in which ADP performs its functions.\textsuperscript{146} Nonetheless their only avenue of complaint is the New

\textsuperscript{139} For the most recent release see SEC Release, supra note 137.
\textsuperscript{140} Cite [Jill—couldn’t find any support here?]
\textsuperscript{141} Cite [Jill—couldn’t find any support here?]
\textsuperscript{142} Traded firms have criticized the reimbursement rates set by the NYSE and advocated a market-based alternative. See SEC Release, 2002 SEC LEXIS 768, *18.
\textsuperscript{143} See id.
\textsuperscript{144} See, e.g., Chris Kentouris, Recordkeepers Protest NYSE’s Proxy Mailing Fees, Securities Industry News, May 25, 1998, at 13 (describing the Council for Institutional Investors’ criticism of “ADP’s practice of rebating some fees to financial intermediary clients” and the Securities Transfer Association’s statement that “the rebate procedure fosters ADP’s monopoly”).
\textsuperscript{145} Cite – Jill?
\textsuperscript{146} For example, in 1989, the California Public Employees Retirement System (CalPERS), called for a reexamination of ADP’s predecessor, IECA, as part of its proposed comprehensive revisions to the federal proxy
York Stock Exchange, which is controlled by member firms with a financial interest in retaining the existing structure. [JILL – Can’t you complain to the SEC too??].

IV. The Financing Challenge

While intermediaries presently provide many services for investors in the capital markets, they face numerous obstacles. As the previous Part has discussed, intermediaries on the one hand often face inadequate funding due to free riding on the part of investors. On the other hand, intermediaries may become subject to corruption at the hands of managers directing funds and other subsidies to the intermediaries out of corporate coffers. Section A specifies the tension between providing adequate financing for intermediaries and avoiding potential conflicts that may arise once traded firms subsidize intermediaries. Section B canvasses existing (and somewhat inconsistent) legal responses ranging from mandatory subsidies from traded firms to certain intermediaries to restrictions on other subsidies to reduce the conflict of interest problem.

A. Identifying the Financing Dilemma

Existing market intermediaries are financed in three ways: market transactions with investors, issuer funding, and cross-subsidization. Some intermediaries charge recipients of their services directly through market transactions. Examples of these intermediaries include pure research analyst firms and proxy advisors such as ISS. These intermediaries offer the highest degree of independence and yet face the largest financing challenge. To the extent investors are able to free ride off of the information such intermediaries generate, the

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147 As discussed in Part III, a fourth possibility exists: intermediary self-financing. Shareholder activists, for example, typically rely on self-financing (obtaining a return from increases in the value of their holdings among other things). See supra Part III.D.
intermediaries in turn will have a reduced incentive to produce such information. In particular, the value of intermediary services to any specific investor is bounded by the potential effect of those services on the value of the investor’s own specific portfolio, despite the overall gain to investors as a group. The problem of independent funding has been exacerbated by the growth of the internet and the resulting quantity of information, allowing investor to free ride on the information research efforts of others at low or no cost.

Other intermediaries receive payment from traded firms, either directly or indirectly through the firms’ purchases of other services. To the extent that intermediary activities benefit firms and their investors, firms serve as ideal collectivizing agents, minimizing free rider and other collective action problems. Examples of firm funded intermediaries include auditors and ADP. Firms directly make payments to auditors for their auditing services. Firms also indirectly subsidize auditing services by retaining their auditors for consulting and other services. ADP likewise receives funding (pursuant to NYSE rules) from traded firms.

The problem with firm funding, whether direct or indirect, lies with who makes the decision on where to direct the funds. Typically, management is vested with control over the allocation of financing. This control may enable management to reduce the quality of the information provided by intermediaries as well as constrain the ability of intermediaries to act as effective monitors. In the case of proxy administrative services, as discussed above, banks and brokers get to determine the recipients of firm funding (e.g., ADP). Firm-sourced financing for intermediaries therefore may generate conflicts of interest that, at a minimum, limit the intermediary’s ability to function as an effective agent for the other shareholders, and, at worst, may cause the intermediary to sacrifice shareholder interests.

The third source of financing is cross-subsidization from other activities. Analysts associated with large financial firms are cross-subsidized through their firms’ brokerage and investment banking revenues. Analysts may also subsidize their research through personal trading. Investor activists may cross-subsidize proxy contests by engaging in activism that

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148 See Benjamin Mark Cole, The Pied Pipers of Wall Street (2001) at 62 (explaining that serious analyst research is costly and citing study showing unwillingness of institutional investors to pay for such research).

149 But see Sec. 201, Sarbanes Oxley Act (prohibiting auditors from providing certain non-audit related services to most publicly-traded firms among others).

150 See supra text accompanying notes 134-137 (discussing NYSE rules requiring traded firms to pay mandatory fees to providers of proxy administrative services).

151 See supra Part III.E (discussing financing for ADP).

152 But see NYSE and NASD rules against this plus firm bans. CITE.
generates (at least in part) private gains for the activists. Cross-subsidies may generate conflicts that cause an intermediary to sacrifice the quality of information or services provided. Such conflicts could, for example, lead an analyst to recommend a traded firm in order to garner greater investment banking revenue from the traded firm despite a negative outlook for the firm. Similarly, an activist may pursue private gains to such an extent as to sacrifice the best interests of the group of all shareholders.

Intermediaries therefore face two interrelated problems. On the one hand, free riding creates a financing problem for intermediaries that provide services to all shareholders without receiving compensation from the firm. Firm-based financing solves this collective action problem but often at the expense of creating a conflict of interest by making intermediaries accountable to firm management rather than investors. The challenge then, involves identifying a financing mechanism that creates a sufficient economic incentive for the provision of socially valuable intermediary services without sacrificing the quality of such services.

B. Existing Legal Responses

Despite the fact that financing poses a common challenge to the various types of intermediaries, lawmakers have taken several different approaches to conflicts and other problems that arise from the funding problem. Often the legal response ignores the relationship between the financing and conflict of interest problems. This Part assesses the legal responses.

1. Firm-Based Subsidies

If financing is the problem for collectivizing intermediaries, one simple solution would be simply to force traded firms to provide more funds. Firm financing collectivizes the interests of investors in a firm, using the firm’s resources to pay for services accruing to the interests of all firm investors. Mandatory subsidies, however, introduce problems related to how to determine the amount of subsidy and who should determine the recipients of the subsidy. These problems limit the political viability of direct subsidies. Nonetheless, in some cases, regulations mandate firm-based subsidies of intermediation.

The prime example of mandated subsidies is the audit requirement for traded firms. The federal securities laws require traded firms to prepare and disclose audited financial
As a result, traded firms must undergo a yearly audit by an “independent” accounting firm. The purpose of the audit is to review the firm’s system of internal financial controls and to verify that the firm’s financial reporting complies with generally accepted accounting principles. The CEO certification requirement imposed under Sarbanes-Oxley requires that CEO’s certify not only the veracity of a firm’s financial statements but also the effectiveness of the firm’s internal control systems, further increasing the importance of auditors in assessing a firm’s set of internal controls. Because of the legal requirements, traded firms are required to hire and pay for the services of an independent auditor. In other words, regulators have mandated subsidization of auditing intermediaries rather than leaving it up to the market to determine the extent to which firms voluntarily undergo audits. Because the cost of the audit is borne by the firm, shareholders pay for the auditor’s services in proportion to their ownership interests.

Technical support to facilitate shareholder voting, including distribution of proxy material and maintaining telephonic and electronic voting mechanisms is also financed through mandatory traded firm-provided subsidies. Rather than handling the proxy solicitation process themselves, virtually all banks and brokerage firms have contracted with ADP to perform these services. Upon obtaining a list of beneficial owners, ADP prepares and distributes proxy solicitation material, together with a request for voting instructions, collects and tabulates shareholder votes, and provides voting information directly to the issuer. Traded firms then reimburse ADP for its costs according to the NYSE’s fee schedule.

Significantly, both audits and the mechanical proxy administrative services represent common services investors in all publicly-traded firms would, arguably, always demand. The information provided through an audit (and the ex ante deterrence effect a thorough investigation of a firm’s financials has on potentially opportunistic managers) benefits all investors of an audited firm. Although investors at varying publicly-traded firms may value an audit differently, a plausible argument exists that the value of an audit is so high that outside investors at all public firms would desire an audit. Similarly, without proxy administrative services, shareholders would lack the ability to vote (and would also lack the assurance that other shareholders would vote). Without such an assurance, individual shareholders may come to believe that expending

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153 See Hazen, supra note 78, at § 9.6 (detailing audit requirements under the federal securities laws).
155 See supra notes 136-137 and accompanying text.
resources in a vote is less worthwhile (why expend resources when no one else will vote?). An argument therefore exists that providing for a mandatory subsidy for proxy administrative services is a decision that investors in all publicly-traded firms would desire. Providing mandatory subsidies for audits and proxy administrative services therefore satisfies the homogeneous preferences of all investors without subjecting regulators to difficult questions of how best to allocate scarce resources to benefit investors among varying intermediary-recipients.

Even when mandatory subsidies are arguably justified for auditors as well as providers of mechanical proxy administrative services, providing such subsidies is not without its own set of costs. As detailed earlier, the audit regulations have historically given management substantial control over the selection of compensation of the firm’s auditors. As a result, although mandatory subsidies generate a substantial amount of auditing activity, auditors are not fully accountable to the investors who rely on their product. Likewise, while traded firms pay for proxy administrative services (according to the NYSE’s fee schedule), they do not control who receives the fees. Instead bankers and brokers often select ADP to provide such services—often receiving a rebate back from ADP of the fee. While free of manager-driven conflicts, the mandatory reimbursement structure involving proxy administrative services may suffer from a conflict between banks and brokers and their investor-clients.

2. Indirect Subsidies – Reducing the Cost of Intermediation

Traded firms may provide subsidies to intermediaries in ways outside of simple transfers of funds. Here, we discuss both (a) mandatory disclosure as well as (b) the ability of shareholders to piggyback certain types of proposals onto the management’s own proxy statement to investors.

a. Mandatory Disclosure

Indirect subsidies are more common under existing law. A prime example is the disclosure requirements of the federal securities laws. Under federal law, publicly traded firms are required to provide several types of disclosure to the markets. Companies must make an extensive amount of disclosure when they first go public, filing a Form S-1 registration statement

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156 See supra Part III.B (discussing the financing of auditors).

