How To Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries

Stephen J. Choi
Jill E. Fisch

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Articles

How To Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries

Stephen J. Choi† and Jill E. Fisch††

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† Professor, University of California, Berkeley (Boalt Hall).
†† Professor, Fordham University School of Law. Thanks for helpful discussions with and comments from Jennifer Arlen, Ian Ayres, Stephen Bainbridge, Lucian Bebchuk, Bernie Black, Jesse Fried, Kim Krawiec, Mark Latham, Mark Lemley, Un Kyung Park, Steve Sugarman, Randall Thomas, and the participants of the 2003 ALEA Annual Meeting, the 2003 AALS Section on Securities Regulation, the 2002 UCLA/USC Corporate Law Conference, the Vanderbilt Law School Law and Economics Seminar, and the UC Berkeley Law and Economics Seminar.

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I. INTRODUCTION

Investors face a difficult task when they value a particular securities investment. They typically put money into an investment with the expectation of taking out even more money sometime in the future. Unlike more tangible investments, securities provide returns only through intangible rights to an issuer’s cash flows in the form of dividends and rights to assets in liquidation. As a result, having credible information on the nature of these intangible rights, as well as on the underlying business of the issuer, is important for individuals and entities seeking to value risk and expected return. Once they have this information, investors must also have the requisite expertise to evaluate it. Both gathering and assessing such information is costly.

These problems persist after the initial investment; investors must decide how to manage their investment (for example, by exercising shareholder rights) and when to sell. Although an important component of share ownership is corporate governance rights, including the right to elect directors, many shareholders fail to exercise these rights. The explanation for shareholder passivity in large, publicly held corporations is straightforward. The dispersed shareholder body is poorly positioned to engage in effective collective action; the costs of monitoring management or leading a proxy contest typically far outweigh the benefits to an individual shareholder. As a result, shareholder collective action is rare, even though it may benefit shareholders as a group.1

The information cost and collective action problems facing dispersed shareholders in public corporations create at least two possibilities for opportunism. First, corporations may attempt to issue securities at inflated prices, thereby shifting value from new investors to preexisting shareholders. Second, managers may take advantage of deficiencies in shareholder monitoring to expropriate a portion of the issuer’s value for their own private benefit through large salaries, insider trading, and other forms of self-dealing.2


2. For example, Dennis Kozlowski, former CEO of Tyco International, is alleged to have used one million dollars of Tyco money to pay for his wife’s fortieth birthday party in Sardinia. See Melissa August et al., Numbers, TIME, Sept. 30, 2002, at 30. The ability of managers to expropriate value from shareholders may lead to additional ex ante costs on issuers. To enhance their ability to engage in insider trading, for example, managers may purposefully shift the company toward less valuable but more confidential (and variable) projects. See, e.g., Frank H. Easterbrook, Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, 1981 SUP. CT. REV. 309, 331.
The market response to these problems is one of pricing. Investors aware of the possibility of opportunism will be more reluctant to invest and will demand a higher return (leading to a reduced price) to compensate them for the risks of self-dealing.3 Where investors cannot distinguish among corporations with varying risks of opportunism, they will discount all securities prices. The investors’ inability to identify riskier issuers leads to a classic lemons problem.4 Corporations that expropriate a lower amount from investors are given the same discount as corporations with higher levels of expropriation, creating a scenario in which the more investor-friendly issuers may exit the capital markets.5

Securities intermediaries offer a market response to the lemons problem. For purposes of this Article, we define intermediaries by their function as collectivizing agents for shareholders—providing services that benefit shareholders directly or indirectly.6 In particular, this Article focuses on information and activism services, which assist shareholders by providing information to the marketplace and by improving shareholder monitoring. Such intermediaries include auditors, who verify and report on the accuracy of corporate disclosures; analysts, who research and disseminate securities information to the marketplace; proxy advisors, who supply voting guidance and, in some cases, facilitate shareholder activism through the voting process; and others who increase shareholder information or reduce the costs of collective action. Individual shareholders themselves may take on an intermediary role when acting on behalf of all shareholders, such as when they initiate a proxy contest or introduce a

3. See BERNARD S. BLACK ET AL., DOES CORPORATE GOVERNANCE MATTER?: EVIDENCE FROM THE KOREAN MARKET (Korean Dev. Inst., Working Paper No. 02-04, 2002), http://www.kdischool.ac.kr/library/data/w02-04.pdf (providing evidence that a higher level of corporate governance protection for issuers listed on the Korean Stock Exchange results in higher Tobin’s Q valuations, among other measures, for issuers); Rafael La Porta et al., Investor Protection and Corporate Governance, 58 J. FIN. ECON. 3, 15-16 (2000) (reporting evidence that coming from a common law jurisdiction has a statistically significant positive impact on Tobin’s Q valuations, and concluding that legal protections for minority shareholders result in increased valuations for issuers).  
5. Alternatively, managers at otherwise more investor-friendly companies may adopt an “if you can’t beat them, join them” attitude and increase the amount of private benefits they expropriate.  
6. Other intermediaries, such as credit rating agencies, provide services to debt investors. See, e.g., Standard & Poor’s, at http://www.standardandpoors.com (describing credit rating services) (last visited Aug. 5, 2003). Because our proposal focuses on shareholders, these intermediaries are beyond the scope of this Article. Similarly, although many intermediaries, such as analysts and auditors, provide services that benefit both debt and equity investors, we focus here on the services provided to shareholders.
shareholder proposal. Issuers also benefit from intermediary services that, by reducing risk to investors, reduce the issuers’ cost of capital. 7

Intermediaries do not always function effectively, however. Indeed, the presence of high-reputation intermediaries may lull investors into a false sense of security, causing them to rely on the intermediaries and seek out less information on their own. Once lulled, investors may lose more money than when the investors enjoyed no intermediary-provided protections. Investors in Enron, for example, expected intermediaries to monitor and disclose the company’s financial condition and were misled by the intermediaries’ failure to identify and report the company’s problems. 8 As Enron’s auditor, Arthur Andersen overlooked widespread accounting violations and failed to report the company’s financial status accurately, leading to large investor losses. 9 Securities analysts ignored serious indications of financial problems and continued to recommend Enron as an investment long after the company entered its death spiral. 10

As recent congressional inquiries and media reports have made clear, many of the problems with intermediary performance can be traced to conflicts of interest. Analyst reports are often influenced by a brokerage firm’s desire to attract or retain investment banking business. 11 Firms that audit an issuer’s financial statements also provide lucrative consulting

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10. See Charles Gasparino & Tom Hamburger, Congress Broadens Probe of Enron Fall and Wall Street Role, Wall St. J., Mar. 7, 2002, at C1 (reporting on a congressional investigation into “analysts who continued to recommend Enron’s stock...as the company careened toward bankruptcy”).

11. For example, Jack Grubman, the premier telecom analyst of the late 1990s, recommended WorldCom and other telecoms despite worsening performance and sustained drops in stock price over 2000 and 2001. See Steven Rosenbush et al., Inside the Telecom Game, Bus. Wk., Aug. 5, 2002, at 34. Grubman’s motivation may have been affected by the prospect of investment banking business for his employer, Citigroup. See 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”).
services that compromise auditing independence. Even shareholder activists may be driven more by personal gain than collective shareholder welfare.

The approach toward addressing the problems facing securities market intermediaries has largely consisted of piecemeal efforts to reduce these conflicts. In the case of analysts, the principal reform seeks to separate analyst research from investment banking business. Merrill Lynch recently entered into a settlement with the New York State Attorney General effecting a partial separation of these roles. The National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) have also implemented conflict-of-interest rules designed to increase the independence of analysts. Similarly, the Sarbanes-Oxley Act of 2002 forbids outside auditors from providing a wide range of consulting services to their audit clients.

Eliminating intermediary conflicts is a flawed solution, however. 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

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12. The settlement between Merrill Lynch and Eliot Spitzer, the New York State Attorney General, provides that Merrill Lynch must compensate analysts based on criteria independent of their value to its investment banking business. See Cheryl Winokur Munk, Merrill Changes Stock-Research Rating Process, WALL ST. J., June 10, 2002, at C16; Press Release, Office of the New York State Attorney General, Spitzer, Merrill Lynch Reach Unprecedented Agreement To Reform Investment Practices (May 21, 2002), http://www.oag.state.ny.us/press/2002/may/may21a_02.html (describing the settlement terms). The Merrill-Spitzer settlement, nevertheless, does not completely separate analysts from investment banking; it allows analysts to receive compensation out of a financial firm’s general revenues, including those derived from investment banking. Id.

13. See Randall Smith, New NASD Rule Limits Analysts at ‘Bake-Offs,’ WALL ST. J., June 6, 2002, at C1 (noting that the NASD’s 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, an analyst is 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 Self-Regulatory Organizations, Exchange Act Release No. 48,252, 68 Fed. Reg. 45,875 (Aug. 4, 2003).


Sarbanes-Oxley also requires the SEC to adopt rules to address analysts’ conflicts of interest. See Sarbanes-Oxley Act of 2002 § 501. In February 2003, the SEC adopted Regulation AC, which requires analysts to certify that the opinions disclosed in their research reports accurately reflect their personal views, and to disclose any compensation related to the recommendations contained in the reports. See Regulation Analyst Certification, 17 C.F.R. §§ 242.500-.505 (2003).
intermediary services from more lucrative services may reduce or eliminate services that are not independently profitable and may thus actually exacerbate existing shortages of intermediary services. In particular, although intermediaries presently provide information and technical support, their provision of more active services—such as the initiation of proxy contests—has been limited.

Indeed, we argue that the persistence of intermediary conflicts signals a more general market failure. Individual transactions under the current market structure may fail to provide efficient levels of intermediary services, leading to excessive provision of some intermediary services and inadequate provision of others. Free riding and shareholder collective action problems inhibit the efficient provision of intermediary services. In many cases, issuers respond to these problems by acting as collectivizing agents, bearing the cost of services that benefit all shareholders. Issuers do this, for example, when they hire an outside auditor to certify their financial statements or when they disseminate a shareholder proposal in accordance with SEC Rule 14a-8. Similarly, some commentators have argued that managers used selective disclosures to subsidize analysts prior to the promulgation of Regulation FD, which severely curtailed such disclosures. Alternatively, intermediaries may cross-subsidize their activities with revenues from related business services. Analyst research, for example, has long been cross-subsidized, first from brokerage commissions and more recently from investment banking services.

Issuer-based subsidies, however, create a conflict of interest for intermediaries. Although companies may work to centralize the funding of securities market intermediaries, corporate managers allocate the company’s funds. Managers are more likely to fund intermediaries that favor managers than those that effectively curb management opportunism. Control over allocation decisions enables managers to influence intermediary output, leading to biased research and other services. Similarly, cross-subsidization may encourage intermediaries to tailor their output to attract more lucrative ancillary business.

15. 17 C.F.R. § 240.14a-8.
18. At least in the area of selective disclosures, other solutions are possible to the problem of managerial opportunism. See, e.g., Choi, supra note 16, at 569-74.
19. For example, auditors have been criticized for allowing their consulting business to influence their auditing vigilance. A 2001 SEC survey found that, among 563 Fortune 1000
Our central observation is that the problems plaguing securities intermediaries result from a financing dilemma. Absent cross-subsidies or issuer-based subsidies, the market cannot sustain the optimal level of intermediary activity. Understanding the issue as a financing dilemma suggests that reform proposals aimed at reducing conflicts of interest without identifying alternative funding sources will ultimately fail. Instead, fixing Wall Street requires a separate solution to the financing problem.

This leads us to our main proposal. We put forth a new funding arrangement for intermediaries that preserves the central role of issuers in subsidizing the activities of intermediaries for the benefit of shareholders, but separates the source of funds from the allocation decision. We propose a voucher financing mechanism, under which issuers fund intermediary activity, but shareholders individually direct funding to their preferred intermediaries.

Voucher financing is not problem-free, and we discuss problems with the proposal in Section V.B. In particular, for reasons we discuss in more detail below, we do not advocate substituting voucher financing for the current system of mandatory audits for issuers, although we would allow vouchers to fund supplementary auditing services. While recently proposed regulatory reforms to the auditing process may have shortcomings, we think it may be both premature and impractical to rely exclusively on voucher financing of auditors. For other types of intermediaries, however, we argue that the benefits of voucher financing outweigh the costs, and that voucher financing provides a superior alternative to existing financing mechanisms.

Our proposal has several important benefits: First, by using the issuer as the source for intermediary funding, the proposal highlights the fact that intermediary services benefit all shareholders collectively. Second, by removing the need for outside sources of funding, the proposal reduces the conflicts that result from existing forms of subsidization. Third, by consolidating intermediary funding within a single mechanism, the proposal facilitates efficient allocation of funding among different types of services. As a result, the proposal may reduce the total level of funding to companies studied, issuers paid their auditors $2.69 in consulting fees for every $1.00 in auditing fees. See Lynn E. Turner, Independence: A Covenant for the Ages, Remarks at the Conference of the International Organization of Securities Commissions (June 28, 2001), http://www.sec.gov/news/speech/spch504.htm (describing the survey’s findings).

20. See infra Subsection V.B.3.

21. Voucher financing could also, in theory, be used to fund the services of other types of intermediaries not considered in this Article. For example, one of us has argued elsewhere that management control over the selection and funding of outside counsel creates the potential for similar corruption. See Jill E. Fisch & Kenneth M. Rosen, Is There a Role for Lawyers in Preventing Future Enrons?, 48 VILL. L. REV. 1097, 1123-26 (2003). Although voucher financing might provide a solution to this problem, the application of voucher financing to lawyers is beyond the scope of this Article.
intermediaries and eliminate the need for some existing mandatory subsidies. Consequently, rather than constituting an additional tax or levy on issuers, the proposal may reduce net costs for issuers. Fourth, 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 the market for intermediary services dramatically. 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. Strengthening private market intermediaries will reduce pressure on regulators to increase antifraud penalties and engage in more searching (and costly) enforcement actions. Voucher financing will provide a more flexible and market-driven means of subsidizing intermediaries compared with regulator-directed subsidies. Thus, while voucher financing may increase the provision of some intermediary services, it may also reduce the excessive provision of other services that, under the current system, results from market failure, regulatory error, or undesirable subsidization. Finally, reinforcing the role of intermediaries offers a meaningful mechanism for restoring (and maintaining) investor confidence in the securities markets.

The Article proceeds as follows: Part II sets forth the collective action problem facing dispersed shareholders and the role of institutional investors in assisting collective action. Part III describes the role and function of securities market intermediaries. We describe existing intermediaries, the services they provide, and the structural problems that prevent them from fulfilling their investor-protection potential. Present and proposed legal responses to these structural problems are assessed in Part IV. Part V sets forth our proposal for creating truly independent intermediaries. Key components of this proposal include creating an independent source of intermediary funding, and allowing shareholders to control this funding through vouchers.

22. For a related argument that securities antifraud liability should take into account alternative market-based mechanisms (which may vary systematically with issuer size), see Stephen J. Choi, Company Registration: Toward a Status-Based Antifraud Regime, 64 U. CHI. L. REV. 567 (1997).

23. 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) (calling the SEC's decades-long prohibition on disclosure of projected earnings "[o]ne particularly egregious example of the SEC's problematic disclosure policies," and noting that although "[t]he SEC modified its position in 1979 to permit the disclosure of projections within a safe harbor rule ... even today the agency's approach is still quite guarded" (citation omitted)). 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, 923-26 (1994) (providing a public choice explanation for the SEC's continued existence despite its obsolescence).
The central problem facing dispersed shareholders in a publicly held corporation is one of collective action. Dispersed shareholders unable to act collectively allow opportunistic managers to expropriate large private benefits of control. Any single shareholder who expends additional resources in monitoring management or coordinating with other shareholders to change management will typically bear the costs alone, while the profits generated by such action are shared by all shareholders, including those who do not contribute.

The free-rider problem also inhibits the provision of intermediary services. Intermediaries may attempt to sell their services to only a subset of investors, but 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 broadly to the investing public. The public goods problem drives much securities research out of the public marketplace, causing many institutional investors separately to engage in costly research through internal buy-side analysts. As a result, investors may collectively produce duplicative and wasteful research.

In addition to the general problem of collective action, shareholders also face a rational apathy problem. To the extent a shareholder believes it unlikely that her activism will be pivotal, the shareholder will not have any incentive to expend resources participating in corporate governance, such as the shareholder voting process. Actions requiring shareholder voting,

24. See Bebchuk & Kahan, supra note 1, at 1080-81 (examining the collective action problem facing shareholder voting).

25. See, e.g., ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932); Jensen & Meckling, supra note 7, at 308-10. Managerial opportunism may become a particular problem where managers force firms to engage in a midstream shift, amending the corporate charter in the managers’ favor well after public (and now mostly passive) shareholders have purchased shares. See Jeffrey N. Gordon, The Mandatory Structure of Corporate Law, 89 COLUM. L. REV. 1549, 1573 (1989).


27. Public goods are defined by two key characteristics: lack of rivalry in consumption and nonexcludability of benefits. See ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 40 (2d ed. 1997).

28. See John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 VA. L. REV. 717, 726 (1984) (“As applied to the securities analyst, the public goods-like character of securities research implies that the analyst cannot obtain the full economic value of his discovery, and this in turn means that he will engage in less search or verification behavior than investors collectively desire.”).

29. See Henry G. Manne, Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle, 64 COLUM. L. REV. 1427, 1441-42 (1964); see also Stephen M. Bainbridge,
including the approval of mergers and the election of directors, therefore face a double problem of collective action—the need for individual shareholders to make expenditures that benefit the group, and rational shareholder apathy in the face of the ineffectiveness of a single vote. Collective action problems thus reduce the ability of shareholders to monitor corporations effectively.

The presence of institutional investors—including mutual funds and pension funds—may reduce the collective action and rational apathy problems facing shareholders, but it may also introduce a new set of problems. In theory, institutional investors provide a private mechanism for the intermediation of dispersed shareholder interests. Fidelity Investments, for example, takes in a large amount of funds from individual investors and, in return, 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; it provides information services by employing its own buy-side analysts to cover the securities traded in its actively managed funds; and it 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 traded firms in the United States, almost sixty percent of the capital stock is in the hands of institutional investors. An institutional investor with a sizeable stake in a particular issuer should have, in theory, a much greater incentive than dispersed individual shareholders to make expenditures that will increase the total value of the company. Not only are institutional


30. Theory does not always match practice. See STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 515 (2002) (noting that empirical studies of U.S. institutional investor activism have found "no strong evidence of a correlation between firm performance and percentage of shares owned by institutions" (quoting Bernard S. Black, Shareholder Activism and Corporate Governance in the United States, in 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459, 462 (Peter Newman ed., 1998))); see also Edward B. Rock, Controlling the Dark Side of Relational Investing, 15 CARDozo L. REV. 987 (1994) (discussing the possibility that shareholders with large block holdings in companies may themselves cooperate with management in pursuit of their own self-interest at the expense of all the shareholders as a group). For a response arguing that in certain situations, the possibility of bribes paid to large block shareholders may be beneficial to all shareholders, see Stephen J. Choi & Eric L. Talley, Playing Favorites with Shareholders, 75 S. CAL. L. REV. 271 (2002).


33. See, e.g., Elliott J. Weiss & John S. Beckerman, Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions, 104 YALE L.J. 2053, 2095 (1995) (arguing that the large stakes of institutional investors should give them sufficient
investors more likely to take individual actions that increase overall share value, but institutional investors also often enjoy repeat relationships with the corporations 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.\textsuperscript{34} Anecdotal evidence suggests that institutional investors are becoming increasingly active.\textsuperscript{35}

The rise of institutional investors, however, has not proved a panacea for the problems facing dispersed shareholders. In particular, institutional investors face their own type of agency problem.\textsuperscript{36} Fund managers direct the investment and management decisions of an institution, such as a mutual fund. The interests of the manager, however, may diverge from those of fund investors.\textsuperscript{37} For example, fund managers do not capture the full benefit of good performance. At the same time, managers may be held accountable for excessive management costs or losses. Moreover, fund managers are typically rated against one another on a frequent, short-term basis.\textsuperscript{38} The tournament aspect of assessing fund manager quality may lead incentives to monitor shareholder litigation). But see Fisch, supra note 26, at 1023-25 (demonstrating that large stakes alone may not give institutions sufficient incentives to engage in activism).


37. See John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 COLUM. L. REV. 1277, 1283 (1991) ("[T]he primary explanation for institutional passivity is not overregulation, but the insufficiency of existing incentives to motivate institutional money managers to monitor."); Edward B. 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.").

38. See Martin Lipton & 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
managers to herd in their investment behavior. Although doing better than the crowd may increase a manager's compensation marginally, doing worse than other money managers may result in the manager being fired.\(^3\)

Even absent an agency problem between money managers and their funds, institutional investors often face a conflict of interest in their relationships with issuers. Some institutional investors provide financial services directly to issuers. A financial services firm, for example, may manage the pension fund of an issuer and also provide the issuer with investment banking services. Institutional investors in such a position may shy away from directly challenging the managers of an issuer, when those managers also hire the institution to provide financial services.\(^4\)

More generally, such institutions may avoid a reputation for shareholder activism out of the concern that an activist reputation will hurt an institution's ability to obtain financial services contracts at other companies or to maintain good contacts with managers.\(^4\)

incentive to accept, even seek, a short-term premium for a portfolio stock.


Fund managers also 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. See, e.g., Fisch, *supra* note 26, at 1022-24 (demonstrating how competition may make active monitoring irrational for institutional investors).

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 fund investors. See Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 801-04 (1993) (describing the political pressure faced by public pension fund managers).

40. See Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 948 (1996) (noting that directors with business ties to the issuer “may have greater incentive to monitor management, in order to protect their own entities' investment in the company. 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”). The SEC recently promulgated new rules requiring investment advisors to disclose a variety of information related to their proxy voting:

The new rule requires an investment adviser that exercises voting authority over client proxies to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients, to disclose to clients information about those policies and procedures, and to disclose to clients how they may obtain information on how the adviser has voted their proxies. The rule amendments also require advisers to maintain certain records relating to proxy voting. Proxy Voting by Investment Advisers, Advisers Act Release No. 2106, 68 Fed. Reg. 6585, 6585 (Feb. 7, 2003) (to be codified at 17 C.F.R. pt. 275). The new SEC rules may make it more difficult for fund managers to ignore shareholder value in proxy voting.

41. Private institutional investors, for example, are notably reluctant to sponsor a proxy issue proposal contest. See Choi, *supra* note 34, at 240-41 (studying proxy contests of the early 1990s
These agency problems, conflicts, and business relationships have, for the most part, limited institutional willingness to engage in activism.\(^4\) Many institutions that are unhappy with the management of a particular company simply exit by selling their shares.\(^4\) Institutional investors therefore present only a partial solution to the collective action problem facing individual investors. Moreover, legal restrictions may limit the shareholdings of any single institution, thereby ensuring the persistence of some collective action problems among even institutional shareholders.\(^4\) As a result, although institutional activism makes collective action possible in ways not feasible for small individual investors, it cannot substitute for

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and finding that shareholder activists, unions, religious organizations, and public pensions sponsored the vast majority of shareholder proposals). The current regulatory climate may nonetheless reduce the ability of managers to favor particular institutional investors. For example, after the promulgation of Regulation FD, which restricted the ability of issuers to make selective disclosures of nonpublic material information to certain market participants, the ability of institutions to obtain superior inside information from managers was severely curtailed. See Selective Disclosure and Insider Trading, supra note 16.

Conflicts may also arise when institutional investors utilize their size and power to obtain preferential treatment. One example of such treatment is the disproportionate ability of institutions to participate in hot IPOs. In 2002, the NASD investigated J.P. Morgan Chase & Co., as well as the Robertson Stephens unit of FleetBoston Financial Corp., among others, for allocating disproportionately large portions of IPO shares to favored large investors. These investors typically paid oversized commissions in return. See Randall Smith & Susan Pulliam, Two More Wall Street Firms Are Targeted in Trading Probe, WALL ST. J., Apr. 25, 2002, at A1. The NASD’s investigation followed a settlement with Credit Suisse First Boston in January 2002 regarding similar IPO allocation abuses. See Susan Pulliam & Randall Smith, CSFB Fines Employees in IPO Case, WALL ST. J., Feb. 20, 2002, at C1.

42. See Lipton & Rosenblum, supra note 38, at 210 (describing how the short-term focus of institutional investors can interfere with “the long-term planning, investment and business development of the corporation”).

43. Jack Coffee has argued this point forcefully. See Coffee, supra note 37, at 1318-28. Despite the possibility of exit, institutions may choose not to exit for at least two reasons. First, because of the size of their holdings, some institutional investors cannot exit without substantial cost. See Robert F. Carlson, International Corporate Governance Network Managers and Shareholders: Bridging the Gap Using Corporate Governance To Increase Portfolio Returns, Address at the International Corporate Governance Network Roundtable on the Economic Value of Good Corporate Governance Practice (July 9, 1997), http://www.calpers-governance.org/viewpoint/speeches/carlson1.asp (explaining that, because of CalPERS’s size, it “cannot simply sell the stocks of companies that are poorly performing, without negatively impacting the market as a whole”). Second, some institutions structure their holdings so as to maintain a broad-based portfolio (such as an index fund) and therefore lack the ability to exit. See id. (explaining that exit would be contrary to CalPERS’s indexing strategy and that CalPERS must therefore seek to improve its returns through corporate governance initiatives). Instead, for these institutions, improving present investments through shareholder activism provides the most cost-effective way to increase their return. See Lucchetti, supra note 35 (reporting Fidelity Investments’ 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”).

44. See Mark J. Roe, A Political Theory of American Corporate Finance, 91 COLUM. L. REV. 10, 16-31 (1991) (listing several legal impediments facing shareholders attempting to build large blocks of shares). Among other restrictions, Roe points to disclosure rules under the securities laws for block shareholders, prohibitions on short-swing profits, and state law fiduciary duties imposed on controlling shareholders as impediments to those attempting to build a substantial ownership interest in a company. See id.
effective participation by all shareholders. Intermediaries working in the collective interest of shareholders play a crucial role in reducing the cost of activism and minimizing free-rider problems.\textsuperscript{45}

III. SECURITIES MARKET INTERMEDIARIES

This Part provides a taxonomy of securities market intermediaries. Our focus is on intermediaries that serve as collectivizing agents for shareholders. We identify how auditors, analysts, proxy insurgents, and other market participants function as intermediaries in particular contexts, providing information and monitoring services to shareholders. In addition, we consider existing sources of intermediary financing and demonstrate the limited role of market constraints on intermediary behavior.

A. Securities Analysts

Securities analysts collect information about issuers, the securities they sell, and the industries in which they operate, along with general market factors, evaluating and synthesizing the information they obtain. Analysts then disseminate their research to the marketplace in the form of reports and recommendations. Information intermediation enables investors to discipline issuers indirectly through the market, adjusting the price at which they are willing to trade securities based on the information provided.

Analysts can generally be divided into sell-side analysts (those providing information directly to the investing public) and buy-side analysts (those providing information to their employer, usually a mutual fund or other type of institutional investor).\textsuperscript{46} Typically, sell-side 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{47} Sell-side

\textsuperscript{45} Intermediaries can also shield the reputation of specific institutional investors. An institution, for example, can point to ISS's recommendation as the reason for its vote in a proxy contest. See Sidel et al., supra note 35.

\textsuperscript{46} For a detailed description of analysts and their role in the securities markets, see Fisch & Sale, supra note 17, at 1040-43.

\textsuperscript{47} Merrill Lynch presently employs a three-part rating system, assigning issuers to either buy, neutral, or sell categories. See Munk, supra note 12. Recent revisions to NASD and NYSE rules require firms to disclose various information about their rating systems, including definitions of the ratings, the percentage of rated securities in each category, and information detailing the relationship between trading prices and published ratings. See Self-Regulatory Organizations, Exchange Act Release No. 45,908, 77 S.E.C. Docket (CCH) 1737 (May 10, 2002) [hereinafter Analyst Release] (describing and approving rule changes).
analyst recommendations are highly influential in investor decisions, and changes in analyst ratings have a substantial effect on stock price.\textsuperscript{48}

Some sell-side analysts are funded through marketplace transactions, selling their information to investors. Value Line, for example, has provided independent investment analysis for decades through its Value Line Investment Survey publication.\textsuperscript{49} Over the past several years, Internet-based independent investor advice has appeared. At www.fool.com, for example, investors can obtain both general investment advice and more specific analysis of individual companies.\textsuperscript{50}

Although analysts who are not affiliated with investment banks are sometimes categorized as independent analysts, there are reasons to question the true extent of this independence.\textsuperscript{51} Sanford Bernstein, Inc., for example, which is frequently touted as an exemplar of the independent analyst, is a unit of mutual fund operator Alliance Capital Management Holding L.P. This association might tempt Sanford Bernstein to tout the value of companies within Alliance Capital’s portfolio.\textsuperscript{52} As a recent \textit{Wall Street Journal} article observed,

\begin{quote}
[F]or all the talk of Bernstein’s independence, data researcher 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
\end{quote}

\begin{footnotesize}
\begin{itemize}
\item[49.] Information on Value Line, with a current staff of approximately seventy analysts, can be found at its website. See ValueLine.com, at http://www.valueline.com (last visited May 7, 2003). As of May 7, 2003, a one-year online subscription to the Value Line Investment Survey cost $598. See id.
\item[51.] See Larry Dignan, \textit{Is Independence All That?}, WALL ST. WK. WITH FORTUNE, Nov. 21, 2002, at http://www.pbs.org/wnet/news/featurestory_20021121.html (demonstrating that various supposedly independent analysts may be compromised by conflicting business relationships).
\end{itemize}
\end{footnotesize}
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 relationships on the full-service firms.53

In addition, studies suggest that, although independent analysts may be less optimistic than affiliated analysts, independent research does not necessarily produce better returns. Independent analysts often cover only a few firms.54 Although several independent firms have recently outperformed the Wall Street regulars, many high-profile independent firms have produced less impressive results.55 Additionally, a recent Starmine study showed that affiliated analysts produced more accurate earnings estimates than unaffiliated analysts.56 One possible explanation for this result is that affiliated analysts have better information because of their closer relationships with covered companies and synergies resulting from their proximity to investment banking business.57 An alternative explanation is that the subsidization of analyst research through investment banking revenues improves the quality of the analyst's product by providing more financing, although the conflicts of interest may bias the reported recommendations. A third possibility is that affiliated analysts were lowballing their earnings estimates in response to management pressure.58 Whether or not independent research is more accurate, the amount of research provided through independent sell-side analyst channels is both limited and costly.

A fundamental problem facing sell-side analysts (as compared to buy-side analysts) is their inability to capture all of the benefits from research...