157 See supra Part III.E (discussing the ability of banks and brokers to select ADP).
with the SEC and distributing a statutory prospectus to potential investors. The registration statement and prospectus contain information related to the firm’s management, business, properties, capital structure, and financials among other information that investors might find valuable. Most publicly-traded companies must also register with the SEC and provide periodic information update filings (under Forms 10-K, 10-Q, and 8-K). The mandatory disclosure regime works to increase substantially the amount of corporation-specific information in the market. New SEC initiatives are increasing the amount of information contained in issuers’ periodic filings as well as the timeliness of such filings.

Analysts and others use internal firm information in combination with the analysts’ own sources of information on the traded firm, information related to competitors of the firm as well as the general economy, among other information, to generate a recommendation related to the firm. Mandatory disclosure thus reduces the cost to analysts of obtaining firm specific information and thereby reduces the free rider problem.

SEC rules also mandate disclosure in connection with the shareholder voting process. When a publicly traded corporation solicits proxies, it must disclose specified material to investors about the subject of the vote. In addition, when shareholders are asked to elect directors, the SEC requires the issuer to disclose various governance information about the firm, including background information about the directors, their participation in board meetings and committees, their compensation and shareholdings, as well as information about the issuer’s management and management’s compensation. These disclosures facilitate the monitoring function of shareholder voting by reducing the information costs associated with the voting

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158 For an overview of the public offering process see Choi, supra note 21, at 605-09.
159 See Securities Act, Forms S-1, S-2, S-3 (detailing required disclosure items for a company selling securities to the public).
160 Firms listed on a national securities exchange must register and comply with the SEC’s periodic information disclosure requirements. See Section 13(a), Exchange Act; Section 12(b), Exchange Act; see also Section 3(a)(1), Exchange Act (defining “exchange” for the purposes of the Exchange Act). Firms whose total assets exceed $10 million and have a class of equity security (other than an exempted security) held of record by more than 500 shareholders, among others, must also register the securities under the Exchange Act and thereby come under the periodic reporting requirements of Section 13(a). See Section 13, Exchange Act; Section 12(g), Exchange Act; see also Rule 12g-1 (raising the asset requirement to $10 million). See also Securities Exchange Act forms 10-K, 10-Q, 8-K.
161 See id. at 725-33 (noting that “[t]o the extent that mandated disclosure reduces the market professional's marginal cost of acquiring and verifying information, it increases the aggregate amount of securities research and verification provided.”).
process. Similarly, the disclosures reduce the research costs of proxy advisory firms. A recent NYSE proposal will require shareholder approval of employee stock option plans. If the proposed rule is adopted, it will entail similar mandatory disclosure to shareholders that will enable them more easily to monitor firms’ use of option-based compensation.

Mandatory disclosure allocates the cost of providing firm specific information on the firm itself. As with more direct mandatory firm subsidies, mandatory disclosure may plausibly satisfy a homogenous interest among investors, reducing free rider problems and ensuring equal access to information among potential investors. Clear advantages exist in having firms provide disclosures of firm-specific inside information. As the least cost provider of such information, firms that make such mandatory disclosure inform the market, subsidize analysts, and at the same time reduce the incentive for wasteful, duplicative research by outsiders into such inside information. Unlike the audit requirement and reimbursements for proxy advisory services, mandatory disclosure does not depend on as much decisionmaking on the part of managers or other groups. Instead, the requirement is relatively fixed for all firms. Mandatory disclosure therefore both solves the financing problem (in a manner in which all investors arguably would equally desire) while at the same time largely avoiding the conflict of interest problem inherent in other financing solutions.

As an information subsidy, nevertheless, mandatory disclosure is limited. Not all information relevant to the valuation of a particular firm is internal to the firm. And the information disclosed through mandatory disclosure is revealed to the entire market. Analysts therefore can only use the information to complement other information they might have on the firm as well as their own expertise. The extent to which mandatory disclosure rules force firms to reveal information that would not have been disclosed voluntarily is also unclear, although it

165 Cite.

166 CITE and describe the disclosures.

167 See Coffee, supra note 16, at 733-34 (contending that “a major significance of a mandatory disclosure system is that it can reduce these costs. Rival firms do not need to incur expenses to produce essentially duplicative data banks when a central securities data bank is in effect created at the SEC.”).

168 Note, nevertheless, that the securities laws in certain contexts distinguish among firms. Larger market capitalization firms with multiple years of Exchange Act reporting history, for example, are able to raise capital using disclosure filings that incorporate information by reference to prior filed documents. See Forms S-2, S-3, Securities Act.

is reasonable to believe that, in the absence of mandatory rules, firms might limit voluntary disclosure to particular market participants, such as institutional investors.

Moreover, to the extent that mandatory disclosure forces firms to reveal information that they would not otherwise disclose, the obligation may have a corresponding cost. Mandatory disclosure may require firms to disclose proprietary information, interfere with business operations or put a firm at a competitive disadvantage. Disclosure obligations may even affect operating decisions, causing managers to choose business projects on the basis of the anticipated effect on the firm’s financial appearance. Many of Enron’s transactions, for example, appear to have been motivated, at least in part, by a desire to maintain high levels of reported revenues and profits and to minimize disclosure of the firm’s debt.

In addition, even mandatory disclosure is not completely free of the conflicts of interest problem. Management in particular is the source of most firm-based disclosure. As a result, management can exercise its control over the quality of the information in order to reduce the market’s capacity for oversight. Earnings manipulation provides the classic example of this type of abuse. Management may be particularly prone to present an inflated picture of the firm’s financial health in order to maintain their positions, to obtain performance-based bonuses or to increase the value of their stock or stock options. This may even lead managers to adjust the firm’s operations to favor short term performance at the cost of the firm’s long-run financial health.  

In the case of Sunbeam, Inc., for example, managers presold inventory at low prices in order to book revenue sooner to meet a quarterly filing deadline. Without the incentive to show higher revenues, managers may have otherwise sold the inventory at higher prices later. Similarly, many of Enron’s transactions appear to have been motivated, at least in part, by a desire to maintain high levels of revenues and profits on the firm’s financial statements and to minimize the disclosure of the firm’s debt.

170 Indeed, firms that match analyst earnings expectations too consistently have come under greater suspicion for accounting trickery. See, e.g., Cassell Bryan-Low, Meeting Expectations Too Often? Such Consistency is Now Suspect, Wall St. J., Aug. 5, 2002, at C1.

171 See Floyd Norris, S.E.C. Accuses Former Sunbeam Official of Fraud, N.Y. Times, May 16, 2001, at A1 (reporting SEC accusations that “Sunbeam recorded some sales that were not real, through a variety of methods, and recorded other sales that came from ‘channel stuffing,’ putting inventory onto the books of distributors and retailers. In one case, the S.E.C. said, electric blankets that had been packaged for a certain retailer were sent to a distributor who agreed, in return for a guaranteed profit, to hold the blankets until the retailer was ready to accept them. Other sales were made by offering deep discounts to persuade customers to buy merchandise that they would not need for many months.”).
b. Shareholder Proposals

The federal securities laws provide another indirect subsidy for intermediation through Securities Exchange Act Rule 14a-8, the shareholder proposal rule.\(^{172}\) The Rule requires that management include certain types of shareholder-initiated proposals in the company’s proxy. The costs of distributing the proposal to shareholders is then borne by the company rather than the sponsoring shareholder. Rule 14a-8 subsidizes an activist’s decision to bring certain types of issues before the shareholder body for a vote by requiring the company as a whole to bear some of the costs of the solicitation.

As a subsidy for shareholder activism, Rule 14a-8 is notoriously incomplete. First, the Rule significantly limits the types of proposals that must be included on the company’s proxy statement. In particular, proposals that deal with ordinary business matters or attempt to interfere with the board of directors’ role in managing the corporation are forbidden.\(^{173}\) As a result, many proposals, such as those seeking to declassify the board of directors and those attempting to remove poison pills, are couched in precatory terms that have no binding effect on the company.\(^{174}\) In addition, the Rule cannot be used to nominate competing candidates for the board of directors. Second, although the inclusion of the proposal reduces costs for sponsors, the sponsors must still bear the cost of convincing other shareholders of the value of their proposal. Third, use of the shareholder proposal rule is not cost free; the ambiguous scope of some of the regulatory exclusions coupled with the SEC’s policy of reviewing management efforts to exclude a proposal on a case-by-case basis can generate substantial legal expenses. Perhaps in recognition of the fact that the subsidy provided by Rule 14a-8 is of limited value, some shareholder activists have begun bypassing the rule by undertaking separate proxy solicitations or introducing floor resolutions.\(^{175}\)

While mandatory subsidies (direct and indirect) for intermediaries provide one solution for the financing problem, the solution is not a complete one. As in the case of Rule 14a-8, the

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\(^{173}\) See Securities Exchange Act, Rule 14a-8(i)(1) (prohibiting proposals “[i]f the proposal is not a proper subject for action by shareholders”); Securities Exchange Act, Rule 14a-8(i)(7) (prohibiting proposals “[i]f the proposal deals with a matter relating to the company’s ordinary business operations”).

\(^{174}\) Even precatory proposals, nevertheless, may put pressure on managers. See Choi, supra note 30, at 241-242 (noting that managers may implement voluntarily a precatory proposal that garners a high vote percentage to avoid continued “negative publicity” among other reasons).

subsidy is often not very substantial. Even when substantial, mandatory subsidies often reside only in narrowly defined areas, including auditors, proxy administrative services, and mandatory disclosure, where a consensus is easily found on what shareholders desire across the entire range of publicly-traded firms. Outside of such areas, heterogeneity in what investors prefer across different firms and across time with regard to intermediary-provided services makes the provision of mandatory subsidies extremely difficult. Regulators simply lack the expertise to determine which intermediaries may provide the highest value for investors. The identity of such intermediaries may shift over time as investors of publicly-traded firms encounter different risks. The optimal level of subsidies to different intermediaries may also vary by different types of firms. Large market capitalization firm already with a following of independent analysts may not require as great a level of subsidy for information research as smaller capitalized (and therefore less-well known) firms. Much of the present level of subsidies for intermediaries, as a result, is left to traded firms to provide voluntarily (with the approval of management).

3. Voluntary Subsidies and Regulation of Conflicts

Voluntary forms of subsidies from traded firms to intermediaries are prevalent in the capital markets. Intermediaries, for example, may be able to generate profits through related activities to finance the costs of intermediation. Accounting firms, for example, may subsidize auditing services by providing consulting services. Brokerage firms subsidize analyst research through investment banking revenues and brokerage commissions. Cross-subsidization solves the financing dilemma at the cost of introducing a potential conflict of interest. The risk is that the related activities will impose pressure on firm decisionmaking that is inconsistent with maximization of shareholder welfare. In order to maximize its revenues, an intermediary may then sacrifice intermediation in favor of its more profitable activities.