55. See id. (comparing the performance of independent research firms with that of investment banks).
56. See Dignan, supra note 51 (questioning whether independent analysts outperform affiliated analysts and citing a Starmine study showing that affiliated analysts "have more accurate earnings estimates than independent researchers"); cf. Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street?: Hearing Before the Subcomm. on Capital Mkts., Ins. and Gov't-Sponsored Enters. of the House Comm. on Fin. Servs., 107th Cong. 166-71 (2001) (statement of James K. Glassman, Resident Fellow, American Enterprise Institute) (citing several empirical studies showing that consensus recommendations of analysts are profitable).
57. See Rebecca Byrne, No-Name Firms Outshine Wall Street's Big Guns, THESTREET.COM, May 8, 2002, at http://www.thestreet.com/markets/rebeccabyrne/10021311.html. The close relationships among analysts, covered companies, and the investment banking business may also lead analysts to sacrifice their objectivity. The recent Wall Street settlement involving the SEC and Eliot Spitzer, the New York State Attorney General, responds in part to the perceived corruption on the part of analysts. See infra Section V.D.
58. Byrne, supra note 57.
through marketplace transactions because of the public good quality of information.\(^\text{59}\) Once an analyst’s research has been released to some investors, other nonpaying 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.\(^\text{60}\) Subsequently, the analyst can no longer sell the information. The rational response for the analyst is to charge a very high initial price in an effort to recoup the cost of the research before its effects are dissipated. In addition, the public good problem causes many analysts to focus primarily on large-capitalization stocks where greater numbers of potential purchasers of information exist even in the face of free-riding problems. The inability of analysts to recoup their research costs thus reduces their incentive to cover mid- and small-capitalization stocks.\(^\text{61}\) Independent analysts may also make their research available exclusively to large institutional investors who are willing to pay substantial fees and who will not disseminate that information to the general public.\(^\text{62}\)

The public good problem limits the quantity of independent research provided to the market. Instead, much of the sell-side analyst research in the market is supplied by large financial firms where analyst research is funded because of its effect on other business operations. Prior to the SEC’s deregulation of fixed commissions in 1975, brokerage firms used analyst research to compete for trading revenues.\(^\text{63}\) The cost of the analyst research was subsidized through the surplus revenues generated by relatively high

\(^{59}\) See Coffee, supra note 28, at 725-27 (discussing the public good nature of securities research).

\(^{60}\) See BENJAMIN MARK COLE, THE PIED PIPERS OF WALL STREET 62 (2001) (explaining that serious analyst research is costly and citing a study showing that institutional investors are generally unwilling to pay for such research). Note also that 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. See, e.g., Lynn A. Stout, Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law, 99 YALE L.J. 1235, 1253 n.92 (1990) (citing empirical studies detailing the magnitude of price reactions in response to large block trades).

\(^{61}\) See Jeremy Kahn, Splitting Up the Street, FORTUNE, Oct. 28, 2002, at 30, 31 (paraphrasing the belief of David Trone, Prudential’s brokerage stock analyst, that if firms separate research from banking, then analysts will drop coverage of small companies).

\(^{62}\) See, e.g., Matt Krantz, Research for Individuals Can Cost a Bundle, USA TODAY, Nov. 27, 2002, at 3B (explaining that most independent research firms do not sell to individual investors, and that those who do charge thousands or even hundreds of thousands of dollars per year). Similarly, Callard Asset Management, an independent firm that has placed highly in recent studies of analyst performance, makes its research available to individual investors for $5000 per year, but warns investors that the information is too complex and encourages them to invest in Callard’s investment fund instead. See id.; see also Phyllis Plitch, GovernanceMetrics Debuts New Corporate Governance Ratings, DOW JONES BUS. NEWS, Dec. 3, 2002, Westlaw Library, Dow Jones Wires Plus File (describing a new corporate governance rating agency’s plans to charge subscribers $18,000 per year).

\(^{63}\) Firms could not compete directly for trading revenues by offering discounted commission rates due to a fixed commission structure. See Fisch & Sale, supra note 17, at 1046.
fixed commissions. A financial firm’s ability to provide high-quality recommendations generated client relationships that, in turn, led to commission revenue when those investor-clients traded (and thereby generated greater brokerage profits). Although subsidization through commission revenues produced some symmetry between the interests of the investors and those of the brokerage firm, since accurate research was more likely to generate repeat trading business, the subsidization nonetheless tended to compromise analyst accuracy by causing analysts to focus on generating transactions. This led to overly optimistic evaluations as well as an increased emphasis on growth and momentum stocks.

After the elimination of fixed commissions, a shift occurred in the source of analyst compensation. Competition reduced the profitability of executing customer trades, providing brokerage firms with less incentive to focus on trading volume. The substantially reduced commissions that resulted were no longer able to provide a significant revenue source for subsidizing analyst research. Financial firms turned to investment banking revenues instead. Ultimately, the source of analyst financing shifted to issuers, who funded analyst research indirectly through payment for investment banking services. Particularly during the late 1990s, analyst compensation rose steadily in tandem with higher investment banking revenues. Analyst contracts often contained clauses explicitly tying

64. See id. (describing the use of fixed commissions to subsidize analyst research).
66. See Fisch & Sale, supra note 17, at 1045-46 (demonstrating the effect of subsidization through commissions on analyst incentives).
69. Mary Meeker of Morgan Stanley, for example, earned $15 million in 1999, with her compensation “directly linked to her ability to secure investment-banking fees for the firm.” Nick Wingfield & Colleen DeBaise, Morgan Stanley Tech Star Sued on Bullish Calls, WALL ST. J., Aug. 2, 2001, at Cl. In 1999, Morgan Stanley pulled in approximately $100 million in fees from helping to underwrite IPOs of Internet companies. Charles Gasparino & Randall Smith, Wall Street Scores in ‘99, WALL ST. J., Dec. 9, 1999, at Cl; see also Patrick McGeehan & Anita Raghavan, Wall Street Investment Bankers, Traders May See Year-End Bonuses Leap by 30%, WALL ST. J., Dec. 3, 1997, at Cl (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 doubled”).
compensation to the analyst's contribution to the firm's investment banking business.\(^7\) Significantly, without the subsidy from investment banking, it is unclear to what extent financial firms would continue to support analyst research.\(^7\)

Subsidization of sell-side analysts is not, per se, problematic. In theory, by subsidizing research through investment banking fees, the issuer acts as a collectivizing agent for its investors. As the issuer expends resources on the development and dissemination of information, its investors benefit while avoiding the free-riding problem (to the extent the use of issuer resources necessarily results in each investor bearing the expenditure indirectly and on a pro rata basis). In addition, for certain types of information—including inside information—the issuer not only represents an ideal collectivizing agent but also the lowest-cost source of information.\(^7\)

The problem with relying on issuers to subsidize analyst production of information is that control over such subsidies is vested in management. Management selects an issuer's investment banker, thereby directing the research subsidy. Managers, however, may have objectives other than maximizing the ability of investors to evaluate the company fairly. The separation of ownership and control, and the resulting divergence between the interests of shareholders and managers, creates the potential for managers to use their control over analyst subsidies to increase their private gains. Managers typically benefit, for example, from high levels of analyst optimism, which allow the managers to maximize their compensation and

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\(^7\) Charles Gasparino, Analysts' Contracts Link Pay to Deal Work, WALL ST. J., May 6, 2002, at C1 (reviewing analyst compensation contracts from Credit Suisse First Boston 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 that a firm provides investment banking services for an issuer, it will gain knowledge and expertise related to valuing the issuer's securities. Second, the linkage between analysts and investment banks allows issuers to indirectly subsidize the research of analysts through higher fees for investment banks. Indeed, evidence exists that investment banks use the possibility of analyst coverage of a company to attract investment banking business. See, e.g., infra text accompanying notes 76-77 (describing Piper Jaffray's tactics toward Antigenics).

\(^7\) See infra notes 190-192 and accompanying text (discussing evidence that efforts at severing the connection between investment banking revenues and analysts have resulted in a decrease in analyst coverage of companies).

\(^7\) Prior to the prohibition of selective disclosures pursuant to Regulation FD, managers could use such disclosures in part to subsidize analysts. See Choi, supra note 16, at 545; Goshen & Parchomovsky, supra note 16, at 1268-69.
reputation.\textsuperscript{73} As a result, managers may discriminate among analysts, selectively providing support only to those analysts who favor management.

At worst, analysts may then become corrupt and eschew unfavorable reports of companies that provide large payments to them or their firms.\textsuperscript{74} Analyst recommendations become more a tool for selling securities than an objective evaluation. In turn, the financial firms may value the analyst's work based on the analyst's success at generating investment banking business, rather than the accuracy of its analysis.\textsuperscript{75} Corporate managers may direct investment banking business only to financial firms where the analysts recommend the issuer's securities highly, perhaps more highly than warranted. Evidence exists suggesting that financial services firms routinely use analyst coverage as a carrot (or stick) to induce issuers 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.\textsuperscript{76} Piper Jaffray also ceased providing market maker services for Antigenics stock.\textsuperscript{77}

\textsuperscript{73} In proposing the prohibition against selective disclosures under Regulation FD, the SEC voiced just such a concern. The SEC contended that issuers may use selective disclosures to bribe analysts to provide better-than-warranted recommendations for the issuer's stock. \textit{See Selective Disclosure and Insider Trading, Exchange Act Release No. 42,259, 64 Fed. Reg. 72,590, 72,592 (Dec. 28, 1999).} For an argument that less restrictive means are possible to allow selective disclosures while curtailing managerial opportunism, see Choi, \textit{supra} note 16, at 569-74.

\textsuperscript{74} The \textit{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.” Charles Gasparino et al., \textit{Wild Card: Citigroup Now Has New Worry: What Grubman Will Say}, WALL ST. J., Oct. 10, 2002, at A1. In the same article, the \textit{Journal} 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.

Claims of analyst corruption are not unique to Salomon Smith Barney. \textit{See, e.g.}, Susanne Craig, \textit{Massachusetts Claims CSFB Stock Reports Led Investors Astray}, WALL ST. J., Oct. 22, 2002, at C1 (reporting allegations made by Massachusetts state securities regulators that CSFB’s investment banking department exerted “undue influence on the firm’s research department”).

\textsuperscript{75} Certainly, higher banking revenues contribute to higher analyst compensation. \textit{See, e.g.}, Charles Gasparino, \textit{Spitzer Staff Gathers Salomon E-Mails Criticizing Grubman}, WALL ST. J., July 16, 2002, at C1 (quoting analyst Jack Grubman as saying “[m]y 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. \textit{See id.}\ Evidence shows, however, that such assertions are false. \textit{See, e.g., supra} note 70 (discussing evidence of explicit contractual ties between analyst compensation and investment banking revenue).


\textsuperscript{77} \textit{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.

Partially in response to the conflicts facing analysts, several new intermediary-driven information services have also recently appeared in the market. Standard & Poor's (S&P), for example, recently launched a new corporate governance rating service. \textit{See Louis Lavelle & Amy Borrus, \ldots And a New Early-Warning System for Investors}, BUS. WK., Oct. 28, 2002, at 101.
Company-subsidized financing for analysts may also crowd out independent analysts in the market to the extent that investors are unable to distinguish those analysts who operate independently of management from analysts who 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 through their investment banking divisions) at little or no cost.

Should we care about analyst financing? Some argue that analysts and others who engage in securities research may already have incentives to generate too much information from a societal 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). Parties engaged in research ignore, however, the systematically lower returns to uninformed traders taking opposite trading positions as well as ancillary impacts from informed trades (including an increase in the accuracy of the stock price of the issuer). Failing to internalize the costs to uninformed traders from informed securities trades, private parties therefore may engage in superoptimal levels of research from a societal perspective. Competition among traders to become the first with an information advantage may further widen the
gap between the incentives of private parties and societal welfare, leading to excessive levels of research.\textsuperscript{82}

Nonetheless, broadly distributed securities research—coupled with mandatory disclosure—plays a valuable role in disseminating information to the marketplace, reducing the incentive of dispersed investors to engage in wasteful, duplicative research.\textsuperscript{83} Once a sell-side analyst provides information to the entire market on a particular research topic, the value to active traders of engaging in the same research is necessarily diminished, if not eliminated, leading to lower levels of buy-side research.\textsuperscript{84} One could argue that the prevalence of buy-side analysts in the current system demonstrates the absence of market confidence in the quality of sell-side analysis and reflects precisely such waste.\textsuperscript{85} Enabling sell-side analysts to distribute information effectively may result, therefore, in a lower aggregate level of expenditures on research (as the widespread presence of sell-side information reduces the value of engaging in dispersed buy-side research).\textsuperscript{86}

The Ayres and Choi approach combats the overincentive of investors to engage in securities research by granting issuers the right to control informed trading in the issuer’s own stock. Alternative sources of funding for sell-side analysts, including our voucher financing proposal, provide another route to reduce overinvestment in research on the part of active traders through the provision of information to the market as a whole.\textsuperscript{87}

B. \textit{Auditors}

Analysts are not the only information intermediaries. Federal law requires public corporations to have their financial statements reviewed and

\textsuperscript{82} See \textit{id.} at 343-45 (discussing the incentive of private, dispersed investors engaged in competition with other investors to engage in excessive research from the standpoint of social welfare).

\textsuperscript{83} See \textit{Coffee, supra} note 28, at 733-34 (discussing how mandatory disclosure reduces the incentive of analysts to engage in duplicative research efforts).

\textsuperscript{84} Of course, dispersed buy-side analysts may engage in secondary and complementary research building upon sell-side research. Nonetheless, to the extent the sell-side research targets the higher-return research first, this secondary and complementary research will produce lower expected returns. In the aggregate, therefore, dispersed buy-side analysts will engage in less overall research expenditures.

\textsuperscript{85} See \textit{Fisch & Sale, supra} note 17, at 1041 n.18 (stating that approximately sixty percent of existing analysts are buy-side analysts).

\textsuperscript{86} For a further discussion of this point, see Stephen J. Choi, The Need To Subsidize Even Wasteful Analyst Research (Mar. 6, 2003) (unpublished manuscript, on file with authors). Voluntary subsidies to analysts from issuers (at the discretion of managers), of course, may fill the vacuum. In this case, the rationale for more independent financing of analysts becomes the displacement of more biased manager-funded analysts with more independent analyst research.

\textsuperscript{87} In addition to the free-riding problem, analysts may fail to distribute information broadly to the market for a separate reason: Private, independent research analysts will have a strong incentive to restrict the distribution of research. Too wide a distribution necessarily reduces the trading value of the information (and in the limit, where the entire market has the information, the value will approach zero). For a discussion of this point, see \textit{id.} (manuscript at 7-8 & n.20).

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certified by an independent accounting firm.\textsuperscript{88} The auditor issues a financial report certifying that the financial statements have been prepared in accordance with Generally Accepted Accounting Principles (GAAP).\textsuperscript{89} Auditing is big business; in 2001, accounting firms earned approximately $10.6 billion in audit fees.\textsuperscript{90}

Auditors typically receive compensation directly from the audit client through what is ostensibly a marketplace transaction. Johnson & Johnson paid $9 million to PricewaterhouseCoopers for auditing services in 2001, for example.\textsuperscript{91} Traditionally, however, the issuer’s managers have exercised substantial control over the selection of auditors. This creates the potential for conflicts of interest, in that managers can choose auditors with a promanagement bias.\textsuperscript{92} Although shareholders are often given the nominal power to ratify management’s selection of auditors, the voting mechanism typically does not give shareholders the power to veto management’s choice or to select an alternative auditor.\textsuperscript{93}

At the same time, auditors have offered an increasing number of nonauditing services to their audit clients. In many cases the fees for these services substantially exceed the fees for auditing work.\textsuperscript{94} In 2001, for example, Johnson & Johnson also paid $57.8 million to PricewaterhouseCoopers for nonaudit services, including several million dollars for design work related to Johnson & Johnson’s financial statements.\textsuperscript{88,91,90}

88. Many SEC filing documents, including public offering registration statements and periodic information filings, require audited financial statements. For an overview of the role of auditors under federal securities regulation, see THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 9.6 (4th ed. 2002).

89. See id.


93. See Klaus Eppler & R. Bruce Steinert, Jr., Drafting the Proxy Statement, in PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 2002, at 737, 767 (PLI Corp. Law & Practice Course, Handbook Series No. B0-018D, 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.”). Some companies have moved to dispense with shareholder approval entirely. See id.