The current regulatory response to these conflicts has taken two forms. One measure has been disclosure regulations aimed at making the conflicts of interest transparent, based on the perception that disclosure of the conflicts will enable the market accurately to evaluate the risk that the intermediary’s services have been compromised. The alternative is structural regulations that attempt to limit or eliminate the conflicts. This section considers both types of responses with respect to two classes of intermediaries, securities analysts and auditors.
a. Securities Analysts

Few securities analysts exist as independent entities in the securities markets. Instead, most analysts are associated with large financial firms providing, among other things, investment banking services. Once managers get involved with providing money to analysts even indirectly, the potential for corruption arises.

Lawmakers and regulators have taken a number of steps toward combating analyst corruption. Until recently, the SEC’s initiatives have focused primarily on disclosure. For example, in the summer of 2001, the SEC published a brochure on its website, Analyzing Analyst Recommendations, warning investors about potential analyst conflicts of interest and providing suggestions on how to uncover such conflicts. Similarly, the SEC has recently pushed forward reforms aimed at increasing the amount of disclosure on how analysts are compensated—including in particular the relationship between analyst compensation and investment banking revenues within a financial firm. Similar reforms have been voluntarily adopted by a number of financial firms (in the wake of actual and threatened litigation). Finally, the Sarbanes-Oxley Act of 2002 requires the SEC to adopt rules increasing disclosure of analyst conflicts, including the extent of an analyst’s investments in securities of a covered issuer, business relationships between covered issuers and brokerage firms, compensation received from the issuer by the analyst or the brokerage firm, and any other material conflicts.

Disclosure-based reforms in theory help make investors aware of the risks they face in relying on the recommendations of potentially conflicted analysts. Disclosure may then indirectly affect how analysts are compensated if investors react negatively to certain forms of compensation (e.g., where it’s quite obvious that the analysts are being paid to tout a company through large fees paid to the investment banking arm of the analysts’ securities firm). Investors for example may simply disregard the disclosures of analysts with a poor reputation, reducing the value to the traded firm of corrupting the analyst in the first place.

176 See supra text accompany notes 54-60 (discussing independent analysts in the market).
177 See supra text accompany notes 70-74 (discussing the possibility of analyst corruption).
179 Cite.
180 See supra note 11 (describing the Merrill-Spitzer settlement).
181 Sarbanes-Oxley Act, § 501, 15D(b).
182 Several have written on the possibility that investors may suffer from bounded rationality and other behavioral biases that may limit the ability of investors to take into account information accurately. See, e.g.,
Disclosure-based reforms, however, are limited in their effectiveness. New information on analysts will often be noisy and incomplete. For example, not all analysts that derive compensation in part from investment banking revenue will be corrupt. Sophisticated investors may already have good information on the level of corruption among analysts.\(^{183}\) Unsophisticated investors, on the other hand, may simply ignore disclosed information related to the credibility of particular analysts.\(^{184}\)

More structural reforms have also been advocated. In the wake of the Enron and Merrill Lynch scandals, regulators considered separating the provision of auditing and analyst services from other more profitable services provided by intermediaries to traded firms (including consulting and investment banking).\(^{185}\) Recently, litigation brought against Merrill Lynch by N.Y. State Attorney General Eliot Spitzer resulted in a settlement under which Merrill Lynch agreed to adopt a number of structural reforms, including separating the calculation of analyst compensation from the level of investment banking revenue (buttressing the height of “Chinese Walls” within financial firms).\(^{186}\) While not deciding the issue, the Sarbanes-Oxley Act directs the SEC or the securities exchanges (including the NASD) to adopt “not later than 1 year after the date of enactment of this section, rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities….\(^{187}\) The Act goes on to specify a variety of appropriate structural reforms for addressing these conflicts.\(^{188}\)

Despite structural reforms, financial firms may still find indirect (and undisclosed) ways of linking the compensation of analysts and investment banking firms even when formally separate. Even without any direct linkage, a falloff in investment banking revenues will affect the overall profitability of a financial firm, indirectly reducing the compensation available for


\(^{184}\) Even sophisticated investors (particularly institutional investors), however, may take excessive risks and otherwise suffer from overconfidence as well as loss avoidance biases. See Langevoort, supra note 182, at 641-48 (identifying “principal factors that can skew the investment decision maker’s attitudes toward risk”).

\(^{185}\) Individual investors may either lack the incentive (especially where there shareholdings are small) to pay attention to information on specific analysts. Even where individual investors have an incentive, they may suffer from a number of behavioral biases (including overconfidence). See id. at 635-41.

\(^{186}\) See supra note 11 (describing the Merrill-Spitzer settlement). In a similar vein, the SEC promulgated Regulation FD in 2000 to curtail the ability of traded firms to use the selective distribution of inside material information to curry favor with analysts. See SEC, Selective Disclosure and Insider Trading, supra note 19 (promulgating Regulation FD).


\(^{188}\) Cite.
analysts. Analysts that realize the potential drop in overall profitability will then have an indirect incentive to take an optimistic spin on the companies which they follow.

Suppose, nonetheless, that disclosure, Chinese Walls, or more extensive separation of intermediary services from other business reduce potential conflicts by eliminating the potential for intermediary services to be cross-subsidized. Absent those cross-subsidies, how will analysts finance recommendations and the underlying research supporting those recommendations? Merely providing disclosure on the level of analyst compensation tied to investment banking exposes the level of subsidization from traded firms without offering any replacement financing. Forcing analysts to separate their compensation (or in the extreme, their entire business) from investment banking firms may simply result in underfunded analysts (and in the long-run a reduction in the amount of analyst supplied information in the market). Financial firms, forced to choose between their investment banking operations and their research departments, may simply reduce or eliminate the analyst role in providing information to the marketplace.  

b. Auditing Services

Despite the high levels of compensation auditors receive for their auditing services, auditing firms also often provide additional services in the form of tax and business consulting as well as internal auditing work. 190 When managers have discretion in the allocation of such services, auditors at least arguably have an incentive to compromise the quality of their audits (toward a more pro-management viewpoint) in order to obtain the additional business. A bigger problem is that when an accounting firm has participated in structuring transactions, it may lack the capacity to audit those same transactions objectively. 191

Regulators initially took primarily a disclosure-based approach to the problem of auditor corruption. Presently, publicly-traded firms must report to the SEC a change in their auditor through a Form 8-K filing. 192 The reporting requirement sends a signal to the market when an

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189 Regulation FD, similarly, works simply to dry up the subsidy provided by corporations through selective disclosures (by forcing companies to give information to all). Cite. Companies may react by cutting off disclosure, subsidizing no one. To the extent that selective disclosure subsidized analyst coverage, eliminating selective disclosure may cause analysts to drop their coverage, particularly of smaller firms. See Goshen and Parchomovsky, supra note 19, at 1268-70.
190 See supra notes 84-86 and accompanying text (discussing auditor provided non-audit consulting services).
191 See text accompanying notes 89-90.
192 See Item 4, Form 8-K.
auditor change occurs in a situation where, for example, the auditor and firm disagree on an accounting matter.\textsuperscript{193} In 2001, as well, the SEC implemented new disclosure rules requiring publicly-traded firms to disclose in their proxy filings the amount of fees they pay their auditors for both auditing and non-auditing related services.\textsuperscript{194}

Providing disclosure on the level of auditing versus non-auditing compensation may potentially result in some market discipline. When investors learn that a firm is providing a large amount of non-auditing compensation to a particular firm, investors may react by pricing down the traded firm’s securities. To the extent managers of the firm care about their share price, the managers may then react by reducing the amount of non-auditing services they provide to the outside auditor. Nevertheless, disclosure alone may not be effective. To the extent managers control the traded firm’s purse strings, a lower stock price only indirectly affects the incentives of managers. Where the stock market reacts only imperfectly to information about the provision of non-auditing services or managers do not care directly about the stock market price, merely disclosing the presence of non-auditing services may not have an immediate incentive effect on managers and auditors.

Following Enron, Congress introduced new measures to further address auditor corruption. The Sarbanes-Oxley Act of 2002 mandates that national securities exchanges and NASD adopt as part of their listing standards a requirement that only independent directors sit on the audit committee of public companies.\textsuperscript{195} The Sarbanes-Oxley Act goes on to require that auditors receive preapproval from the audit committee for all auditing as well as permissible non-auditing services provided to the firm.\textsuperscript{196} Moreover, the Act requires securities exchanges and NASD to impose independence requirements for members of listed firms’ audit committees.\textsuperscript{197} The Act therefore relies on the assumption that so-called independent directors

\textsuperscript{193} See Item 304(a)(1), Regulation S-K (as required under Item 4, Form 8-K).
\textsuperscript{195} See Sec. 301, Sarbanes-Oxley Act of 2002. Section 301 further goes on to state that “In order to be considered to be independent … a member of an audit committee of an issuer may not, other than in his or her capacity of the audit committee, the board of directors, or any other board committee—(i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary.” Id.
\textsuperscript{196} See Section 201, Sarbanes-Oxley Act of 2002.
\textsuperscript{197} See Section 301, Sarbanes-Oxley Act of 2002. In an effort to increase the reliability of financial statements, Harvey Pitt, the Chairman of the SEC, post-Enron called for the CEO and other top officers to certify personally the accuracy of their financial statements, and the Senate recently passed a bill adopting a similar requirement. Cite. Following up Pitt’s efforts, the Sarbanes-Oxley Act codifies the certification requirement for
will take better care in selecting auditors than managers. To the extent managers typically select the slate of independent directors (which in turn receives rubber stamp approval from shareholders), however, it is unclear how effective requiring independent directors on the audit committee will be as device to protect shareholders.

In theory, prohibiting auditors from providing other services reduces the financial incentive for an auditing firm to compromise auditor quality for a higher fee from the client-firm. The Sarbanes-Oxley Act puts this theory into action, prohibiting firms that provide auditing services from providing a delineated list of non-auditing services to the same client firm. Among the prohibited non-auditing activities, the Sarbanes-Oxley Act includes “financial information systems design and implementation” as well as “internal audit outsourcing services”. Note, however, that the prohibitions under Sarbanes-Oxley are actually quite limited. [CITE on Jon Macey Villanova draft demonstrates that the statutory restrictions are almost exactly the same as those imposed by prior law] Tax related services, in particular, are not one of the explicitly prohibited list of non-auditing services auditors may provide to a firm while performing an audit.

Even where Sarbanes-Oxley does in fact effect a separation of auditing and non-auditing services, it is unclear if such a bright-line prohibition increases investor welfare. Reforms aimed at simply splitting auditing apart from other types of services provided through auditing firms may result in a loss of economies of scale on the part of auditing firms. Information derived from an audit, for example, may reduce the cost of performing subsequent tax and business consulting projects for the issuer. The accounting firms have responded to the adoption of

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198 See Sec. 201, Sarbanes-Oxley Act of 2002.
200 See id. Note that the Sarbanes-Oxley Act applies only to issuers that are also either Exchange Act Reporting Companies or that have filed a registration statement as part of a public offering with the SEC. See Sec 2(a)(7), Sarbanes-Oxley Act of 2002.

Some lawmakers have also called for prohibitions on the ability of auditors to work for their client-firm should they leave the employment of the auditing firm. A large number of Enron’s own internal auditing personnel, for example, originally worked for Arthur Andersen. See, e.g., Thaddeus Herrick and Alexei Barrionuevo, Were Auditor and Client Too Close-Knit?, Wall St. J., Jan. 21, 2002, at C1. The prospect of obtaining employment at a client may lead some individual auditors to reduce the quality of their audits in the hopes of currying favor with the client-firm. In response, the Sarbanes-Oxley Act prohibits auditors from performing auditing services for a firm if the firm’s chief executive officer, chief financial officer, or chief accounting officer “was employed by that [auditor] and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.” See Section 206, Sarbanes-Oxley Act of 2002.
Sarbanes-Oxley by splitting off their consulting operations into separate firms. Early evaluations of the break-ups suggest, however, that this response was inefficient from a market perspective. Commentators have observed that the accounting firms received relatively low value for their consulting operations, in part because those consulting operations were worth less when operating independently of the auditing process.  

[add auditor rotation??]?

C. Summary of Inadequacies of the Present Legal Response

The collective action problem facing dispersed shareholders is well-known. Moreover, the problem exists in a wide variety of areas ranging from the provision of auditing services and analyst recommendations to the pursuit of proxy contests against incumbent managers. For many intermediaries the collective action problem manifests itself through a lack of funding. Sponsors of proxy issue proposals, for example, never receive reimbursement for their expenses in communicating with other shareholders the merits of their proposals. Independent analysts may fail to fully recoup the costs of their research through sales solely to investors to the extent some investors may free ride on the information generated from the research.

Regulators have responded to the collective action problem in a number of different ways. As discussed above, regulators in certain circumstances have forced traded firms to provide subsidies to intermediaries (through mandatory disclosures for example). Sponsors of proxy issue proposals are also often able to insert their proposal onto the company’s own annual proxy statement pursuant to Rule 14a-8 of the Exchange Act, reducing the sponsors’ costs of pursuing such a proposal.

Mandatory subsidies, however, are not a panacea. Regulators run the risk of imposing too high levels of subsidies. Regulators may also miss certain opportunities to provide a legally mandated subsidy that helps the group of all investors. The ISS’s efforts to provide information to shareholders during a proxy vote helps all shareholders to the extent a more informed vote results from these efforts. Nevertheless, no provision exists for the ISS to obtain any form of

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202 See id. (observing that consulting arms were worth less absent the relationships with auditing clients as well as the reputations and brand names of their former parents, and citing industry insiders’ opinions that consulting services are best provided by the auditing firms, who are closer to their clients than outside consultants).
203 See supra text accompanying notes 91-94 (describing ISS).
subsidy (even where the contest is successful) from the traded firm or the firm’s shareholders generally.

Moreover, where firm managers (and other private groups other than shareholders) are given discretion over where to direct mandatory subsidies, conflicts of interest problems may arise even when financing is mandated. Neither auditors nor ADP are free from conflicts of interest. Expansion of mandatory subsidies without attention to who makes the decision on where to direct the subsidies, therefore, may simply compound the conflicts of interest problem. For reasons of lack of expertise and the looming conflicts problem, therefore, we do not view greater levels of mandatory subsidies alone as the solution to the intermediary financing problem. Mandatory subsidies under the present regime are best suited where investors are homogeneous in their preference for a particular subsidy and little discretion is therefore subsequently needed (on the part of regulators, managers, or other parties) in determining the size or recipient of the subsidy (such as in mandatory disclosure).

Instead voluntary subsidies today largely fill the void. And managers may in fact enjoy greater expertise compared with regulators on where best to allocate subsidies for intermediaries—particularly to the extent the need for specific intermediary services varies across firms, industries, and indeed over time. But as we have discussed, voluntary subsidies themselves are subject to similar conflicts of interest problems. Firms, for example, may use increased investment banking revenues to corrupt analysts. Regulators have sought to address the conflicts problem with more stringent prohibitions of voluntary subsidies, separating analysts from investment banking for example.204

While such solutions may ameliorate the conflicts problem, they exacerbate the financing problem, robbing investors of potentially useful intermediary services. Lost in the zeal of the SEC and other regulators to curtail the conflict of interest problem is the recognition that the conflict of interest problem exists primarily because of the need for the traded firm to provide subsidies to securities market intermediaries. Simply prohibiting payments from the traded firm to intermediaries may prevent managers from co-opting intermediaries. Nevertheless, this draconian approach—without any attention to the collective action problem—will simply dry up funding for intermediaries. Analysts without the prospect of selective disclosures or indirect subsidies through investment banking arms of financial firms may then find themselves unable to

204 See SEC, Selective Disclosure and Insider Trading, supra note 19 (promulgating Regulation FD).
meet their expenses. Just as we now see few independent analysts, cutting off the ability of traded firms to support analysts through investment banking revenues may result in the elimination of analyst services within the financial firms.

We are therefore faced with a conundrum. Not only are the financing and conflict of interest problems tied together but present mandatory and voluntary approaches to financing have failed to generate a common solution. We provide such a common solution below through our voucher financing proposal.

V. Voucher Financing Proposal

The core problem for intermediaries is one of funding. To the extent an adequate source of funding (encompassing the collective interests of all shareholders) is provided to intermediaries in a fashion designed to maximize the best interests of shareholders both the collective action and managerial corruption problems will disappear. We sketch a preliminary proposal based on shareholder vouchers that relies on traded firms as the primary source for funding but delinks the source of funds from the decisionmaking authority to decide on where the funds should go.

Vouchers are not a new idea. In the area of school financing, the Supreme Court recently upheld a broad-based voucher system. Similarly, Arizona since 1997 has allowed taxpayers to self-direct $500 to one of several intermediary non-profit groups specializing in providing scholarships to students attending a private school. Taxpayers who choose to participate in Arizona’s program receive a $500 dollar-for-dollar tax credit, making the $500 contribution to an intermediary group economically equivalent to a voucher (usable only to finance scholarships or to increase Arizona’s state treasury).

Supporters argue that school vouchers address collective action problems in school financing while maintaining accountability of individual schools. Vouchers enable the government to determine overall funding levels, but permit individual families to direct funding

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206 Information on Arizona’s taxpayer directed financing of private school tuition scholarships can be found at the Goldwater Institute’s web site (a proponent of Arizona’s financing program). See http://www.goldwaterinstitute.org (visited on Nov. 4, 2002). See also Dan Lips, The Arizona Scholarship Tax Credit: A Model for Federal Reform (Goldwater Institute, Arizona Issue Analysis 173) (available at http://www.goldwaterinstitute.org/article.php/113.html).
207 See Lips, supra note 206.
208 See id. [CITE OTHERS]
for their children’s education themselves to the school of their choice. In theory, families will then have an incentive to shift their money to schools that provide the education the families’ desire most. To the extent different families have varying preferences for education, a range of different schools may arise to meet these varying preferences. Moreover, vouchers enable the market to impose accountability on schools. Competition among schools for voucher dollars should lead to better quality overall in the provision of educational services.

Recently, Bruce Ackerman and Ian Ayres have expanded on the notion of vouchers to the arena of political campaign finance. As with schools, political campaign financing is subject to a collective action problem. Many people may in fact align themselves with the viewpoint of a particular candidate. Nevertheless, each individual person may choose not to help finance the candidate, preferring instead to free ride off of the efforts of others. Vouchers (termed “Patriot Dollars” under their proposal) targeted specifically for campaign finance force everyone to participate in campaign financing, leaving individual voters only with the decision of which campaign to finance. Ackerman and Ayres also propose that Patriot Dollar vouchers be anonymous, preventing recipients from learning the identity of a specific donor.

Our proposal takes aspects of voucher financing proposals from the school and campaign finance arena and applies them to the corporate context. Vouchers allow regulators to separate the financing decision from the allocation decision – vesting responsibility for intermediary financing with traded firms, but removing the decision of how to allocate the funds from management control. As with school vouchers, intermediary financing incorporates market discipline to increase the range and quality of services that intermediaries are willing to provide the market. Vouchers also reduce the incentives of the part of intermediaries to cooperate with management to expropriate value from a corporation and its shareholders.

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209 See id. [CITE OTHERS]
210 See id. [CITE OTHERS]. Of course, school vouchers are not without their critics. Among arguments made against school vouchers is the notion that having a common education is a public good, developing virtues of citizenships among students for example. [CITE SOMEONE?] Without going further into the school voucher debate, we note that while these counterarguments may be valid, they have little relevance in the corporate arena. Instead, the more general idea that education is a collective good whose financing may be met through vouchers is relevant. As well, individuals directing vouchers to the providers of their choice may have salutary effects on the entire range of providers of such services
211 See Bruce Ackerman and Ian Ayres, Voting with Dollars, A New Paradigm for Campaign Finance (2002).
212 Under Ackerman and Ayres’ proposal, each vote would receive vouchers worth $50 of public monies to distribute. See id. at 4.
213 See id. at 6.
Section A introduces the intermediary voucher financing proposal. Section B assesses the potential benefits of the proposal. Finally, Section C responds to the most substantial potential criticism of the voucher proposal – the coordination problem.

A. **The Proposal**

One central principle behind the voucher proposal is that the traded firm is the best collectivizing agent with respect to the interests of its current and prospective investors. When money is allocated at the firm level, free-rider and collective action problems are eliminated. Money spent by the firm to increase investor information and improve monitoring redounds to the benefit of all investors. Improved monitoring can lead to more shareholder-oriented management decisions, improving corporate revenues and profits. Intermediaries can also provide technical services that reduce the cost of corporate governance, communication with shareholders and so forth. Intermediaries can also take advantage of economies of scale to develop software, standardize communication tools and provide investor-wide communication and information networks. Investors will then reduce the discount they demand for securities investments, thereby reducing the cost of capital for quality firms.\(^\text{214}\)

At the same time, the voucher proposal recognizes the problem with using managers (and other non-shareholder decisionmakers) to allocate intermediary funding and restores intermediary accountability by giving allocation decisions ultimately to the group of shareholders. In this section, we sketch briefly important aspects of a voucher financing system for securities market intermediaries.