94. A 2002 survey of Chicago firms found that issuers, on 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 C1.
Securities Intermediaries

Prior to Enron's collapse, Arthur Andersen 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 before auditing firms may compromise the quality of audits. In particular, managers may use a reduction in their purchase of nonaudit consulting services as a disciplining device, punishing auditors that do not take a promanagement point of view. Competition among auditors to obtain business from managers, in turn, may lead auditors to accept a reduced auditing fee in the hope of obtaining other service business from managers. Moreover, even those auditors that do not provide consulting services experience some influence from the client's managers. To the extent that an auditing-only firm faces 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 promanagement viewpoint.

In addition, an auditor that provides consulting services gains a stake in the transactions that it has structured, and thus may lack the independence to subject those transactions to rigorous auditing scrutiny. Importantly, investors are poorly placed to discipline auditors for substandard work. Although investors may penalize the issuer's stock price by selling, this reaction may only occur long after the fact, when the deficiencies of the auditor's work eventually come to light. Auditors, of course, may care about their long-term reputations with investors. Individual (and

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95. See Bryan-Low, supra note 91.
96. See Deborah Solomon, After Enron, a Push To Limit Accountants to . . . Accounting, WALL ST. J., Jan 25, 2002, at C1 ("In 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.").
97. Jeff Gordon voices a similar idea in a recent article on Enron. See Gordon, supra note 8, at 1237-38 (discussing the possibility that issuers may employ auditors for nonaudit related consulting services in order to give issuers a low-visibility way of sanctioning auditors—e.g., by terminating such consulting services—that go against the wishes of management).
98. An individual audit partner, for example, may choose to sacrifice the audit fee (and indeed compromise the quality of the audit and, more generally, the reputation of the entire audit firm) in order to increase the individual partner's own overall profits. See also Gordon, supra note 8, at 1238 ("Accountants cannot afford to compete on their relative independence. The willingness to expose oneself to low-visibility sanctions—the sacrifice of inherent independence—offers such a competitive advantage in attracting audit clients that there will be a race to the bottom.").
99. The influence of managers is limited to the extent the issuer must make a report to the SEC in the event an auditor resigns, is dismissed, or declines to stand for reelection. Such disclosure is required under Item 4 of Form 8-K. See supra note 92.
100. In part, the difficulties accountants face may stem from a confirmation bias. Under the confirmation bias, people tend to confirm the correctness of their prior decisions regardless of whether the decisions were in fact correct. See, e.g., Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC, 56 STAN. L. REV. (forthcoming Oct. 2003) (manuscript at 8 n.31, on file with authors) (describing the confirmation bias).
decentralized) decisionmakers within an auditor, nevertheless, may not take into account the full value of reputation, sacrificing it in return for a more direct personal profit (through higher revenues from clients seeking to engage in aggressive accounting, for example).\(^{101}\)

C. *Proxy Advisory Services*

Intermediaries also provide information directly related 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 advisor is Institutional Shareholder Services (ISS).\(^{102}\) ISS provides information and analysis to help institutional investors understand the financial implications of proxy proposals and to cast informed votes.\(^{103}\) Run as a fee-based service with 750 clients worldwide, ISS prepares detailed reports analyzing the proxy issues for approximately 22,000 shareholder meetings per year.\(^{104}\) 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, an institution can delegate the physical part of voting—receipt of ballots, share reconciliation, casting votes, and recordkeeping—to ISS, which casts the vote according to ISS’s voting guidelines or the institution’s customized instructions.\(^{105}\) For these services, ISS charges its institutional investor clients annual fees that range from a few thousand to hundreds of thousands of dollars.\(^{106}\)

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 Council of Institutional Investors

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101. See, e.g., Gordon, *supra* note 8, at 1239 ("[T]he 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.")


103. See Sidel et al., *supra* note 35 (stating that ISS’s recommendation in favor of the Hewlett-Packard and Compaq merger “helped bolster H-P’s position in one of the most contentious proxy battles in recent years”).


106. See Paul Taylor, *HP-Compaq Vote To Test Adviser’s Influence*, *FIN. TIMES*, Mar. 8, 2002, 2002 WL 13657104 (quoting Jamie Heard, ISS chief executive, as stating that ISS annual subscriptions range from “a few thousand dollars to well into six figures”).

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Securities Intermediaries, for example, seeks 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." CII actively monitors submissions and results of shareholder initiatives, including on its website information on the text of submitted shareholder proposals and the resulting shareholder votes. Significantly, in cases in which a company has failed to respond to a majority shareholder vote in favor of a proposal, CII sends the issuer a letter inquiring as to the company’s intentions. The issuers’ responses are posted on CII’s website. Although some of CII’s information is publicly available, CII is member-financed, and its full range of services is available to members only.

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. Other investors may simply choose to free-ride on the efforts of investors who do pay for the advice of proxy advisory services. Since ISS makes its positions publicly known, and since institutional investors can communicate with each other anyway, an institution need not subscribe in order to obtain ISS’s voting recommendations. Moreover, few individual investors pay for advice on how to vote on various proxy issue proposals and control contests.

109. See id.
110. For information on obtaining membership to CII, see Council of Institutional Investors, Council Memberships, http://www.cii.org/membership.asp (last visited Apr. 30, 2003). 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 $3000 and no more than $30,000. See id. The CII also has Educational Sustainers, which include issuers, mutual funds, and even law firms with annual dues ranging from $7000 to $10,000. See id.

A few other organizations provide services similar to those of ISS on a smaller scale. Two of the better known are the Investor Responsibility Research Center (IRRC) and Davis Global Advisors. IRRC provides proxy research, agency voting services, proxy monitoring, and proxy guidelines through consulting services and customized software. See Investor Responsibility Research Center, at http://www.irrc.com (last visited Apr. 30, 2003). 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. See Davis Global Advisors, at http://www.davisglobal.com (last visited Apr. 30, 2003).
111. See sources cited supra note 29 (describing the rational apathy problem).
112. Institutional Shareholder Services, for example, gears specific services to corporations and to institutional investors. No such services are tailored for individual investors. See Solutions for Institutional Investors, at http://www.issproxy.com/institutional/index.asp (last visited May 1, 2003).
Given our earlier analysis of institutional activism, one might wonder why any institutional investors are willing to pay even for current levels of funding of proxy advisory services. The answer may come, in part, from the ERISA requirements that pension funds consider their beneficiaries’ best interests when voting stockholdings. 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.

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 extensive competition. Within the last several years, ISS has absorbed two of its main competitors—Fairvest Corporation, which was the leading provider to institutional investors of Canadian corporate governance research and related services, and Proxy Monitor, the second-leading proxy services firm, which merged with ISS in July 2001. The inability of the market to support competitive production of proxy advisory services suggests potential public good and free-riding obstacles, despite the existence of marketplace transactions.

Limited competition leads to two problems. First, the high cost of proxy advisory services makes them largely unavailable to individual investors. Second, the virtual monopoly endows services like ISS with a tremendous

113. See supra Part II (discussing the incentives of institutional investors to engage in shareholder activism).

114. See 29 C.F.R. § 2509.94-2(1) (2003); see also Letter from Alan D. Lebowitz, Deputy Assistant Secretary, Department of Labor, to Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc. (Feb. 23, 1988), in 15 Pens. & Ben. Rep. (BNA) 391, 392 (Feb. 29, 1988) (asserting that “with respect to proxy voting . . . [an] investment manager or other responsible fiduciary [must] keep accurate records as to the voting of proxies”).

115. The new SEC rules imposing disclosure requirements on investment advisor proxy votes may also put pressure on investment advisors to turn to ISS (or a similar intermediary) to provide justification for their votes. See supra note 40 (discussing the new SEC investment advisor proxy voting rules).

116. See, e.g., Ed Leefeldt, The Power Behind Proxy Fights, BLOOMBERG MARKETS, May 2002, at 63, 65 (quoting money manager Tim Griskey as stating that “[a]nybody worried about having to justify their vote will blindly follow ISS”).


118. See Robin Sidel, After This Deal, Is Anyone Left To Give Advice?, WALL ST. J., July 26, 2001, at Cl.

119. Recent 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., Gillette Co., SEC No-Action Letter (Feb. 1, 2001), 2001 SEC No-Act. LEXIS 175, at *2-3 (rejecting arguments that a shareholder proposal requesting the board to hire an independent proxy advisory firm can be excluded from the issuer’s proxy statement).
amount of power. Recently, for example, the NYSE and NASDAQ adopted rules requiring shareholder approval of all executive stock option plans and, in addition, eliminating the authority of brokers to vote on such plans without explicit shareholder instructions. As a result, approval of stock option plans for many large publicly traded companies 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 companies.

Although the services provided by proxy advisory intermediaries are not extensive, they appear to be reliable. Nonetheless, one potential risk is that these intermediaries may be subject to conflicts of interest. In the vote on the 2002 merger between Compaq and Hewlett-Packard, for example, one commentator, a securities analyst, raised allegations of such conflicts with respect to ISS. SEC filings revealed that a substantial percentage of ISS was owned by venture capital firm Warburg Pincus, that Warburg was a general partner of ISS, and that three Warburg partners sat on the eight-member ISS board of directors. Significantly, Warburg Pincus had been involved in a number of business deals with Hewlett-Packard. Another substantial owner of ISS was Hermes, an asset management firm that manages four of the seven largest pension plans in the United Kingdom. The analyst alleged that ISS’s position with respect to

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122. Interestingly, ISS recommended that shareholders vote against a proposal requesting a board of directors to hire an independent shareholder advisory firm. See E-mail from Mark Latham, Coordinator, The Corporate Monitoring Project, to Shirley Westcott, ISS (Mar. 22, 2000), http://www.corpmon.com/ResponseToISS.htm (quoting from the ISS recommendation).

123. See Johnson, supra note 120 (describing ISS as “the only independent U.S. firm providing investors with advice on merger and shareholder contests”).

124. See Leefeldt, supra note 116, at 64. Indeed, ISS, which is a private company, does not disclose either the revenues it receives or the fees it charges. Id.


126. See Uniform Application for Investment Adviser Registration (Form ADV) for Institutional Shareholder Services, Inc. (Mar. 27, 2002), at http://www.adviserinfo.sec.gov/IAPD/Content/ViewForm/ADV022001/Sections/iapd_AdvScheduleBSection.asp (providing a search form with which a visitor can find ISS’s Form ADV).

127. See Rosencrance, supra note 125.
the merger might have been influenced by Hermes's customer relationships and the prospect of future asset management fees for Hermes.\textsuperscript{128}

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 nonactivist institutions that prefer to delegate their proxy decisionmaking to a third party. A stance that is too critical on the part of ISS may lead such institutions—many of whom depend on corporate managers for ongoing pension fund management and investment banking business—to eschew ISS’s services. 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{129} The sale of these services would be threatened if ISS appeared too critical of corporate management.\textsuperscript{130} Indeed, ISS has recently come under attack for selling issuers access to its corporate governance rating system.\textsuperscript{131} For a fee of approximately $15,000, a corporation may gain access to ISS’s online service, which the corporation may then use to improve its score dramatically—often by making a series of modest governance changes.\textsuperscript{132} Obviously, the process of selling issuers the access necessary to improve their governance ratings raises questions about the value of those ratings.

D. Shareholder Activism

Individual shareholders may also act as collectivizing intermediaries.\textsuperscript{133} Shareholders may increase investor welfare simply by providing information. For example, several large institutional investors, including

\begin{itemize}
\item \textsuperscript{128} See Press Release, Parish & Co., Proposed HP Merger: Institutional Shareholder Services (ISS) Found Not Independent and Along with Barclays Plays Key Role in Microsoft Pyramid Scheme (Mar. 18, 2003) (on file with authors).
\item \textsuperscript{129} For more information on ISS’s services for corporations, see Institutional S’holder Servs., Solutions for Corporate Issuers, \textit{at} http://www.issproxy.com/corporate/index.asp (last visited Sept. 24, 2003).
\item \textsuperscript{130} See Leefeldt, \textit{supra} note 116, at 64 (explaining that ISS charges corporations a fee for advising them as to how to meet its guidelines on corporate governance). As Leefeldt describes it, corporations may feel pressure to do business with ISS in order to obtain a favorable voting recommendation. Similarly, although ISS maintains a separation between its consulting and research services, its independence with respect to such recommendations may be affected by its corporate consulting services. \textit{See id.}
\item \textsuperscript{131} See Monica Langley, \textit{Making the Grade: Want To Lift Your Firm's Rating on Governance? Buy the Test}, WALL ST. J., June 6, 2003, at A1 (describing ISS’s sales of access to its rating system and resulting criticisms).
\item \textsuperscript{132} See id. (explaining the procedure by which an issuer may buy access and the ability of an issuer subsequently to affect its ratings).
\item \textsuperscript{133} Shareholders may also provide monitoring services by initiating or supervising shareholder litigation.
\end{itemize}
CalPERS and TIAA-CREF, have begun publicly announcing their proxy voting decisions along with the reasons for those decisions. 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 services. An individual shareholder who chooses to launch a proxy contest to change the board of directors or who proposes a corporate governance initiative designed to increase shareholder welfare acts in the collective best interest of all investors in the company. Even a large institutional investor that uses its ownership position to pressure management informally benefits all investors. Indeed, some empirical studies identify a correlation between institutional activism and higher overall returns, suggesting that institutional activism provides value to shareholders.

In theory, intermediaries could attempt to sell activist services to investors in the market. Indeed, certain intermediaries already act as strategic advisors and proxy solicitors for investor activists. Firms such as Allen Nelson & Co. assist dissident shareholders in mounting proxy contests and describe themselves as “devising innovative tactics to enhance corporate governance” through their battles for corporate control.

The free-riding problem, however, is even larger for shareholder activism than for the provision of information research. With respect to sales of information, initial purchasers retain an advantage over other investors. As a result, investors are willing to pay for information based on their ability to profit before the information is broadly disseminated into the market. In the case of activism, on the other hand, investors who refuse to pay are just as well off as investors who pay for such actions. Investors who do not pay for the services of a proxy contest insurgent benefit from the change in management to the same extent as investors who do pay for such services (in proportion to their shareholdings). To the extent investors are

134. For examples of public announcements of voting intentions in the Hewlett-Packard and Compaq merger vote, see Tam, supra note 35. See also 17 C.F.R. § 240.14a-1(f)(2)(iv) (2003) (excluding public announcements by shareholders on how they intend to vote, including public speeches and press releases, from the definition of a proxy solicitation).


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.

As a result, 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 offer, for example, is rewarded in part by the extent to which its efforts raise the value of all shares in the company including the bidder’s own prebid block of shares. Large institutional investors that put pressure on management to raise share value also benefit as their shareholdings increase in value. Despite the possibility of benefiting through share ownership, an activist shareholder that owns only a fraction of the outstanding shares will be undercompensated for activism that promotes the best interests of all shareholders.

At the same time, shareholder activists bear the full costs of their efforts—costs that often are substantial. A 2001 Bloomberg Markets article reported that shareholder-sponsored proxy contests cost an average of $6.2 million each.\(^{137}\) 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 that is successful in changing control of the board.\(^{138}\) Reimbursement may also require shareholder approval in some cases.\(^{139}\) Financing constraints, as Bebchuk and Kahan have noted, may lead to a suboptimally low level of shareholder activism.\(^{140}\) Indeed, proxy contests are rare. According to one report, activists have launched an average of twenty-five proxy contests a year since 1996, and most such contests have involved relatively small companies.\(^{141}\)

Alternatively, shareholder activists may subsidize their activism through private gains. The successful bidder in a control contest may receive a private gain to the extent that it subsequently uses control to expropriate value from remaining public shareholders or other corporate


\(^{138}\) See Bebchuk & Kahan, supra note 1, 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”).

\(^{139}\) 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) (finding reimbursement appropriate where it was approved by both the board and a majority of the shareholders); Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291, 293 (N.Y. 1955) (upholding the right of shareholders to reimburse successful proxy contestants “subject to the scrutiny of the courts when duly challenged”).

\(^{140}\) See Bebchuk & Kahan, supra note 1, at 1093 (“[E]ntry 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.”).

\(^{141}\) See Robinson, supra note 137.
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 suggesting 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. Public pension funds may be motivated by political objectives such as the desire to provide benefits to local constituencies. Activists may also obtain payments from corporations in exchange for dropping their challenges. Computer Associates International Inc. paid dissident shareholder Sam Wyly $10 million, for example, to terminate his proxy fight for board representation. The private gains of activists may therefore be in tension with—or even come at the expense of—shareholder welfare, calling into question the desirability of activist-sponsored proxy contests and other initiatives. In addition, shareholder activists seeking private benefits may have too great an incentive to engage in such actions relative to the best interests of the group of all shareholders.

E. Administrative Services

Intermediaries also provide technical assistance that facilitates shareholders’ exercise of their governance rights. The most visible example


144. See, e.g., Fisch, supra note 26, at 1044 (describing efforts by public pension funds to influence corporate policies for political reasons as a type of private gain); see also Mary Williams Walsh, Calpers Wears a Party, or Union, Label, N.Y. TIMES, Oct. 13, 2002, § 3, at 1 (describing CalPERS’s use of its influence over corporate decisionmaking to promote social and political objectives).


146. See id. (quoting Computer Associates director Jay Lorsch’s defense of the payment to dissident shareholder Sam Wyly as good for shareholders because “we need to get Sanjay [Kumar] and the rest of management focused on making money, not these distractions”).

147. See Bebchuk & Kahan, supra note 1, at 1094-95 (noting that the divergence between private costs and social costs may lead to more than the socially optimal level of shareholder activism).
of this type of intermediary is Automatic Data Processing (ADP).\textsuperscript{148} ADP administers the distribution of proxy solicitation material and the collection of voting instructions for virtually all U.S. securities that are held in nominee or "street" name.\textsuperscript{149} 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.\textsuperscript{150} 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.\textsuperscript{151} ADP then aggregates shareholder voting instructions and delivers them directly to the issuer.

The costs for ADP's services are borne by issuers. Under a pilot program established in 1997,\textsuperscript{152} NYSE Rules 451 and 465 require issuers to pay for ADP's distribution of proxy material according to a set fee schedule that has been approved by the SEC.\textsuperscript{153} Because ADP's fees are determined by regulation, it is difficult to determine the relationship between the fees, which can be substantial, and the true cost of ADP's services. As of August 2001, for example, ADP's fees in connection with the proxy fight between Computer Associates International Inc. and Ranger Governance Ltd. amounted to $1.33 million plus postage.\textsuperscript{154} Several commentators have questioned the fee rates.\textsuperscript{155} They have observed, for example, that ADP charges issuers a premium for electronic distribution of proxy material even

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\textsuperscript{148} For information on ADP, see Automatic Data Processing, Inc, at http://www.adp.com (last visited May 1, 2003).


\textsuperscript{150} See 17 C.F.R. § 240.14b-1 (2003); see also N.Y. STOCK EXCH., INC., THE OFFICIAL CONSTITUTION AND RULES OF THE NEW YORK STOCK EXCHANGE R. 451 (2002), LEXIS, Nexis Library, N.Y. Stock Exch. Const. & Rules File (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).


\textsuperscript{153} See, e.g., Proxy Reimbursement 2002, supra note 149 (approving the most recent modifications to the fee schedule).

\textsuperscript{154} See Paul Schreiber, In the Middle of Big Battle; ADP Unit Plays Major Role Behind the Scenes, NEWSDAY, Aug. 27, 2001, at C14.

\textsuperscript{155} For the most recent release, see Proxy Reimbursement 2002, supra note 149.
though such distribution is less costly than mail distribution.\footnote{156} Similarly, ADP is able to reduce its costs through the use of bulk mail discounts, but those discounts are not fully passed on to issuers.\footnote{157} 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.\footnote{158}

Problems with the ADP structure may arise from the fact that, although ADP provides services for the benefit of issuers and shareholders, ADP is not accountable to either group.\footnote{159} 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. Issuers in particular have criticized the ability of banks and brokers to select ADP (or another technical assistance intermediary) for depriving the issuers of control over the process of

\footnote{156} See Letter from Paul Conn, Executive Vice President, Computershare Ltd., and Steven Rothbloom, President, Computershare Investor Services (US), to the SEC (Feb. 6, 2002), http://www.sec.gov/rules/sro/nyse200153/conn1.htm (commenting on Self-Regulatory Organizations, Exchange Act Release No. 45,263, 67 Fed. Reg. 2264 (Jan. 16, 2002), and stating that "in the United States, issuers are charged a 'premium' for electronic distribution whereas elsewhere in the world electronic distribution is offered at a discount").


\footnote{158} Issuers have criticized the reimbursement rates set by the NYSE and advocated a market-based alternative. See Proxy Reimbursement 2002, supra note 149, at 15,442; see also Tony Lystra, \textit{ADP Faces Renewed Fire on Proxy and Prospectus Costs, Competition, Mutual Fund Market News}, July 30, 2001, 2001 WL 2252013 (describing attempts by potential competitors to challenge ADP's monopoly).

\footnote{159} Importantly, ADP exercises substantial control over the manner in which it transmits information to shareholders and over the voting mechanisms that it provides. Issuers and investors have occasionally identified problems with the manner in which ADP performs its functions. For example, in 1989 CalPERS called for a reexamination of ADP's predecessor, IECA, as part of its proposed comprehensive revisions to the federal proxy rules. See Letter from Richard H. Koppes, General Counsel, CalPERS, to Linda C. Quinn, Director, Division of Corporation Finance, SEC 14-15 (Nov. 3, 1989), reprinted in Edward D. Herlihy & David A. Katz, \textit{Developments in Takeover Tactics and Defense, in CONTESTS FOR CORPORATE CONTROL} 1991, at 7 app. A (PLI Corp. Law & Practice Course, Handbook Series No. B4-6954, 1991). In 1993, ADP was widely criticized for a series of processing errors. See Dale A. Oesterle & Alan R. Palmiter, \textit{Judicial Schizophrenia in Shareholder Voting Cases}, 79 IOWA L. REV. 485, 510-11 (1994) (describing proxy tabulation problems that occurred at ADP during the 1993 proxy season); Elizabeth Lesly, \textit{A Number-Cruncher Gets an “E” for Errors}, BUS. WK., May 24, 1993, at 35. Again in 1996, reports surfaced of some problems with ADP's operations. For example, the Council of Institutional Investors was pushed to investigate vote-tallying problems after the votes of two institutional investors at the Kmart annual meeting were tallied incorrectly. See Matthew Greco, \textit{Kmart Mix-Up Engenders Wider Look at Voting Irregularities}, INVESTOR REL. BUS., June 24, 1996, LEXIS, Nexis Library, Investor Rel. Bus. File; see also Union of Needletrades Indus. & Textile Employees v. Kmart Corp., No. 96-629078 CZ (Mich. Cir. Ct. 1996), reprinted in Daniel M. Taitz & Lance J. Gotko, \textit{Shareholder Communications, in DOING DEALS} 1997, at 133 exbt. D (PLI Corp. Law & Practice Course, Handbook Series No. B4-7168, 1996) (reporting errors in the votes cast by ADP). Nonetheless, the only avenue of complaint for shareholders is the New York Stock Exchange, which is controlled by member firms with a financial interest in retaining the existing structure.
distributing proxy materials to shareholders. Indeed, ADP’s monopoly may be due in part to the fact that ADP rebates part of the fees that it obtains from issuers to banks and brokers. These rebates can amount to as much as thirty-seven percent of the fee paid by an issuer.

IV. THE FINANCING CHALLENGE

While intermediaries presently provide many services for investors in the capital markets, they face numerous obstacles. As the previous Part demonstrated, market failures may lead to inadequate funding of some intermediaries. Financing constraints, for example, may explain the relative infrequency of proxy contests and the absence of marketplace competition among proxy advisors. Issuer-based subsidies can lead to intermediary corruption at the hands of corporate managers who allocate the subsidies out of corporate coffers. Moreover, financing problems do not always lead to underfunding. Overfunding is also possible, as may be the case with duplicative buy-side analyst research.

This Part directly addresses the challenges present in financing intermediaries. Section A specifies the financing dilemma and describes the problems that can result from existing sources of financing. Section B considers the two dominant legal responses to the financing dilemma: mandatory issuer-based subsidies and restrictions on conflicts of interest.

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

160. See Proxy Reimbursement 2002, supra note 149.
161. See, e.g., Chris Kentouris, Recordkeepers Protest NYSE’s Proxy Mailing Fees, SEC. 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 noting the Securities Transfer Association’s statement that “the rebate procedure fosters ADP’s monopoly”).
162. See Letter from Rachel E. Kosmal, Senior Attorney, Intel Corp., et al. to the SEC (Feb. 6, 2002), http://www.sec.gov/rules/sro/nyse200153/kosmal1.htm (commenting on Exchange Act Release No. 45,263 and stating that “some banks and brokers receive as much as 37% of the current ‘mail elimination’ fees paid by the issuers to the service providers”).
163. See supra text accompanying notes 79-82.
164. 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 shareholdings, among other things). See supra Section III.D. Self-financing is not a panacea, however. To the extent a shareholder activist owns less than one hundred percent of the issuer, the shareholder will not internalize the full gain from its activities for all shareholders. Worse still, the activist may finance himself through the pursuit of his own self-interest rather than the maximization of overall shareholder welfare.
transactions. Examples of these intermediaries include pure research analyst firms and proxy advisors such as ISS. These intermediaries offer the highest degree of independence because of the market's ability to impose accountability through pricing. As described above, however, market imperfections may hinder the provision of many intermediary services. Free-rider and public good problems limit the ability of intermediaries to capture the value of their efforts through market transactions. In particular, the value of intermediary services to any specific investor is limited to the potential effect of those services on the value of the investor's own specific portfolio, irrespective of the overall gain to investors as a group.

Other intermediaries receive payment from issuers, either directly or indirectly through the issuers' purchases of other services. To the extent that intermediary activities benefit issuers and their investors, issuers serve as ideal collectivizing agents, causing shareholders to incur the cost of intermediary services in proportion to their financial interest. Examples of issuer-funded intermediaries include auditors and administrative services providers such as ADP. Issuers pay auditors directly for their auditing services. Issuers also indirectly subsidize auditing services by retaining their auditors for consulting and other services. ADP likewise receives funding, pursuant to NYSE rules, from issuers.

One problem with issuer funding lies with the allocation decision. Management typically decides where to direct the funds, allowing managers to reduce the quality of the information provided by intermediaries as well as to constrain the ability of intermediaries to act as effective monitors. Issuer funding also may not result in the optimal amount of subsidies for intermediaries. To the extent an intermediary may impact a number of different firms, any individual firm will not completely internalize the benefit of providing subsidies to the intermediary. For example, a proxy contest proponent may provide a deterrent effect for managers at multiple firms. No individual firm, however, will capture fully the value of this deterrence. Management may also lack the proper incentives to determine efficient funding levels, preferring instead to underfund intermediaries who may constrain managerial opportunism.


166. See supra text accompanying notes 152-154 (discussing NYSE rules requiring issuers to pay mandatory fees to providers of proxy administrative services).

167. Likewise, in the case of ADP's administrative services, banks and brokers are able to choose the recipient of issuer funding in exchange for side payments from ADP, leading to actions on the part of ADP arguably not in the best interests of the issuer or shareholders. See supra text accompanying notes 152-158 (discussing financing for ADP).

168. In the alternative, managers may seek to supply excessive funding to intermediaries who acquiesce in assisting the managers—including, for example, analysts who provide overly optimistic earnings forecasts.
Intermediary services are also financed through cross-subsidization. Analyst research has been cross-subsidized with 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 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 corporation in order to garner greater investment banking revenue from the corporation 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. First, market-based transactions may fail to produce efficient levels of intermediary services. Second, issuer-based financing solves this collective action problem, but often creates a conflict of interest by making intermediaries accountable to management rather than to investors. The challenge, then, is to identify 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

Recognizing that market failures may lead to suboptimal levels of intermediary services, lawmakers have, in some cases, provided subsidies through mandatory issuer-based financing. At least two aspects of the legal responses are noteworthy. First, 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, rather than identifying commonalities across all intermediaries. The lack of a consistent approach has often resulted in regulators ignoring funding issues in favor of more visible conflict-of-interest problems, leaving many intermediaries with inadequate sources of funding. Second, mandatory financing requirements are limited to the least

169. Under newly adopted NYSE and NASD rules, analysts are prohibited from certain personal trading. See Analyst Release, supra note 47, at 1748. The rules prohibit: analysts and their household members from: (1) purchasing or receiving pre-IPO shares in companies/industries that are the subject of their research reports; (2) trading in recommended securities thirty days prior and five days after issuance of a research report or a change in rating or price target; and (3) trading in a manner contrary to the analyst’s recommendations.

Id. Some brokerage firms have implemented more extensive restrictions on personal trading by their analysts. See, e.g., Megan Barnett, No More Buying for Merrill Analysts, INDUSTRY STANDARD, July 10, 2001 (on file with authors) (describing a newly instituted Merrill Lynch policy prohibiting analysts from investing in companies that they cover).
controversial intermediary services. Thus, mandatory financing typically does not extend to innovative services, even though such services may suffer most from financing problems. This Section describes the legal responses.

1. Mandatory Issuer-Based Subsidies

If financing is the problem for collectivizing intermediaries, one simple solution would be to force issuers to provide more funds. Issuer-based financing collectivizes the interests of investors, using the company’s resources to pay for services accruing to the interests of all investors in the company. The political viability of mandatory subsidies is limited, however, by the need for regulators to determine the amount of the subsidy and to identify appropriate recipients. Nonetheless, various regulations mandate both direct and indirect issuer-based subsidies of intermediation.

The shareholder proposal rule, SEC Rule 14a-8, offers one example of a mandatory subsidy. The rule requires that management include certain types of shareholder-initiated proposals in the company’s proxy. The cost 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 initiatives 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 that attempt to interfere with the role of the board of directors in managing the corporation are forbidden. As a result, many proposals, such as those seeking to declassify boards of directors and those attempting to remove poison pills, are couched in precatory terms that have no binding effect on the company. In addition, the rule cannot be used to nominate competing candidates for the board of directors. Second, although the inclusion of


171. See id. § 240.14a-8(i)(1) (prohibiting a proposal “if the proposal is not a proper subject for action by shareholders”); id. § 240.14a-8(i)(7) (prohibiting a proposal “if the proposal deals with a matter relating to the company’s ordinary business operations”); see also Jill E. Fisch, From Legitimacy to Logic: Reconstructing Proxy Regulation, 46 VAND. L. REV. 1129, 1155-62 (1993) (describing the scope of exclusion for ordinary business matters).

172. Even precatory proposals may nevertheless put pressure on managers. See Choi, supra note 34, at 241-42 (noting that managers may voluntarily implement a precatory proposal that garners a high vote in favor of it, to avoid “damaging publicity,” among other reasons).

173. See Fisch, supra note 171, at 1162-65 (describing failed proposals for shareholder nomination of directors along with the existing exclusion of shareholder proposals that relate to elections to office).
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 completely 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 for activists. 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 by introducing floor resolutions at the annual meeting.174

Similar and more direct forms of mandatory subsidies are the audit requirement for issuers and the payment of proxy voting administrative costs. The federal securities laws require issuers to prepare and disclose audited financial statements,175 which essentially means that issuers must 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 issuers voluntarily undergo audits. Because the cost of the audit is borne by the issuer, shareholders pay for the auditor’s services in proportion to their ownership interests.