1. **Origination of Funds**

Our proposal identifies publicly-traded firms as the most appropriate source of intermediary financing. The requirement that firms finance information, monitoring and technical services is not novel. As discussed above, traded firms already furnish intermediaries with many types of financing.\(^\text{215}\) Firms subsidize analysts through federally mandated disclosures. Firms pay for the services of independent auditors. Firms pay for the services of

\(^{214}\) As quality firms are able to attract capital at a lower cost, the allocational efficiency of the securities markets is improved.

\(^{215}\) See supra Part IV.B.1 (Firm-Based Subsidies); Part IV.B.2 (Indirect Subsidies).
ADP in distributing proxy information and collecting shareholder votes. Firms pay for the services of Georgeson Shareholder and other proxy solicitation firms.216

Unlike several existing sources of funding, voucher funding would be transparent. Prior to the promulgation of Regulation FD, firms routinely gave select analysts an informational advantage with respect to inside corporate information. Analysts with this advantage would, in turn, profit relative to other market participants lacking this information. Moreover, market participants had no way of monitoring management’s use of selective disclosure. This led to the potential for management self dealing. Even after Regulation FD prohibited most selective disclosures,217 firms continue to make implicit subsidies to analysts through elevated investment banking fees.218 As with selective disclosure, the extent to which investment banking fees reflect subsidization of analyst recommendations, and the further extent to which these subsidies influence the content of the recommendations, cannot readily be observed by the market. Under a voucher system, in contrast, investors would have the ability to assess quickly the aggregate vouchers directed toward any one intermediary.219

Our proposal would give regulators the authority to determine and implement payment levels through the imposition of a mandatory annual fee. The rationale for mandatory fee-setting is twofold. First, although firms currently possess, at least in theory, the incentive to set payments at a level to maximize firm value, existing intermediary payments are largely subject to management control. Unlike investors, managers face a conflict of interest in determining payment levels, because intermediary oversight reduces the ability of managers to expropriate private benefits of control. Even where firms may wish to implement a voucher system, practical difficulties may stop any single firm from being the first to do so. To the extent investors are unfamiliar with voucher financing, they may not adjust the price of a participating company adequately upward in response (in anticipation of benefits to overall shareholder welfare). Scale economies may also exist with implementation of a voucher system. Specialized

216 Among other services, Georgeson Shareholder offers public firms proxy solicitation services. Information on Georgeson Shareholder can be found at http://www.georgeson.com (visited on Oct. 29, 2002) (noting that Georgeson Shareholder has “the strategists, researchers, data technology and call centers to manage every step of the [proxy] process.”).


218 See supra Part III.A (discussing forms of analyst financing).

219 We envision that the SEC would have a role in tracking the flow of vouchers. See infra Part V.A.3 (discussing the possibility of registering intermediaries and using the SEC to transmit information to the market on each registered intermediary).
intermediaries may develop to assist investors in analyzing where to place their vouchers and assisting in the distribution of vouchers, but only if a minimum number of companies is involved in the voucher system. \(^{220}\) Investors, likewise, may not find it worthwhile to invest resources in determining what to do with vouchers unless the investors—aggregated over their whole portfolio of stock—have sufficiently large dollar amounts of vouchers to distribute. The more companies in a particular investor’s portfolio that participate in a voucher financing system, the more likely that investors will in fact have an incentive to participate actively.

Second, even if individual firms are able to determine appropriate payment levels, they face a free-riding problem in purchasing intermediary services. Payments to intermediaries may create potential spillover effects across multiple firms. Analysts, for instance, may have economies of scale in determining the value of the entire range of companies dealing in a specific industry (such as oil exploration). Launching a proxy contest against one underperforming firm not only raises the value in the one firm but also increases deterrence across all firms (simply from the possibility of facing a proxy contest in the future).

Accordingly, a firm can underfund intermediaries, hoping instead to benefit from the monitoring purchased by its competitors. Third, potential spillover effects generate positive externalities that may not be fully reflected in a firm’s financing decisions. If a firm’s investors do not reap the full benefit from the purchased services, the firm may set too low a level of subsidies.

Accordingly, our proposal requires all traded firms to contribute to intermediary financing through mandatory, firm level fees. Although the firm would be responsible for paying the fee, the firm’s managers would not control its allocation. Instead the fee would be allocated by shareholders through vouchers, as we describe below. Regulators would set firm payments, initially on a trial basis, which would subsequently be adjusted after the effects of the voucher system had been assessed. The level of the fee for a particular firm would be determined by a formula based on factors related to the benefits intermediaries may provide shareholders of a particular firm, including firm size, market capitalization, and total number of shareholders. Larger firms typically obtain a greater relative share of the collective benefits from intermediary services.

In theory, the total allocation should be determined by the point at which the marginal value of an additional dollar of intermediary financing yields precisely a dollar of collective

\(^{220}\) See infra text accompanying note 238 (discussing specialized voucher intermediaries).
benefits. Although calculating the precise amount of this allocation is beyond the scope of this article, the initial allocation could be based on an estimate of present levels of firm-based intermediary subsidization.\textsuperscript{221} In particular, regulators could assess initial levels of subsidization for proxy services intermediation by looking to the expenses incurred by firms with respect to solicitations by management.\textsuperscript{222} Regulators, of course, may make errors in determining of the correct level of voucher financing to levy on public firms. Subsequent reexamination of the voucher program would provide the opportunity to evaluate and adjust the formula. The cost of errors in adjusting to the optimal level of voucher financing overtime, moreover, may not be large. Too high a level of voucher financing will simply result in greater firm levies (and regulators may compensate with relatively low levels in the future). Too low levels of voucher financing will still improve on the present underfunding of many securities market intermediaries. Significantly, because we advocate only a subsidy of intermediaries our voucher financing proposal will not necessarily displace present intermediaries providing services for investors.\textsuperscript{223}

The prospect of financing a collective benefit through a mandatory firm-based fee is not unprecedented. As noted above, mandatory disclosure and the regulatory requirement of an independent audit are longstanding examples of indirect fees levied on public firms for the benefit of the market as a whole. There is also precedent for the imposition of direct firm-based fees. Securities exchanges already impose levies on listed firms in the form of listing fees.\textsuperscript{224} ADP’s services in disseminating proxy material and collecting shareholder votes are paid for by issuers, according to a rate schedule established through NYSE rules and approved by the

\textsuperscript{221} The SEC-Spitzer proposal to fund independent analysts, discussed infra in Part V.B, makes a similar attempt to quantify the size of the subsidy needed in the case of analysts, proposing $1 billion total subsidies over the first five years.

\textsuperscript{222} This benchmark is likely to produce too low a level of initial funding. Nonetheless, the starting point may be beneficial. First, it will reduce waste until the market for intermediary services is able to expand to meet the newly created demand. Second, it will reduce transition costs associated with development of the information and reporting systems described in subsection 2. Third, too low an initial level of financing will still improve upon the current regime’s underfunding of intermediaries. Fourth, a low initial level will improve the political feasibility of the proposal by capping the level of firm expenditures until the system is able to demonstrate the demand for and value of increased intermediation.

\textsuperscript{223} See infra Part V.A.5 (discussing whether voucher intermediary recipients should be barred from receiving non-voucher subsidies).

\textsuperscript{224} The NYSE, for example, charges an maximum original listing fee of $250,000 and a maximum continuing annual fee of $500,000. See NYSE Listed Company Manual § 902.02 (2002).
SEC. 225 Although the fees are loosely related to the cost of the services provided to the firm, the fee structure reflects the fact that ADP’s proxy network provides spillover benefits across firms by facilitating the shareholder voting process. 226 More recently, the Sarbanes-Oxley Act established a new five-member public oversight board to oversee the accounting profession. 227 To fund the board (as well as a separate accounting standard setting body), the Sarbanes-Oxley Act provides for issuer provided fees in proportion to the market capitalization of each issuer. 228

2. Allocation of Vouchers

The key component of the voucher system that reflects an improvement over direct firm financing of intermediaries is its capacity to separate the source of funds from the authority to decide where the funds should go. Once funds are collected from each individual firm, individual shareholders are granted the authority to allocate their respective share of the firm’s levy. Berkshire Hathaway already provides a similar procedure for allocating the firm’s charitable contributions. Under its “Shareholder-Designated Contributions Program”, Berkshire Hathaway gives its Class A shareholders the ability to direct charitable contributions made by Berkshire Hathaway in proportion to their share ownership. 229 Each Class A shareholder may designate up to three charities qualified to receive tax deductible donations, and those charities then receive contributions directly from Berkshire Hathaway. 230 In 2001, Berkshire Hathaway contributed $16.7 million to shareholder designated charities. 231 Almost 98% of eligible shares participated in the program. 232

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226 While the SEC recently approved a move toward a tiered proxy reimbursement rate structure (more closely tracking the true costs of delivering proxies for specific companies), it also noted that “[s]maller issuers . . . could be substantially impacted by a tiered fee structure that could result in increased costs, making it difficult to pay for the proxy process.” See id. at *29.


228 See Section 109(d)(2), Sarbanes-Oxley Act of 2002 (stating that “The rules of the Board under paragraph (1) shall provide for the equitable allocation, assessment, and collection by the Board (or an agent appointed by the Board) of the fee established under paragraph (1), among issuers, in accordance with subsection (g), allowing for differentiation among classes of issuers, as appropriate.”); Section 109(g), Sarbanes-Oxley Act of 2002 (allocating support fees according to relative market capitalization).


230 See id.

231 See id.

232 See id.
We envision a voucher system along the lines of the Berkshire Hathaway program. Regulators may consider incorporating the mechanics of the voucher system into the proxy voting process. Individual shareholders would be allocated voucher dollars, based on their pro rata share of the firm’s total levy, which would be determined in accordance with their ownership interest. Firms would be required to disclose to shareholders, as part of the proxy statement disclosure in connection with the annual meeting, the total level of each shareholders vouchers derived from each firm. Each shareholder would then allocate voucher dollars in proportion to his or her ownership interest, to designated intermediaries on the proxy card. Firms individually would then forward monies in proportion to allocated vouchers to designated recipients.

Piggybacking voucher allocation decisions onto each firm’s proxy ballot allows regulators to implement voucher financing with a minimum of additional regulatory apparatus. In contrast, regulators could alternatively distribute vouchers through a centralized voucher system administered possibly by the SEC (or a private entity such as ADP). Under the system, firms would pay into a common voucher fund pool. The SEC would then advise investors, in advance, as to the voucher dollars over which they have allocational authority, as well as the allocation procedure. Investors would then have the opportunity to allocate vouchers individually for each company in their portfolio (according to the respective contribution of that company to the investors’ total amount of vouchers) or aggregate the vouchers and distribute them according to a common allocation scheme. Indeed, we envision that the allocation process could take place online, and investors could even maintain an allocation default template with the SEC for all future allocations unless otherwise specified. The SEC would then distribute voucher funds in accordance with the shareholder’s revealed preferences. The SEC, moreover, would enjoy scale economies in distributing funds associated with vouchers to various intermediaries in the market. Once a voucher system is in place, the incremental cost to the SEC of adding an additional firm’s vouchers would be negligible. Voucher dollars of a specific firm that are not allocated through failure of shareholders to respond could be distributed in proportion to the vouchers that are explicitly allocated for shareholders of that specific firm (the proportional allocation rule).

Under either system of voucher allocation, we would allow investors receiving vouchers from one firm to designate vouchers to an intermediary that undertakes actions impacting the
value of other firms. Investors typically own more than one stock and therefore will find value in directing vouchers to intermediaries that improve the overall value of the investors’ entire portfolio. Unlike company-specific shareholder voting, therefore, for most investors (institutional and individual) the choice on how to allocate vouchers often will take the form of a common choice across all the firms in the investors’ portfolios. To the extent intermediaries impact the various companies in an investor’s portfolio in a similar fashion (providing a deterrent effect against managerial opportunism), an investor may choose to allocate vouchers at all her portfolio companies similarly, thus reducing the information costs associated with the allocation decision and enabling even relatively small shareholders to enjoy economies of scale. Investors choosing to make one common allocation of vouchers for all the firms in their portfolio may then enjoy scale economies in making this determination. An institutional investor with holdings in 50 different companies, for example, may make the choice generally to allocate 60% of its voucher dollars to a specialized voucher intermediary specializing in redistributing vouchers to worthy shareholder causes. The investor may then allocate 30% of its voucher dollars to analysts covering a large subset (if not all) of the 50 portfolio companies. The investor finally allocates the remaining 10% to an intermediary specializing in bringing proxy insurgent contests against underperforming companies generally.

3. Registered Investor Intermediaries

Although the universe of potential recipients of voucher dollars is finite, shareholders—even when making a common allocation for portfolios of companies—may still face costs in participating in the voucher program. All other things being equal, shareholders have a greater incentive to allocate vouchers compared with shareholders confronted with a vote. All shareholders are pivotal in that their decision on how to allocate their vouchers will in fact result in more (or less) money for various intermediaries. Nonetheless, while investors do not face the rational apathy problem as in shareholder voting, they still must decide how to distribute their vouchers. Investors may face information costs, lack expertise, or simply fail to participate.

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233 As well, intermediary led actions involving one specific firm may have spillover effects on all firms. For example, when investor vouchers help finance a proxy insurgency contest against an underperforming firm, the contest will deter potentially underperforming managers at all other firms.

234 See infra Part V.A.3 (discussing specialized voucher intermediaries).

235 See supra note 26 (citing sources discussing the rational apathy problem).
To facilitate shareholder participation, as well as to increase intermediary accountability, our proposal suggests that the SEC implement a registration process for voucher recipients. Through this process, intermediaries would register with the SEC in order to become eligible to receive voucher dollars. Such registered investor intermediaries (RIIs), would be required to provide data periodically to the SEC on their activities, the amount of voucher dollars they receive annually, and how they use the voucher dollars. The SEC could then publish this information in an easy-to-access format, potentially on the internet as it does presently with CEO and CFO certifications of financial statements, to provide investors a low cost method of determining how to allocate their vouchers. Our proposal would permit shareholders to designate one or more recipients of their voucher dollars from among all eligible RIIs.

RII disclosure would provide further benefits. First, it would increase intermediary accountability by allowing investors readily to scrutinize such factors as the costs incurred by an intermediary, the targets of its efforts, and the success of its initiatives. It is also likely that third party rating services or institutional investors would develop techniques for reporting on the quality of intermediary services. Second, the registration process would increase transparency in intermediary funding. Although it would be possible, and perhaps prudent, to preclude RIIs from receiving non-voucher financing in order to avoid the conflicts of interest that could arise from management directed payments or cross-subsidization, even absent such a prohibition, disclosure would enable investors readily to identify potential conflicts by reviewing the RIIs’ sources of financing.

Importantly, the decision on how to allocate vouchers across various different classes of intermediaries providing collectivizing services remains with shareholders. This allows shareholders to allocate funds to particular types of intermediaries that may provide more value-enhancing services at a particular point in time. When managers at several firms engage in a particularly high level of fraud, for example, shareholders may choose to allocate more vouchers toward activist groups bringing proxy contests against such managers. Through funding based on vouchers received from a large number of investors, proxy insurgent may have the ability to launch contests at a larger number of underperforming firms. In other years, shareholders may choose instead to allocate more vouchers to analysts, increasing the quality of information in the

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237 For a discussion of this point see infra Part V.A.5.
market. A successful analyst could collect voucher dollars from a number of investors, thereby supporting his or her research efforts without the need for cross-subsidization despite an inability to collect research-based fees. Unlike a government regulator, vouchers provide a flexible form of financing that shifts money to its highest value for investors over time.

The allocation process therefore incorporates market decisionmaking into the financing of intermediaries, rather than relying on a regulator or the trading firm to decide which intermediaries are worthy of financial support. The theory behind this approach is that, by overcoming collective action problems, voucher dollars enable the allocation decision to be made by those who have the best incentive to maximize firm value – the shareholders. In particular, shareholder allocation decisions should generate funding results that better approximate the theoretical ideal of group shareholder action compared with incumbent managers of a traded firm. Moreover, unlike with shareholder voting, all shareholders are pivotal in making voucher financing decisions. Each shareholder has sole control over where to allocate her allotted portion of vouchers.

In addition to the implementation of the RII system, an SEC-administered common voucher distribution system, and the use of proportionate allocation to address shareholder failure to participate, we anticipate two market-based developments to address shareholder participation problems. First, we expect intermediaries to arise that specialize in funneling voucher dollars to their best possible use.\textsuperscript{238} In other words, specialized intermediaries will provide expertise for investors lacking information and expertise as to where to best use the vouchers. Individual investors may then rely on the expertise of such intermediaries, transferring their voucher dollars to the intermediaries. Investors with the ability to direct vouchers, therefore, do not necessarily have to research and distinguish among different independent analysts, potential proxy insurgents, and other collectivizing intermediaries. They can instead direct their vouchers to organizations, such as possibly Institutional Shareholder Services. ISS may then save the vouchers for use at later year (shifting vouchers forward into time) or distribute the funds to other intermediaries providing analyst coverage or auditing services. Likewise, ISS could rechannel funds to specific sponsors of proxy issue proposals and other forms of actions designed to benefit shareholders.

\textsuperscript{238} Ackerman and Ayres rely on similar such intermediaries to redistribute their “Patriot Dollar” vouchers. See Ackerman and Ayres, supra note 211, at 72-75 (advocating the use of political action committees as intermediaries to redistribute Patriot Dollars from individual voters to specific candidates).
Reliance on intermediaries to provide assistance in how to direct financing is not without precedence. Arizona’s school choice program relies on non-profit intermediaries as a buffer between taxpayers deciding where to place their $500 tax credit dollars and the ultimate recipients of scholarship aid for private schools. Where individual taxpayers may not have good information on individual potential scholarship recipients, the non-profit intermediaries in Arizona provide this expertise. Moreover, the range of intermediaries gives taxpayers a degree of choice in how to use their $500 allocation. Competition among intermediaries further aligns this choice with the overall preferences of taxpayers in Arizona.

Second, we expect market competition to provide shareholders with information on individual intermediaries. Intermediaries will compete for voucher dollars, in part, by advertising their services, their quality and their results directly to the investing public. Because voucher dollars are not necessarily company specific, an intermediary that provides beneficial services for a wide variety of companies at once may have economies of scale in communicating this information to all investors in the market. Combined with the SEC’s own provision of information on RIIs in the market, the provision of information on the part of intermediaries competing with one another to obtain voucher dollars will substantially reduce the costs of information for shareholders considering how to allocate their voucher dollars. Importantly, market competition will result in allocational efficiency. As intermediaries compete on the basis of the value that they provide, shareholders will be able to direct their dollars to the intermediaries that best increase shareholder welfare. Quality intermediaries will be able to brand themselves, by establishing a reputation based on their results. Through annual financing decisions, moreover, shareholders will be able to maintain intermediary accountability.

4. Coordination Problems

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239 See notes 206-207 and accompanying text (describing the Arizona school scholarship program).
240 On the other hand, intermediaries in competition may spend too large amounts of money on advertising from the perspective of overall social welfare. The centralized provision of much of the information relevant to investors on registered investor intermediaries through the SEC, in part, reduces the risk of competition leading to too high levels of advertising. To the extent the problem persists, regulators may consider imposing caps on the amount any single intermediary may spend advertising itself to the investing public.
241 SEC provision of information on RIIs reduces considerably the cost to investors of distinguishing among different intermediaries. Nevertheless, to the extent investors are unable to distinguish among intermediaries, a lemon’s problem may arise where some intermediaries may free ride off the reputation of other intermediaries, reducing the overall value of reputation. See, e.g., Black, supra note 31, at 787-88.
In addition to the information problem facing shareholders, voucher financing presents a potentially even more severe problem in the form of coordination among shareholders. Under a voucher system, shareholders may fail to coordinate with one another on voucher allocation.\footnote{The coordination problem is not unique to voucher financing. Most corporate governance mechanisms that require shareholder participation present some type of coordination problem. Cf. Paul L. McKaskle, Of Wasted Votes and No Influence: An Essay on Voting Systems in the United States, 35 Hous. L. Rev. 1119 (1998) (identifying coordination problems under various political voting systems).} As a result, those intermediaries that shareholders value most highly may be overfunded. This may lead to wasteful or unproductive activity by the most popular intermediaries or, alternatively, provide some intermediaries with more voucher dollars than they can productively use. Additionally, shareholders may fail to direct their vouchers to other deserving recipients. At the extreme, we might see a narrowing rather than an expansion of available intermediary services if shareholders systematically disregard or undervalue some forms of intermediation.

We recognize the coordination problem as one of the most severe objections to our proposal. Nonetheless, we offer several observations which suggest that the problem is less serious than it initially appears. First, we note that many shareholder coordination problems may be random. To the extent that no systematic bias exists in investor allocations, errors in voucher allocation are likely to be reduced over a range of companies. An analyst who receives too few vouchers at one company, for example, may receive too many vouchers from another. Similarly, because investors at different companies have different needs, the voucher marketplace is likely to reflect a range of intermediary services. Allocations from one company, at which investors desire greater activism to displace entrenched management, will be balanced by those from another company in which investors are content with management and seek greater technological innovations such as electronic annual meeting attendance and proxy voting.