Technical support to facilitate shareholder voting—including the distribution of proxy material and the maintenance of telephonic and electronic voting mechanisms—is also financed through mandatory issuer subsidies. SEC and NYSE rules require banks and brokerages to provide proxy information and solicit voting instructions from beneficial owners.176 Rather than handling the process themselves, virtually all banks and brokerage firms have contracted with ADP to perform these services. The costs of the service are borne by the issuer, which reimburses the banks and brokers according to the NYSE’s fee schedule.177

175. See Hazen, supra note 88, § 9.6(2) (detailing audit requirements under the federal securities laws).
176. See supra notes 152-153 and accompanying text.
177. Another plausible example of a mandatory subsidy is the disclosure requirements of the federal securities laws. Under federal law, publicly traded firms are required to engage in a wide range of disclosures to the capital markets. Mandatory disclosure provides a subsidy to analysts and others who use company-specific information. See Coffee, supra note 28, at 729 (“To 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.”). By reducing the cost of obtaining the information, disclosure offers a partial solution to the free-rider and public goods problems. In addition, mandatory disclosure is an efficient mechanism for supplying information because the issuer is typically the least-cost provider of such information. At the same time, mandatory disclosure reduces the incentive for wasteful and duplicative research by outsiders. See id. at 733-34 (“[A] major significance of a mandatory disclosure system is that it can reduce these costs. Rival firms do not need to incur expenses to
While mandatory subsidies (direct and indirect) for intermediaries provide one solution to the financing problem, the solution is not comprehensive. As in the case of Rule 14a-8, the subsidy is often not substantial. More substantial subsidies appear limited to narrowly defined areas, including auditors and proxy administrative services, 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 companies 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. Regulators also run the risk of imposing excessively high levels of subsidies. Some commentators argue, for example, that even Rule 14a-8 mandates an excessive subsidy because shareholder proposals do not provide sufficient value to justify their costs.\footnote{See, e.g., Susan W. Liebeler, \textit{A Proposal To Rescind the Shareholder Proposal Rule}, 18 GA. L. REV. 425, 453-57 (1984) (noting the costs to corporations of complying with Rule 14a-8 and arguing that the rule "probably does not produce additional or better information about management than that already produced by the marketplace and the Commission's mandatory disclosure system").}

The regulatory apparatus is difficult to adjust over time as the identity of such intermediaries and the optimal subsidy levels shift in response to changes in the markets. In addition, the appropriate level of subsidies to different intermediaries may vary by type of company. Large market capitalization issuers may require lower subsidies for analyst research and other information services than less well-known smaller companies.

\section{Regulation of Conflicts}

Many intermediaries address the financing problem with cross-subsidization, using the profits from 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. While private market efforts at subsidizing analysts hold the promise of introducing expertise and flexibility (compared with mandatory subsidies), the private market itself may introduce potential conflicts of produce essentially duplicative data banks when a central securities data bank is in effect created at the SEC.\footnote{As an information subsidy, nevertheless, mandatory disclosure is limited. Not all information relevant to the valuation of a particular company is internal to the company. See Ayres & Choi, \textit{supra} note 79, at 341-42 (describing the importance of outside information in valuing a particular company's stock). Moreover, because the information subject to mandatory disclosure is revealed to the entire market (reducing the value of such information for trading purposes to zero), analysts receive no direct benefit from mandatory disclosure. Rather, analysts can only use the information to complement other information they might have on the company as well as their own expertise.}

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interest. In order to increase revenues, an intermediary may sacrifice the quality of its intermediation services in favor of its more profitable activities, catering to the interests of corporate managers, who ultimately provide the private market subsidies (through their payment of consulting and investment banking fees).

The current regulatory response to these conflicts has taken two forms. One approach is to require disclosure to make the conflicts of interest transparent. These regulations are 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 approach is to limit or prohibit the conflicts. Examples of both types of responses are reflected in recent reforms to the regulation of securities analysts, focusing in particular on analysts associated with large financial firms that also provide investment banking services.

Until recently, the SEC’s initiatives centered 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.179 Similarly, the SEC recently increased the requirements for disclosure of analyst compensation—including, in particular, the relationship between analyst compensation and investment banking revenues within a financial firm.180 Similar reforms have been voluntarily adopted by a number of financial firms in the wake of actual and threatened litigation.181 Finally, the Sarbanes-Oxley Act of 2002 required 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.182

Disclosure-based reforms in theory make investors aware of the risks they face in relying on the recommendations of potentially conflicted analysts. If investors react negatively to certain forms of compensation—such as when disclosure reveals that analysts are being paid to tout a company through large fees paid to the investment banking arm of the analysts’ securities firm—disclosure may lead to changes in compensation structures. Disclosure may reduce the ability of a conflicted analyst to

180. See Analyst Release, supra note 47.
181. See supra note 12 (describing the Merrill-Spitzer settlement).
mislead investors. Investors, for example, may simply disregard information provided by analysts with poor reputations, reducing the value to the issuer of corrupting the analyst in the first place.\textsuperscript{183}

Disclosure-based reforms, however, are limited in their effectiveness. New information on analysts will often be noisy and incomplete. For example, not all analysts who 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.\textsuperscript{184} Unsophisticated investors, on the other hand, may simply ignore the information.\textsuperscript{185} In addition, some services, such as Thomson ONE Financial, bundle together analyst recommendations and report only a consensus opinion, making it impossible to determine the potential biases of the analysts whose recommendations are so aggregated.\textsuperscript{186}

Structural reforms typically extend beyond disclosure and affirmatively limit or prohibit cross-subsidization. The Sarbanes-Oxley Act restricts auditors from providing a variety of consulting services and authorizes the Public Company Accounting Oversight Board to impose additional restrictions.\textsuperscript{187} The Sarbanes-Oxley Act also requires the SEC or the self-regulatory organizations to adopt rules to address analyst conflicts of interest.\textsuperscript{188} Litigation brought against Merrill Lynch by New York State Attorney General Eliot Spitzer similarly resulted in a settlement imposing a

\textsuperscript{183} Several commentators have written on the possibility that investors may suffer from bounded rationality and other behavioral biases that can limit their ability to take into account information accurately. See, e.g., Choi & Pritchard, supra note 100 (manuscript at 7-9); see also Langevoort, supra note 36, at 639-60 (detailing behavioral biases plaguing investors).

\textsuperscript{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 36, at 641-48 (identifying "principal factors that can skew the investment decision maker's attitudes toward risk").

\textsuperscript{185} Individual investors may lack the incentive (especially where their 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.

\textsuperscript{186} See supra note 78 (describing Thomson ONE Analytics, formerly FirstCall).


\textsuperscript{188} See Sarbanes-Oxley Act of 2002 § 501(a). Section 501(a) mandates rules that, among other things, (1) limit "the supervision and compensatory evaluation of securities analysts to officials employed by the broker or dealer who are not engaged in investment banking activities"; and (2) require that "a broker or dealer and persons employed by a broker or dealer who are involved with investment banking activities may not... retaliate against or threaten to retaliate against any securities analyst employed by that broker or dealer... as a result of an adverse, negative, or otherwise unfavorable research report." Id. § 501(a)(1)(B)-(C).
number of structural reforms, including the elimination of ties between analyst compensation levels and investment banking revenue.\textsuperscript{189}

Financial firms may find ways of circumventing these rules and thereby continue to link the compensation of analysts to investment banking. 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 analysts. Analysts can readily recognize that a reduction in firm revenues will affect their compensation. As a result, they will continue to have an incentive to take an optimistic spin on the companies that they follow.

Suppose, nonetheless, that disclosure, Chinese Walls, and more extensive separation of intermediary services from other business reduce conflicts by eliminating the potential for intermediary services to be cross-subsidized. It is unclear how analysts will finance recommendations and the underlying research without these subsidies. Forcing analysts to separate their compensation—or their entire business—from investment banking firms may simply result in underfunded analysts. In the long run, this lack of funding will reduce the amount of information supplied by analysts to 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.\textsuperscript{190} Indeed, there are indications that recent efforts to eliminate analyst conflicts have already narrowed the scope of analyst coverage.\textsuperscript{191} During the past two years, research coverage for U.S. companies has reportedly dropped by approximately twenty percent, and forty-four percent of NASDAQ companies have no analyst coverage at all.\textsuperscript{192}

C. \textit{Summary of Inadequacies of the Present Legal Response}

Regulators have responded to the collective action problem in a number of different ways. In certain circumstances, regulators have forced issuers to

\textsuperscript{189} \textit{See supra} note 12 (describing the Merrill-Spitzer settlement). In a similar vein, the SEC promulgated Regulation FD in 2000 to curtail the ability of issuers to use the selective distribution of material inside information to curry favor with analysts. \textit{See Selective Disclosure and Insider Trading, supra} note 16 (promulgating Regulation FD).

\textsuperscript{190} Regulation FD, similarly, works simply to dry up the subsidy provided by corporations through selective disclosures (by forcing companies to give information to all or remain silent). 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 companies. \textit{See Goshen \& Parchomovsky, supra} note 16, at 1268-70.

\textsuperscript{191} \textit{See Susanne Craig, Left Out of Shrinking Research Pool, Companies Resort To Buying Coverage, WALL ST. J., Mar. 26, 2003, at C1} (describing how regulatory restrictions that prevent Wall Street firms from paying for research with investment banking revenues are causing firms to trim their research departments).

\textsuperscript{192} \textit{Id.}

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provide subsidies to intermediaries.\textsuperscript{193} Mandatory subsidies, however, are not a panacea. Regulators are not omniscient social planners and may make errors in choosing which intermediary activities to subsidize and in determining the appropriate subsidy levels.\textsuperscript{194} Not surprisingly, mandatory subsidies appear most common in areas in which investors generally agree on their value, reducing the risk of regulator error. The requirement that all publicly traded firms have their financials audited by an outside, expert accounting firm, for example, enjoys widespread support among investors. Other intermediaries, such as analysts or proxy advisors, do not enjoy such uniform support.

Mandatory financing may also lead to conflicts of interest so long as management is given control over the selection of the intermediary. This problem has recently been quite visible with respect to the auditing process. Expansion of mandatory subsidies without attention to the allocation decision is likely to compound the conflicts problem.\textsuperscript{195} As a result, we do not advocate addressing intermediary financing through increased levels of mandatory subsidies.

The relative absence of mandatory subsidies has left the door open for private market actors, including, in particular, issuers, to subsidize the activities of securities market intermediaries. Nonetheless, private market subsidies are also not a complete solution. Managers may use voluntary issuer-based subsidies opportunistically, leading to conflicts of interest. While structural prohibitions against cross-subsidization may ameliorate the conflict 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 problem exists primarily because of the need to subsidize intermediary services. Prohibiting payments from issuers to intermediaries may prevent managers from coopting intermediaries, but it will also reduce intermediary funding. Analysts without the prospect of selective disclosures or indirect subsidies through investment banking arms of financial firms may then find themselves unable to meet their expenses. Indeed, the inability of intermediaries to obtain issuer-based funding or to cross-subsidize their services may be responsible for underprovision of some intermediary services, such as proxy activism. Similarly, financing pressure may cause

\textsuperscript{193} See supra Subsection IV.B.1 (discussing mandatory subsidies for intermediaries).
\textsuperscript{194} See Choi & Pritchard, supra note 100 (manuscript at 20-38) (discussing behavioral biases that plague regulators).
\textsuperscript{195} Voluntary subsidies are subject to similar conflict-of-interest problems. In some cases, this has led regulators to restrict the use of voluntary subsidies, such as through the promulgation of SEC Regulation FD. See Selective Disclosure and Insider Trading, supra note 16.
existing intermediaries to develop funding sources that threaten the quality of their services, such as ISS’s expansion into corporate consulting.196

We are therefore faced with a conundrum. Not only are the financing and conflict-of-interest problems tied together, but existing approaches to financing are also flawed. Moreover, the financing problem exists across a range of intermediary services. We provide, in the next Part, a common solution to the financing problem through our voucher financing proposal.

V. THE VOUCHER FINANCING PROPOSAL

The core problem for intermediaries is to obtain sufficient and unbiased funding. To the extent that an adequate source of funding is provided to intermediaries in a manner designed to maximize the best interests of shareholders, both the collective action and managerial corruption problems will disappear. We outline a preliminary proposal based on shareholder vouchers that relies on issuers as the primary source for funding, but delinks the source of funds from the authority to decide 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.197 The U.S. Department of Housing and Urban Development likewise provides housing vouchers for those lacking sufficient financial resources.198 Since 1997, Arizona has allowed taxpayers to direct $500 to one of several intermediary nonprofit groups specializing in providing scholarships to students attending private schools.199 Taxpayers who choose to participate in Arizona’s program receive a $500 dollar-for-dollar tax credit,200 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

196. See supra note 129 and accompanying text.
198. See U.S. DEP’T OF HOUS. & URBAN DEV., VOUCHER PROGRAM GUIDEBOOK: HOUSING CHOICE 1-1 to 1-5 (2001) (discussing, among others, the Section 8 rental certificate program). The housing voucher program, however, imposes significant delays on participants. See, e.g., BENJAMIN I. PAGE & JAMES R. SIMMONS, WHAT GOVERNMENT CAN DO 262 (2000) (noting multiyear waits for those seeking housing voucher assistance).
200. See LIPS, supra note 199, at 7.
school. Vouchers enable the government to determine overall funding levels, but permit individual families to direct funding for their own children’s education 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 that 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. 201

Recently, Bruce Ackerman and Ian Ayres have expanded the notion of vouchers to the arena of political campaign finance. 202 As with schools, 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 the efforts of others. Vouchers targeted specifically for campaign finance force everyone to participate in campaign financing, leaving individual voters with only the decision of which campaign to support. 203

Our proposal takes aspects of voucher financing proposals from the school and campaign finance arenas 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 issuers, but removing the decision of how to allocate the funds from


Of course, school vouchers do not enjoy universal support. Critics have argued, for example, that school vouchers have destructive effects on the educational system. See, e.g., Adam Cohen, A First Report Card on Vouchers, TIME, Apr. 26, 1999, at 36 (noting that critics contend that school vouchers will “[b]alkanize America by abandoning its common core of teachings and traditions . . . turning [public schools] into repositories for America’s unwilling, or unwanted, schoolchildren”); see also Martha Minow, Reforming School Reform, 68 FORDHAM L. REV. 257, 265-68 (1999) (contending that school vouchers will increase disparities among public schools); James S. Liebman, Voice, Not Choice, 101 YALE L.J. 259, 262 (1991) (reviewing CHUBB & MOE, supra) (contending that “enhancement of choice along the lines [Chubb and Moe] propose would put even more children at educational risk than the existing system and thus would make an educationally (and equitably) bad situation worse”). Without going further into the school voucher debate, we note that these concerns have little relevance in the corporate arena. Instead, the relevant components of school vouchers are the general ideas that education is a collective good that may be financed through vouchers and that individual allocation of vouchers to education providers may create valuable incentives for those providers.


203. Under Ackerman and Ayres’s proposal, each vote would receive vouchers worth fifty dollars of public monies to distribute. See id. at 4. Ackerman and Ayres also propose that Patriot Dollar vouchers be anonymous, preventing recipients from learning the identity of a specific donor. See id. at 6.
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 on the part of intermediaries to cooperate with management to expropriate value from a corporation and its shareholders.

Section A describes the intermediary voucher financing proposal. Section B identifies and responds to potential problems with the proposal. In particular, while we believe voucher financing has much to offer for securities market intermediaries, we nonetheless exclude the present requirement of a mandatory audit from the scope of our proposal, although we do include the funding of supplementary auditing services. Section C discusses the benefits of voucher financing. Finally, Section D compares voucher financing to a somewhat similar reform proposal put forth by the New York State Attorney General in conjunction with the SEC and the NASD. The proposal provides, among other things, funds for independent analyst research through a settlement with the financial services industry.

A. A New System of Intermediary Financing

The central principle behind the voucher proposal is that the issuer is the best collectivizing agent with respect to the interests of its current and prospective investors. When subsidies are provided to intermediaries directly from the issuer, all the shareholders of the firm implicitly bear the burden of the subsidy pro rata. Money spent by the issuer to increase investor information and improve monitoring redounds to the benefit of all investors. Improved monitoring can lead to more shareholder-oriented management decisions, increasing corporate revenues and profits. Intermediaries can also provide technical services that reduce the cost of corporate governance, communication with shareholders, and so forth. Investors will then reduce the discount they demand for securities investments, thereby lowering the cost of capital for quality issuers. At the same time, the voucher proposal recognizes the problem with using managers and other nonshareholder decisionmakers to allocate intermediary funding, and restores intermediary accountability by giving allocation decisions to shareholders. In this Section, we sketch briefly the important aspects of a voucher financing system for securities market intermediaries.

204. As quality issuers are able to attract capital at lower cost, the allocative efficiency of the securities markets is improved.
1. \textit{Origination of Funds}

Our proposal identifies publicly traded firms as the most appropriate source of intermediary financing. The requirement that issuers finance information, monitoring, and technical services is not novel. As discussed above, issuers already furnish intermediaries with many types of financing.\textsuperscript{205}

Unlike existing sources of funding, voucher funding would be transparent. Prior to the promulgation of Regulation FD, prohibiting most selective disclosures,\textsuperscript{206} issuers routinely gave favored analysts an informational advantage with respect to inside corporate information. Analysts possessing this advantage would 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 the promulgation of Regulation FD, issuers continued to make implicit subsidies to analysts through elevated investment banking fees. 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 those recommendations, cannot readily be observed by the market. Under a voucher system, in contrast, investors would have the ability to assess the aggregate vouchers directed toward any one intermediary.\textsuperscript{207}

Our proposal would give regulators the authority to determine and implement payment levels by imposing a mandatory annual fee. The rationale for mandatory fee-setting is twofold: First, although issuers currently possess, at least in theory, the incentive to set payments at a level that maximizes 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.

Second, issuers are likely to face a collective action problem preventing them from adopting a voucher system voluntarily. Practical difficulties are likely to prevent any single firm from initiating a voucher financing system. To the extent that investors are unfamiliar with voucher financing, the market may not respond appropriately in adjusting the company’s stock price. Scale economies may also exist with implementation of a voucher

\textsuperscript{205} See supra Subsection IV.B.1 (discussing various mandatory forms of subsidies provided under the current regime).

\textsuperscript{206} See sources cited supra note 16 (discussing Regulation FD).

\textsuperscript{207} We envision that the SEC would have a role in tracking the flow of vouchers. See \textit{infra} Subsection V.A.3 (discussing the possibility of registering intermediaries and using the SEC to transmit information to the market on each registered intermediary).
system. Investors may not find it worthwhile to invest resources in determining what to do with vouchers unless the investors have sufficiently large dollar amounts of vouchers—aggregated over their whole portfolio of stock—to distribute. The more companies in a particular investor’s portfolio that participate in a voucher financing system, the greater the investor’s incentive to participate actively. Similarly, intermediaries may not be able to finance their services on the basis of voucher revenues from a small number of firms.

Individual issuers also face a free-riding problem in purchasing intermediary services. Payments to intermediaries may create potential spillover effects across multiple issuers. Analysts, for instance, may have economies of scale in determining the value of the entire range of companies dealing in a specific industry. To provide another example, launching a proxy contest against one underperforming company not only raises the value of that one firm but also increases deterrence across all corporations, based on the possibility of facing a proxy contest in the future. If an issuer’s investors do not reap the full benefit from the purchased services, the issuer is unlikely to purchase an efficient level of services.²⁰⁸

Accordingly, our proposal requires all issuers to contribute to intermediary financing through mandatory, firm-level fees.²⁰⁹ Although the issuer would be responsible for paying the fee, the issuer’s managers would not control its allocation. Instead, shareholders would allocate the fee through vouchers, as we describe below. Regulators would set issuer payments, initially on a trial basis, which would then be adjusted after the effects of the voucher system had been assessed. The level of the fee for a particular issuer would be determined by a formula based on factors related to the benefits intermediaries may provide shareholders of a particular issuer.²¹⁰

²⁰⁸. Note that Roberta Romano has made the argument, in the context of securities disclosure decisions, that investors will take into account external benefits of disclosures by one issuer for other issuers. See Romano, supra note 23, at 2368 (“The majority of investors hold portfolios, not single shares of stock, and therefore, unlike the issuer, they will internalize the externality if they make the disclosure decision.”).

²⁰⁹. One of us has written on the value of choice in securities regulation. See, e.g., Stephen J. Choi, Promoting Issuer Choice in Securities Regulation, 41 VA. J. INT’L L. 815 (2001). It is possible that eventually, after a voucher financing system gains sufficient economies of scale (thereby making the benefits of voucher financing for shareholders more apparent), individual companies (and their shareholders as a group) could be given some amount of discretion as to their participation in the system. While opportunistic managers may always choose to opt out of a voucher system, shareholders as a group will not do so where voucher financing improves the value of their portfolios. Alternatively, the level of voucher financing could be left to securities exchanges—and individual companies could opt into a system of their choice through their initial decision to list on a particular exchange.

²¹⁰. In general, we would expect larger issuers to obtain a greater absolute share of the collective benefits from intermediary services. Accordingly, factors relevant to the fee calculation would include issuer size, market capitalization, and total number of shareholders. It can be argued, however, that small issuers benefit more from intermediary services on a relative basis.
In theory, the point at which the marginal value of an additional dollar of intermediary financing yields precisely a dollar of collective benefits should determine the aggregate level of funding required from issuers. 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 issuer-based intermediary subsidization. For example, regulators could assess initial levels of subsidization for proxy services intermediation by looking to the expenses incurred by issuers with respect to solicitations by management. Subsequent reexamination of the voucher program would provide the opportunity to evaluate and adjust the formula. Regulators, of course, may make errors in determining the correct level of voucher financing to levy on issuers, but the cost of these errors is unlikely to be large. In particular, regulators need only determine the overall level of funding—and not how to allocate the funding, where the potential error costs are far greater. Too high a level of voucher financing will simply result in greater issuer levies, which can be corrected by lower levies in future years. Too low a level of voucher financing will still improve on the present system. For intermediaries presently receiving too

(e.g., per dollar asset size of the firm or per dollar market capitalization of the firm). Market information about small issuers, for example, is likely to be less available than it is for large issuers, leading small issuers to benefit more from analyst coverage. Small issuers may also have fewer effective governance mechanisms, such as independent boards, for monitoring management, leading them to benefit more from intermediary monitoring. As a result, it would probably be appropriate to allocate fees in accordance with issuer size, but at a declining rate as issuer size increases.

211. The Spitzer settlement, discussed in Section V.D, makes a similar attempt to quantify the size of the subsidy needed in the case of analysts. The settlement sets aside $432.5 million to fund such analysts. See infra Section V.D.

212. 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 V.A.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 issuer levies until the system is able to demonstrate the demand for and value of increased intermediation.

213. A fear nonetheless exists that even when regulators are left to make the decision solely on the total level of intermediary funding, they may fall subject to industry capture. Analysts and other securities market professionals may use their influence to ensure an overly high level of funding. On the other hand, this influence may be counterbalanced by the interests of issuers who will not desire an excessive level of voucher financing. Because there are well-funded institutional players on both sides of the issue, the risk that regulators will be biased in favor of either excessive or inadequate funding levels is reduced.

214. Regulators, of course, will need some method of determining whether the total level of voucher dollars is either too high or too low. Several sources of information may provide regulators guidance, including direct feedback from a variety of market participants who, as indicated above, may have opposing biases. Regulators will also be able to observe the extent to which issuers and institutions continue to purchase intermediary services independently—a possible indication that voucher levies are too low—or the extent to which voucher dollars go unallocated, a possible indication that voucher levies are too high. Of course, the number of
little funding (such as independent analysts and proxy advisory service providers), voucher financing will fund a greater level of investor services.\textsuperscript{215} Even where certain intermediaries already receive too much funding, in the form of payoffs from managers in return for manager-biased services, voucher financing may advance investor welfare. Once competing and more independent intermediaries receive financing, investors will give less weight to information and services provided through biased, manager-financed intermediaries.\textsuperscript{216} Faced with a lower return from funding-biased intermediaries, managers will respond with a reduction in such funding.\textsuperscript{217}

The prospect of financing a collective benefit through a mandatory issuer-based fee is not unprecedented. As noted above, the shareholder proposal rule and the requirement of an independent audit are longstanding examples of indirect fees levied on issuers for the benefit of the market as a whole. There is also precedent for the imposition of direct issuer-based fees. Securities exchanges impose levies on listed firms in the form of listing fees.\textsuperscript{218} Issuers pay for ADP's services in disseminating proxy material and collecting shareholder votes according to a rate schedule established through NYSE rules and approved by the SEC.\textsuperscript{219} Although the fees are loosely related to the cost of the services provided to the issuer, the fee structure reflects the fact that ADP's proxy network provides spillover benefits across firms by facilitating the shareholder voting process.\textsuperscript{220} More recently, the Sarbanes-Oxley Act established a new five-member public board to oversee the accounting profession.\textsuperscript{221} To fund the board, as well as

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unallocated vouchers is not determinative; lack of allocation may simply be due to investor apathy.

\textsuperscript{215} Significantly, because we advocate only a subsidy of intermediaries (and not a bar on nonvoucher financing for intermediaries), our voucher financing proposal need not displace present financing of intermediaries. \textit{See infra} Subsection V.B.2 (discussing whether voucher intermediary recipients should be barred from receiving nonvoucher subsidies).

\textsuperscript{216} The extent to which investors pay attention to more independent analysts turns on their ability to identify such analysts quickly and cheaply. We argue below that disclosure of the amount of voucher dollars each intermediary receives provides investors with a quick and easy market metric to determine how the group of all investors views the credibility and value of a specific intermediary. \textit{See infra} Subsection V.A.3.

\textsuperscript{217} \textit{See infra} Subsection V.B.2 (discussing whether voucher intermediary recipients should be barred from receiving nonvoucher subsidies).

\textsuperscript{218} The NYSE, for example, charges a maximum original listing fee of $250,000 and a maximum continuing annual fee of $500,000. \textit{See} N.Y. STOCK EXCH., INC., LISTED COMPANY MANUAL § 902.02 (2002).

\textsuperscript{219} \textit{See id.} § 402.10(A); N.Y. STOCK EXCH., INC., \textit{supra} note 150, R. 451.90; \textit{id.} R. 465.20; \textit{see also} Proxy Reimbursement 2002, \textit{supra} note 149, at 15,444 (approving the NYSE's proposed proxy distribution rate schedule).

\textsuperscript{220} 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." Proxy Reimbursement 2002, \textit{supra} note 149, at 15,444.

a separate standard-setting body for accountants, the Sarbanes-Oxley Act imposes fees on public companies in proportion to their market capitalization.222

We do not view the voucher levy as an additional tax imposed on public firms because voucher dollars would not be used to support programs that are external to the funding firms but would instead fund intermediary services that benefit issuers. We expect that the voucher program, once operational, will serve as a substitute for some existing intermediary costs that are currently borne by issuers or investors. In the shadow of a well-functioning voucher financing system, small firms will have less of a need to subsidize analysts or to pay them directly in order to obtain research coverage. Voucher dollars could also offer an alternative for present forms of mandatory subsidies such as the requirement of SEC Rule 14a-8 that issuers subsidize shareholder proposals.223 In addition, the increased information and monitoring provided by voucher-financed intermediaries might improve market information and shareholder monitoring, leading to lower levels of corporate misconduct or fraud. To the extent that improved intermediary services reduce the incidence of corporate misconduct, substantial litigation expenditures such as those incurred by Enron might be avoided.224

2. Allocation of Vouchers

The key component of the voucher system that reflects an improvement over direct issuer financing of intermediaries is its separation of the source of funds from the allocation of those funds. Once funds are collected from each issuer, individual shareholders designate the recipient of their respective share of the issuer's levy. Until recently, Berkshire Hathaway provided a similar procedure for allocating the company's charitable contributions. Under its "Shareholder-Designated Contributions Program," Berkshire Hathaway permitted its Class A shareholders to direct charitable contributions made by Berkshire Hathaway in proportion to their share ownership.225 Each Class A shareholder was able to designate up to three

222. See id. § 109(d)(2) (stating that "[t]he 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"); id. § 109(g) (allocating support fees according to relative market capitalization).

223. See supra Subsection IV.B.I (describing SEC Rule 14a-8, 17 C.F.R. § 240.14a-8 (2003)).


charities qualified to receive tax-deductible donations, and those charities then received contributions directly from Berkshire Hathaway. 226

We envision a voucher system along the lines of the Berkshire Hathaway program. One option is for regulators to incorporate the voucher system directly into the existing proxy voting process. Individual shareholders would be allotted a percentage of the issuer's voucher levy based on their proportionate ownership interest in the issuer. Issuers would be required to disclose to shareholders their allotment as part of the proxy statement disclosure in connection with the annual meeting. Shareholders would allocate their share of the issuer's voucher dollars by designating their chosen intermediaries on the proxy card. Issuers would then forward money to designated recipients in proportion to their voucher allocations.

Piggybacking voucher allocation decisions onto the proxy ballot allows regulators to implement voucher financing with minimal additional regulatory apparatus. An alternative option would provide for the distribution and allocation of vouchers through a centralized voucher system, possibly administered by the SEC (or a private entity such as ADP). 227 Under such a system, issuers would pay into a common voucher fund pool. The SEC would advise shareholders as to the voucher dollars over which they had allocational authority, as well as the allocation procedure. Investors could either 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 a default allocation template with the SEC for all future allocations unless otherwise specified. 228 The SEC would then distribute voucher funds in accordance with the shareholders' decisions. The SEC would enjoy scale economies in distributing funds associated with vouchers to various intermediaries in the market. Once the voucher system was established, the incremental cost of adding additional issuers or recipients would be negligible.

Under either system of voucher allocation, the voucher mechanism would allow investors receiving vouchers from one issuer to designate vouchers to an intermediary that undertakes actions impacting the value of

226. See id. at 70. In 2001, Berkshire Hathaway contributed $16.7 million to shareholder-designated charities. Almost ninety-eight percent of eligible shares participated in the program. Id. While this Article was in the editing process, Berkshire Hathaway announced the end of its charitable contributions program. See Thomas Strobhar, Giving Until It Hurts, WALL ST. J., Aug. 1, 2003, at W15 (noting that "the program offered as many opportunities for threatening profits as for enhancing charitable self-expression").

227. For a discussion of ADP, see supra Section III.E.

228. Such a template might resemble the manner in which many employees allocate contributions to their 401(k) plans.
other issuers. Investors typically own stock in more than one issuer and therefore could benefit by directing vouchers to intermediaries that improve the overall value of the investors' entire portfolio.\textsuperscript{229} Therefore, unlike most shareholder voting, which is company-specific, the choice of how to allocate vouchers for most investors would take the form of a common choice across all the companies in the investors' portfolios. Investors making a common choice face reduced information costs associated with the allocation decision, enabling even relatively small shareholders to enjoy economies of scale. For institutional investors, the economies of scale would be greater, and it would clearly be rational for institutions to become informed about their allocation options.\textsuperscript{230}

Importantly, the decision on how to allocate vouchers across various different classes of intermediaries remains with shareholders. This allows shareholders to allocate funds to those intermediaries that provide the most investor value at any given time. When managers at several issuers 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 insurgents may have the ability to launch contests at a larger number of underperforming companies. In other years, shareholders may choose instead to allocate more vouchers to analysts, increasing the quality of information in the 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. Unlike a government regulator, vouchers provide a flexible form of financing that shifts money to its highest-value use for investors over time.

3. Refining the Voucher Proposal

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

\textsuperscript{229} Intermediary-led actions involving one specific company may also have spillover effects on all companies. For example, when investor vouchers help finance a proxy insurgency contest against an underperforming company, the contest will deter potentially underperforming managers at all other companies.