Second, short term disparities in voucher allocation are likely to be resolved in a multi-year time frame. If investors identify that a particular intermediary has received too much financing in a given year (obtaining such information from a centralized SEC database for example), they can adjust their allocations for the following year. Similarly, an intermediary need not spend all allocated dollars within a given year – an action intermediary who is overfinanced can retain some voucher dollars to sponsor challenges in succeeding proxy seasons.
Third, as we have identified, the voucher program may result in the development of intermediaries who specialize in rechanneling vouchers.\textsuperscript{243} Such intermediaries would offer expertise in identifying and evaluating RIIs, but would also offer a mechanism for coordinating voucher allocations, particularly for individual investors.

Finally, and most important, a large number of voucher dollars will be controlled by institutional investors. Voucher financing is a particularly efficient mechanism for institutional activism because institutions can enjoy economies of scale by coordinating their research and allocation efforts across their entire portfolios. Institutions also enjoy relatively low costs coordinating their allocation efforts with other institutions. Analogously, Jeff Gordon has argued that the relatively low coordination costs for institutional investors offer new potential for improving corporate governance through cumulative voting.\textsuperscript{244} Coordination with respect to voucher financing would be far easier than coordination on voting, because such coordination need not occur on an individual firm basis and because voucher financing provides institutions with a level of political insulation for their decisions. Additionally, institutions could develop and publicly announce their allocation policies, thereby providing information to other investors that would prevent duplicative or excessive allocations.

Other programs exist providing for decentralized allocation of funding without overly great coordination problems. Taxpayers under the Federal tax code, for example, may make charitable contributions to certain non-profit entities and thereby receive a tax deduction.\textsuperscript{245} The deduction effectively makes the government a co-donator to the charity of the individual taxpayer’s choosing.\textsuperscript{246} The Arizona program to allow taxpayers to make a $500 contribution

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\textsuperscript{243} See supra note 238 and accompanying text.
\textsuperscript{244} See Jeffrey N. Gordon, Institutions as Relational Investors: A New Look at Cumulative Voting, 94 Colum. L. Rev. 124, 173, 177 (1994).
\textsuperscript{245} See Internal Revenue Code Section 170.
\textsuperscript{246} For an examination of the implications of allowing taxpayers to direct for themselves the use of funds through the charitable contribution deduction provision of the Internal Revenue Code see Saul Levmore, Taxes as Ballots, 65 U. Chi. L. Rev. 387, 404-418 (1998). Levmore, in particular, focuses “on the charitable deduction as an illustration of the idea that the tax system can be understood as allowing dispersed donors to determine which agents, projects, or causes the government will finance.” Id. at 388. In responding to the possibility of a collective action problem among decentralized taxpayers making charitable contribution decisions without coordination, Levmore writes:
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A further advantage of the charitable deduction returns us to the collective action problem that may be associated with aggregating preferences in order to determine an expenditure level. The charitable deduction scheme permits a kind of ongoing vote. If a donor's decision as to how to allocate his own funds, and therefore the government's as well, depends on other contributors' decisions,
(and receive a corresponding tax credit) to a non-profit intermediary providing private school scholarships also provides for decentralized financing. \(^{247}\) Moreover, any coordination problems must be weighed against the benefit of providing market discipline in providing subsidies for securities market intermediaries.

5. **Exclusivity and Intermediary Corruption**

The capacity of voucher financing to eliminate intermediary corruption depends on its implementation. If RIIs are able to accept outside funding in addition to voucher dollars, the risk remains that managers will be able to influence intermediary services. Managers intent on expropriating value from their companies could still use corporate resources to bribe intermediaries to certify financial statements falsely, to provide a higher-than-warranted analyst recommendation, or to refrain from sponsoring a shareholder proposal challenging management policy.

One simple way to prevent corruption is to eliminate the opportunity for outside funding. The SEC could impose, as a condition of registration, that RIIs agree to accept only voucher dollars. Those intermediaries that wanted to solicit market based payments, from investors, firms, or elsewhere, would be free to do so, but they would not be eligible for voucher financing.

The restriction on outside financing, coupled with Regulation FD’s existing prohibition on selective subsidization through information, \(^{248}\) would effectively preclude management from paying RIIs in order to influence their services.

There is reason to be cautious, however, about precluding managers from directing corporate funds to intermediaries as a supplement to voucher dollars. First, our proposal may result—to the extent regulators misjudge the amount of the firm levies—in an underfunding of intermediaries. Issuers, in theory, still retain an incentive to ensure that they adopt investor protection devices that maximize the value of their stock for shareholders. At least some well-meaning managers may desire to accomplish this objective, providing continued subsidies to analysts for example. Curtailing the ability of managers to direct corporate resources to intermediaries may therefore increase the cost of error in implementing our proposal.

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\(^{247}\) See notes 206-207 and accompanying text (describing the Arizona school scholarship program).

\(^{248}\) See SEC, Selective Disclosure and Insider Trading, supra note 19 (promulgating Regulation FD).
Second, the ability of managers to corrupt intermediaries is reduced under our proposal. To the extent a ready source of funds exists through the voucher program for intermediaries, intermediaries intent on creating and maintaining a reputation for investor protection will be able to do so without resorting to funds directly from traded firms. Managers may attempt to corrupt certain intermediaries, but competition from the newly funded high investor protection intermediaries will reduce the effectiveness of manager-funded intermediaries. Investors that receive a pro-management recommendation from an intermediary known to receive funds from managers will not weigh such an opinion greatly in the face of a competing negative recommendation from a voucher-financed independent analyst. Indeed, to remain competitive, intermediaries receiving financing through manager-determined subsidies must take extra efforts to convince investors of the intermediaries’ credibility once investors have voucher-funded alternative sources of research.

Third, under our proposal, the government will have a role in publicizing those companies with voucher financing. RII registration will operate as a certification of intermediary reputation. Intermediaries receiving voucher financing will also have an incentive to advertise their level of voucher financing. Investors will use the information on voucher financing to distinguish among intermediaries. Indeed, the SEC could take an intermediate position on outside funding, consistent with the disclosure orientation of the federal securities laws, by permitting such funding of RIIs but requiring RIIs to disclose their funding sources on a regular basis. Because the possibility of intermediary corruption turns on sources of funding, this solution would be tailored to reduce the risk of corruption while maintaining the availability of outside funding.

6. Refining the Scope of the Proposal

In describing the proposal, we have implicitly assumed that voucher financing should encompass the funding of all intermediaries that provide aggregating services for investors. Intermediaries differ dramatically, however, in the scope of their operations, the extent to which their services suffer from free-riding and spillover effects, and the extent to which they are underfunded by the present system. Voucher financing provides the greatest value for intermediaries that provide services which impact a wide variety of companies, either at once, or over a period of time. Analysts, for example, provide information and research services for a
broad range of companies at any one time. Proxy advisors or insurgents can focus their attention on a single target company and, when their goals have been accomplished, turn their efforts to another target. Even where the work of an analyst or proxy challenger is focused upon a specific firm, the services are likely to generate spillover effects. For example, the proxy contest brought at one company has a deterrent effect against under-performing managers at other companies. Moreover, compared with regulator-directed mandatory subsidies, voucher financing provides benefits where heterogeneity exists across firms (and across time) with respect to which intermediaries provide investors the most value. In particular, voucher financing allows investors the flexibility to redirect funds to meet varying and changing needs in a way which mandatory regulation is simply incapable.

In contrast, the efforts of some intermediaries are focused more on a single company. It is relatively less clear, for example, that an auditor’s efforts reviewing one company’s system of internal controls provide benefits that extend beyond the target company and its shareholders. Often such intermediaries are already compensated directly from the trade firm (due to mandatory audit requirements), undermining the need to subsidize through voucher financing. Broad consensus may also exist among investors that some services, such as auditing, are worthwhile to fund at all publicly traded firms. In such cases, mandatory financing provides a mechanism to fund such services without requiring regulators to make a choice as to where to direct such financing (since almost all publicly-traded firms must comply). Moreover, procedural devices to constrain managerial opportunism, such as improved audit committee oversight or shareholder voting, may be more effective with respect to intermediary services performed for a single firm.

On the other hand, voucher financing may still offer benefits in improving market structure and competition even where an intermediary performs services for a single firm at a time (and is compensated from the traded firm already). Existing limits to entry have reduced public companies to a choice of four auditing firms. Voucher financing, perhaps as a supplement to firm-based fees, might offer a mechanism for facilitating entry and increasing competition among accounting firms.

Accordingly, the voucher proposal offers greater value for some classes of intermediaries than others. Although we have identified auditing services as presenting the same financing

249 For a discussion of present mandatory subsidies see supra Part IV.B.
dilemma as proxy advisors, analysts and other types of intermediaries, voucher financing offers the least value for auditing services. In addition, using voucher financing for auditors presents administrative complexities beyond those applicable to other types of intermediaries. Voucher financing would not solve, for example, the dilemma of who should select the single official auditor for any particular firm. Voucher financing would not provide a basis for allocating workload among auditors, yet the relationship between workload and fees is an essential element of audit profitability. Moreover, a variety of existing reform proposals, including new SEC rules and several sections of Sarbanes-Oxley, are addressed to auditor selection, compensation and independence. Until these proposals are implemented and tested, the need for voucher financing in this area is uncertain. Accordingly, we do not propose in this article that voucher financing be used for auditing services. Instead we focus on voucher financing as a mechanism for financing non-auditing intermediary services.

B. Benefits of the Proposal

Implementation of a voucher financing system for intermediaries will generate several benefits for investors. The overall amount of intermediary activity in the securities market will increase. Voucher financing will make it financially viable for intermediaries to provide services that cannot be provided through standard market transactions because of free rider and public good problems. Voucher financing also enables the provision of services that cannot be cross subsidized through other business operations. In particular, we expect the voucher proposal to enable the development of intermediaries that will provide substantially greater monitoring and activism services. Intermediaries will be able to use voucher dollars to finance shareholder proposals, bylaw amendments, and election contests, as well as public and private negotiations with corporate management. Moreover, through vouchers, intermediaries will be freed from their dependence on existing forms of activism. Vouchers may, for example, lead to more direct proxy solicitations, in which insurgents are not limited by the constraints of Rule 14a-8.250

Vouchers may be a particularly helpful complement to existing efforts to identify a broader pool of independent directors by providing shareholders an effective tool for nominating of directors outside the framework of control contests. [Jill-WHAT DO YOU MEAN??] In turn, investor endorsement of these actions, through financing, will give state courts greater

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250 See supra Part IV.B.2.b (discussing shareholder proposals under Rule 14a-8).
comfort in accepting the legitimacy of increased shareholder participation in corporate governance. Activist intermediaries will also enable large investors, such as institutions, to increase management accountability without the coordination problems or risk of unfavorable retaliation that exist under current law.

The quality of intermediary services should also increase. Market competition will cause quality intermediaries to receive higher levels of funding. Voucher financing will readily direct funding to intermediaries who provide useful services to investors and the marketplace. Analysts who provide accurate and unbiased information, for example, will have their research funded through voucher dollars. Voucher financing will further increase market information by creating an incentive for analysts, proxy advisors and other information intermediaries to disseminate the results of their efforts widely so as to attract vouchers from a wide range of investors. Rating services and institutional investors are likely to assist market functioning by reviewing and reporting on the quality and results of intermediary efforts. Intermediaries can also secure funds by serving unmet investor needs. At the same time, intermediaries that fail to meet their commitments will be disciplined through the annual allocation process. It is difficult to imagine that shareholder gadflies who sponsor shareholder proposals to further their private political agendas or simply to generate personal publicity would be successful in obtaining significant voucher dollars.

Voucher financing will thus provide a market-based mechanism for eliminating existing conflicts in the provision of intermediation without the need for draconian regulatory restrictions. The availability of voucher dollars as a funding source will reduce the need for intermediaries to rely on cross-subsidization from investment banking operations or consulting services to finance their efforts. Indeed, an intermediary’s commitment to independence is likely to increase its ability to attract voucher dollars. As well, competition may lead intermediaries to focus more on addressing agency problems within their own structure that may lead them not to cater solely to investor protection-oriented goals. Competition for vouchers, may make intermediaries less likely to succumb to the inducements on the part of managers to corrupt the intermediaries.

Moreover, coupling disclosure with an alternative funding source creates a market-based mechanism for testing the impact of potential conflicts of interest on intermediary quality.

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251 But see supra note 240 (discussing the possible need for caps on the amount individual intermediaries expend on advertising).
Under the recently proposed regulatory solutions, regulators determine the extent to which intermediary conflicts are permissible, thereby specifying the degree of intermediary independence. This role creates a substantial risk of regulatory error. First, it may be difficult for regulators to determine the qualitative impact of a particular type of conflict upon an intermediary’s services. Second, the regulator may be unable to ascertain the extent to which proposed solutions such as Chinese Walls, remedy the conflict or are ineffective window dressing. Finally, regulators are poorly situated to weigh the benefits of independence against the costs. In particular, economies of scale may, in some cases, justify combining intermediation with related services such as consulting, brokerage, or investment banking operations. In contrast to current proposals, voucher financing does not require regulators to determine the optimal degree of separation. If a firm can provide better services despite engaging in conflicting businesses, and can satisfy investors as to the quality of its product, it is free to continue with its existing structure. The disclosure required of RIIs will effectively bring such potential conflicts to the attention of investors, and voucher financing will provide a mechanism for providing investors with truly independent alternatives if those alternatives are desirable.

The possibility of voucher financing also reduces the need for regulators to engage in other forms of regulatory interventions. Voucher financing applied to sponsors of proxy issue proposals and proxy contests, for example, reduces the need for mandated subsidies of such efforts. It also frees regulators from the potential inefficiencies of regulatory meddling. Ultimately, voucher financing offers the potential, for example, to allow the SEC to extract itself from the difficult task of determining the appropriate subject matter for a subsidized shareholder proposal under SEC Rule 14a-8. Instead, shareholders will be able to make that decision themselves by rewarding an intermediary that sponsors value-increasing proposals and failing to support an intermediary that engages in wasteful activism. Similarly it will be unnecessary to develop a rule to permit or require reimbursement of insurgent’s expenses in an election contest; intermediaries will be able secure funding based on their ability to identify companies at which a change in management is appropriate and to identify suitable replacements. Again, a market mechanism for evaluating and compensating intermediaries based on their performance – in terms of shareholder welfare – is superior to regulatory error.

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252 See supra Part IV.B.3 (discussing various proposals to reduce conflicts of interest among analysts and auditors).
253 For an example of such an effort see Bebchuk and Kahan, supra note 23.
One might object that a central planner with perfect information and the incentive to maximize shareholder welfare would present a superior alternative to our financing proposal. Such a central planner could costlessly identify the intermediaries who, on the margin, provide the greatest increase in overall shareholder welfare, and direct dollars to those intermediaries. Of course such a central planner does not exist as a solution to the intermediary financing dilemma, and, public choice considerations aside, existing regulators are unlikely to offer a comparable alternative.

Moreover, voucher financing is superior to regulatory alternatives by virtue of its greater flexibility. Unlike regulatory solutions, which require affirmative government action to refine, voucher financing is capable of responding automatically to changes in intermediary structure or market needs. If the market views Chinese Walls as a sufficient guarantee of analyst independence, shareholders can direct their vouchers to analysts employed by investment banking firms with such barriers in place. If the market loses confidence in these structures, shareholders can redirect their dollars to independent analysts. The capacity of voucher financing to adjust to these changes is particularly valuable in a dynamic market environment.

Recently, the SEC and the New York State Attorney General’s office have pursued a similar tactic toward reform: calling for the establishment of a new analyst oversight board with separate resources to fund independent analysts.\(^\text{254}\) The SEC and New York proposal would obtain financing from the financial services industry (imposing a levy of $10 to 20 million dollars per firm), aiming initially for $200 million in total per year for the first five years.\(^\text{255}\) The oversight board would then have the discretion to finance approximately 20 independent analysts to provide research (possibly over the internet) to the investing public.\(^\text{256}\) Financial firms would have the ability to retain their own analysts, but would have to direct at least retail investors to not only the firms’ own in-house research but also the analysis for the selected independent analysts.

Our proposal, nonetheless, dominates the SEC and New York’s proposal along a number of dimensions. First, the traded firm acts as a more natural source of collectivizing the interests of investors compared with individual financial firms. When uninformed investors are protected


\(^{255}\) See id.

\(^{256}\) See id.
from the risk of trading against informed traders, they will bid up the share price of the traded firm. On the other hand, individual financial firms are not necessarily benefited when uninformed investors are protected, particularly where the client base of a particular firm consists primarily of institutional investors. Second, as we have discussed above, several types of intermediaries provide collectivizing activities to the benefit of all investors, ranging from analysts to proxy contest insurgents. Our proposal provides flexibility for funds to shift toward those intermediaries at any given point in time providing the highest value for investors. Finally, instead of a rigid oversight board, we rely on the market—working through the collective preferences of investors—to determine where to direct subsidy dollars. Questions exist as to the independence of an oversight board dependent on money from investment banks.\textsuperscript{257} Competition among voucher recipients, in contrast, will provide a more forceful mechanism to ensure that vouchers end up with intermediaries providing the highest return for shareholders compared with an insulated oversight board lacking any direct financial stake in their allocation decisions.

\section{VI. Conclusion}

The voucher financing proposal we propose represents a dramatic departure from how intermediaries are financed and the way in which shareholders interact with intermediaries and with each other. For a relatively minor problem facing the capital markets, the cost of implementing a voucher financing system may outweigh the benefits. But securities intermediary financing is no ordinary problem.

Shareholders of large publicly-held corporations face a large collective action problem in monitoring managers and voting in proxy contests. Certain intermediaries play a collectivizing role, aggregating the interests of investors through the supply of investment analysis, proxy contest advice, and other services. However, intermediaries are subject to the same collective action problem they work to overcome. In particular, the financing structure of securities intermediaries may undermine their efforts. Intermediaries unable to obtain compensation for

\textsuperscript{257} The Wall Street Journal, for example, reported: Scott Cleland, found of Precursor Group, an independent research firm that could benefit from the [research] board’s creation said he likely would not take money from the panel. “You can’t get rid of the conflict by laundering it through a separate entity.” Mr. Cleland said recently.

the full benefit of their work may, at the very least, provide less information and other services than they otherwise would. At worst, intermediaries may simply choose not to provide valuable market services.

Although firm-based subsidies and cross-subsidization offer solutions to the underfunding problem, they bring their own shortcomings. Firm-based subsidies allow firm managers to control selection and compensation of intermediaries, leading to problems of intermediary corruption. Cross-subsidization generates the potential for conflicts of interest, as demonstrated by the recent role of investment banking operations in (arguably) corrupting analyst reports and recommendations. Moreover, simply addressing the conflict problem alone, without recognizing the underlying financing dilemma facing securities market intermediaries may increase the harm to investors by causing intermediaries to stop providing the subsidized services. One way of solving the conflicts of interest problem, for example, would be to prohibit analysts from associating with investment banks in any form. This solution, nevertheless, may simply result in fewer (if any) analysts providing information to the market.258

Rather than tackle the conflicts of interest problem, we focus directly on the financing problem. Solve the financing problem and the need for subsidies from the traded firm dissipates, alleviating the conflicts of interest problem. The key motivating insight behind our voucher financing is the need to separate the question of how much to subsidize intermediaries from the decision on how to allocate such subsidies. Theoretically, other mechanisms may provide the same separation. The government, for example, may impose a tax on publicly-held firms and rely on regulators to apportion the tax revenue among “worthy” intermediaries. But while we envision a potential role for the government in setting the mandatory payment on the part of firms into the voucher financing system, we would rely more on the market—working through investors and intermediaries—to decide how to allocate the voucher driven subsidies. Well-known limits exist on the expertise and incentive of regulators to micromanage the market. And we avoid these limitations through reliance on investors individually or through specialized intermediaries to direct vouchers.

While the voucher financing proposal is radical, it is feasible to implement. There is ample precedent for using firm-based levies to subsidize collectively valuable market services.

258 When fewer analysts provide information to the entire market, buy-side analysts may then have a greater incentive to engage in competitive (and often duplicative) efforts at generating information to obtain a trading advantage. See supra text accompanying notes 62-190.
The NYSE, for example, could implement the voucher financing proposal for its listed firms along lines similar to the method in which it sets the rates for ADP’s services.\textsuperscript{259} Broader implementation of our proposal could be achieved through legislation or possibly SEC rulemaking. Indeed, in comparison to the recent corporate governance reforms implemented by Sarbanes-Oxley and the SEC, our proposal is quite modest. Importantly, unlike existing reform efforts, voucher financing does not place Congress, the SEC or the SROs in the position of a central planner, charged with the task of designing an ideal structuring for redressing existing shortcomings in the securities markets. Instead voucher financing allows shareholders to make that decision through a dynamic process that is capable of shifting market resources to wherever they can be used most effectively.

\textsuperscript{259} See supra text accompanying notes 132-146 (describing ADP and the financing for ADP’s services).