\textsuperscript{230} An investor with holdings in a large portfolio of companies, for example, may make the choice generally to allocate sixty percent of its voucher dollars to a voucher intermediary specializing in redistributing vouchers to worthy shareholder causes. See infra notes 242-245 and accompanying text (discussing specialized voucher intermediaries). The investor may then allocate thirty percent of its voucher dollars to analysts covering a large subset (if not all) of the portfolio companies. The investor finally allocates the remaining ten percent to an intermediary specializing in bringing proxy insurgent contests against underperforming companies generally.
allocate vouchers than to vote. All shareholders are pivotal in that their
decision on how to allocate their vouchers will result in more (or less)
money for various intermediaries. Nonetheless, while investors do not face
the same magnitude of rational apathy 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. If
shareholders are unable or unwilling to become informed, a market process
for allocation of proxies will be ineffective. Worse yet, shareholders may
simply fail to utilize their vouchers.

To facilitate shareholder participation, as well as to increase
intermediary accountability, our proposal also entails a registration process
for voucher recipients, administered by the SEC. In order to be eligible to
receive voucher dollars, intermediaries would be required to register with
the SEC. The registration process would require that registered investor
intermediaries (RIIs) periodically provide data to the SEC on their
activities, the amount of voucher dollars they receive annually, other
sources of funding (if any), 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 with 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 to scrutinize such factors
as the costs incurred by an intermediary, the targets of its efforts, and the
success of its initiatives. Second, the registration process would increase
transparency in intermediary funding. Although it would be possible,
and perhaps prudent, to preclude RIIs from receiving nonvoucher
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 to identify potential
conflicts more easily by reviewing the RIIs’ sources of nonvoucher
financing.

If investors fail to pay attention to disclosures, or if the information
provided through the disclosures is incomplete and noisy, investors may fail
to appreciate the differences among intermediaries. Nonetheless, involving

231. See Statements by Company CEOs and CFOs, at http://www.sec.gov/rules/extra/
232. Some may argue, as well, that the mere act of registering intermediaries will “lull”
investors into trusting them excessively. The provision of explicit information on the successes
(and failures) of such intermediaries as well as the costs they incur will work to counteract any
such lulling effect.
233. We discuss this point more thoroughly at the beginning of Subsection V.B.2.
the SEC in providing salient information on RIIs in one centralized and easy-to-access location reduces the information cost of voucher financing. Providing information on the total amount of vouchers that each intermediary receives gives investors a simple market metric for how investors as a group view the credibility and quality of a particular RII. Larger institutional investors (with a correspondingly larger number of vouchers) will drive the total number of vouchers each RII receives. An RII that performs better for investors over time will receive greater voucher allocations. Smaller, individual investors may then look to the voucher-received metric in determining how much to rely on a particular RII. It is also likely that third-party rating services (such as Standard & Poor’s) or institutional investors would develop techniques for reporting on the quality of intermediary services.

To further address the shareholder apathy problem, we also propose creating an explicit mechanism for small shareholders to free-ride on the allocation decisions of larger investors through a proportional allocation rule. Vouchers for a specific issuer that are not affirmatively allocated—due to shareholder failure to respond—would be allocated in proportion to those vouchers that have been allocated by the issuer’s shareholders. Investors under a proportional allocation rule will then have the opportunity to free-ride on the allocation decisions of others. In addition to permitting efficient free riding, the rule would reduce the incentive for intermediaries to spend excessive amounts on advertising their services to small investors, who may not allocate their vouchers. Investors can also free-ride by using their vouchers to mirror the decisions of other investors, such as institutions. Regulators may allow investors to designate a particular institution (such as CalPERS or TIAA-CREF) and then automatically have the investors’ voucher allocations track that institution’s allocations into the future. An institution, in turn, with knowledge of the number of investor-designated vouchers free-riding on the institution’s allocations, may better distribute the total aggregate number of vouchers to their highest-value use for investors. Alternatively, as noted below,

234. An alternative solution to the rational apathy problem would be to have a regulator adjust the value of each individual voucher either for the next round of voucher financing or, if an obvious funding drought exists, for the current round. Ackerman and Ayres propose such a solution in the context of political campaign voucher financing. See ACKERMAN & AYRES, supra note 202, at 85-87. Relying on a regulator to make adjustments to the value of vouchers, nonetheless, would delay financing and create the possibility that regulators might act out of self-interest in making adjustments. See id. at 87 (“[T]here will inevitably be a certain amount of discretion required in rapidly calculating the relevant sums—and candidates will be quick to claim that the agency is abusing its discretion in favor of their rivals.”). An automatic proportional allocation rule avoids these problems.

235. Such designations may be made relatively cost-free through the SEC’s own website. Mark Latham proposes more generally that shareholders be given the ability to imitate the voting decisions of institutions. See Mark Latham, Vote Your Stock (Sept. 8, 2003), http://www.corpmon.com/VoteYourStock.htm.
investors can delegate the allocation decision by allocating to an intermediary that specializes in redistributing vouchers to other intermediaries.\textsuperscript{236}

The proportional allocation rule raises the question of whether we should go further with our proposal and allow vouchers to be sold.\textsuperscript{237} An explicit market in vouchers would further enable efficient free riding and tend to concentrate allocation decisions in the hands of those who might have the strongest economic interest in those decisions.\textsuperscript{238} Nonetheless, the problems with voucher sales, in our view, outweigh the costs. Voucher sales would enable allocation decisions to become unduly concentrated, reducing the accountability of voucher recipients. Voucher sales would also increase the potential for corruption in the process.\textsuperscript{239} More importantly, allowing voucher sales would implicitly endorse the view that voucher allocations should reflect the self-interest of a specific investor rather than the interests of the investor class generally.\textsuperscript{240} This in turn would tend to further the more problematic aspects of institutional investor activism.\textsuperscript{241}

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{242} In other words, specialized intermediaries will provide expertise for investors lacking information as to where best to use the vouchers, taking a fraction of the vouchers as compensation.\textsuperscript{243} Individual investors may then rely on

\textsuperscript{236} See infra notes 242-245 and accompanying text (predicting the development of intermediaries specializing in directing voucher dollars).

\textsuperscript{237} We thank Harold Demsetz for raising this interesting point.

\textsuperscript{238} Cf. Robert Charles Clark, Vote Buying and Corporate Law, 29 CASE W. RES. L. REV. 776 (1979) (arguing that shareholders should be able to purchase the voting rights of others so long as the purchaser has a substantial equity interest and hopes to profit solely from the appreciation of that interest).

\textsuperscript{239} Initial shareholder recipients of vouchers, for example, may sell their vouchers too cheaply to the extent the benefit from allocating a voucher accrues not only to the specific recipient but also to all other shareholders.

\textsuperscript{240} A similar policy rationale underlies the traditional prohibition against vote-selling. See Hall v. John S. Isaacs & Sons Farms, Inc., 146 A.2d 602, 613 (Del. Ch. 1958) ("Shareholder votes may not be purchased for any consideration personal to the stockholder.").

\textsuperscript{241} See Fisch, supra note 26, at 1041-45 (identifying the potential for value-decreasing institutional investor activism when investors act primarily to obtain private gains).

\textsuperscript{242} Ackerman and Ayres rely on similar intermediaries to redistribute their "Patriot Dollar" vouchers. See ACKERMAN & AYRES, supra note 202, at 72-75 (advocating the use of political action committees as intermediaries to redistribute Patriot Dollars from individual voters to specific candidates).

\textsuperscript{243} We would not fix the amount of this compensation. Instead, specialized voucher intermediaries in competition with one another would competitively set the compensation. As part of their effort to attract vouchers, intermediaries would have to disclose and compete based on the percentage of vouchers that they would keep.
Securities Intermediaries

such intermediaries, transferring their voucher dollars to the intermediaries rather than incurring the costs of researching and distinguishing among different independent analysts, potential proxy insurgents, and other collectivizing intermediaries. A specialized intermediary could save the vouchers for use in a later year or distribute the funds to other intermediaries providing analyst coverage or auditing services. Likewise, it could rechannel funds to sponsors of specific proxy issue proposals and other forms of actions designed to benefit shareholders.

Relying on intermediaries to assist in the allocation of funds is not without precedent. Arizona’s school choice program relies on nonprofit 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 nonprofit 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 similarly expect competition among securities market intermediaries 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 range of companies will have economies of scale in communicating this information to investors. This information—combined with the SEC’s information about RIIs—will reduce research costs for shareholders considering how to allocate their voucher dollars. Importantly, market competition will lead to allocative 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 most effectively increase shareholder welfare. Quality intermediaries will be able to brand themselves by

244. While we believe that specialized intermediaries would add value to our voucher proposal, they would also add another layer of administrative cost. Accordingly, our proposal does not entail the creation of such intermediaries by regulators. Instead, we leave it to the market to determine whether and to what extent such specialized intermediaries will in fact arise, with the expectation that they will only succeed in the market if the benefit they provide in terms of increasing the value of voucher distributions exceeds their cost.

245. See supra text accompanying notes 199-200 (describing the Arizona school scholarship program).

246. On the other hand, intermediaries in competition may spend too much money on advertising from the perspective of overall social welfare. The SEC’s centralized provision of relevant information on registered investor intermediaries reduces the risk that competition will lead to excessive levels of advertising. To the extent that the problem persists, regulators may consider imposing caps on the amount any single intermediary may spend on advertising.
establishing a reputation based on their results. Through annual financing decisions, shareholders will be able to maintain intermediary accountability.

B. Potential Problems with Voucher Financing

The theory behind our proposal is that by overcoming collective action problems voucher financing enables the allocation decision to be made by those who have the best incentive to maximize corporate value—the shareholders. We argue that even dispersed shareholder decisions should generate better allocation results than decisions by incumbent managers of a publicly traded firm. In addition to the shareholder apathy problem addressed above, several additional objections to our voucher proposal are possible. In this Section we anticipate and respond to possible criticisms.

1. Coordination Problems

Voucher financing presents a potential coordination problem among shareholders. Under a voucher system, shareholders may fail to coordinate with one another on voucher allocation. 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. Any coordination problems, however, must be weighed against the benefit of providing market discipline in the funding of securities market intermediaries. The relevant comparison is not to a perfect world where intermediary financing is determined through an omnipotent social planner, but rather to the current system, which itself suffers from

247. 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 lemons problem may arise where some intermediaries may free-ride off the reputation of other intermediaries, reducing the overall value of reputation. See, e.g., Bernard S. Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 UCLA L. REV. 781, 787-88 (2001).

coordination problems as well as more problematic conflict-of-interest biases.\textsuperscript{249}

Several factors also suggest that the coordination 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 from the shareholders of one company, for example, may receive too many vouchers from the shareholders of another. Similarly, because investors at different companies have varying 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, although coordination problems may initially result in inefficient dispersion of vouchers across too many intermediaries, the nature of most intermediary services will make it feasible for intermediaries to operate effectively even with small allocations. For example, a shareholder activist may use a small initial allocation to fund a single shareholder proposal; an analyst may initiate coverage on a limited number of issuers. Over time, the market process should enable intermediaries to build reputations that will enable them to obtain sufficient vouchers to reap economies of scale in their operations.

Third, short-term disparities in voucher allocation are likely to be resolved in a multiyear time frame. If investors discover 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 intermediary who is overfinanced can retain some voucher dollars to sponsor challenges in succeeding proxy seasons, for example.\textsuperscript{250}

Fourth, as we have identified, the voucher program may result in the development of intermediaries who specialize in rechanneling vouchers.\textsuperscript{251}

\textsuperscript{249} See supra notes 164-168 and accompanying text (discussing the conflict-of-interest problems arising from manager-directed financing of intermediaries).

\textsuperscript{250} In essence, the ability of shareholders to allocate their vouchers over time creates a type of storable votes. Storable voting has been defended as a superior mechanism for improving voting efficiency than existing mechanisms such as strategic voting and vote trading. See ALESSANDRA CASELLA, STORABLE VOTES (Nat’l Bureau of Econ. Research, Working Paper No. W9189, 2002), http://www.nber.org/papers/w9189.pdf (demonstrating that welfare gains are possible through storable voting).

\textsuperscript{251} See supra notes 242-245 and accompanying text.
Such intermediaries would offer expertise in identifying and evaluating RIIs and would also offer a mechanism for coordinating voucher allocations, particularly for individual investors.

Finally, and most importantly, 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.\textsuperscript{252} Institutions also enjoy relatively low costs in coordinating their allocation efforts with other institutions.\textsuperscript{253} Coordination with respect to voucher financing would be far easier than coordination of voting, because such coordination need not occur on an individual company basis and because voucher financing would provide 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.\textsuperscript{254} Significantly, our proposal does not rely on the active participation of all institutions because of our mechanism for allocating undesignated vouchers.

Other existing programs provide for decentralized allocation of funding without insurmountable coordination problems. Taxpayers under the federal tax code, for example, may make charitable contributions to certain nonprofit entities and thereby receive a tax deduction.\textsuperscript{255} The deduction effectively makes the government a co-donor to the charity of the individual taxpayer’s choosing.\textsuperscript{256} As with our proposal, taxpayers face a

\begin{enumerate}
\item \textsuperscript{252} Under our proportional allocation rule, as well, individual investors may free-ride on the voucher allocation efforts of larger institutional investors. See supra text accompanying notes 234-236.
\item \textsuperscript{253} Analogously, Jeff Gordon has argued that the relatively low coordination costs for institutional investors offer new potential for improving corporate governance through cumulative voting. See Jeffrey N. Gordon, Institutions as Relational Investors: A New Look at Cumulative Voting, 94 COLUM. L. REV. 124, 173, 177 (1994). But see sources cited supra note 30 (casting doubt on the ability of institutional investors to coordinate in ways beneficial to all shareholders).
\item \textsuperscript{254} Notably, the SEC has taken some steps to enable small investors to free-ride off the governance decisions of institutional investors. For example, the SEC recently adopted a rule requiring mutual funds to disclose their proxy votes publicly. Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Exchange Act Release No. 47,304, 68 Fed. Reg. 6564 (Feb. 7, 2003) (to be codified at 17 C.F.R. pts. 239, 249, 270, and 274).
\item \textsuperscript{255} See I.R.C. § 170 (2000). Unlike vouchers (which under our proposal would have a fixed value), the charitable contribution deduction leaves the amount of government money to donate up to the individual taxpayer, limited of course by the taxpayer’s corresponding taxable income.
\item \textsuperscript{256} 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, 404-18 (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, he writes:
\end{enumerate}
substantial problem coordinating their donations in any single year, but
disclosure of nonprofit funding coupled with ongoing taxpayer adjustments
through their donation decisions in subsequent years provides a mechanism
for responding to short-term inefficiencies.\footnote{257}

Regulators could further respond to the coordination problem by
cabining the voucher decision somewhat. Rather than allowing investors to
allocate vouchers across different types of intermediaries, for example,
regulators could establish different categories of functional vouchers aimed
separately at analysts, proxy contest activists, and so forth. This approach
would correspond more closely to Ackerman and Ayres’s proposal in the
campaign finance context of using different vouchers for the elections of
the President, the Senate, and the House.\footnote{258} Although a differentiated
voucher scheme would allow investors to tailor their choices more
precisely, we view it as less attractive for two reasons: First, differentiated
vouchers would not allow shareholders to correct funding disparities across
classes of intermediary services. Thus, a shareholder who believes that
analyst research is overfunded could not use vouchers to redirect funds
away from analysts and toward proxy contests. Second, differentiated
vouchers would require a government regulator to determine appropriate
funding levels for each category of intermediary services. We are cautious
about a regulator’s ability even to determine aggregate funding levels;
indeed one of the motivations for voucher financing is the superiority of
having investors rather than regulators determine the optimal quantity and
type of intermediary services.\footnote{259}

\begin{quote}
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, then this uncertain donor can receive
information regarding charities’ receipts as the year progresses.
\end{quote}

\textit{Id.} at 411 (footnote omitted).

\footnote{257} Arizona’s charitable tax contribution program also provides for decentralized financing. \textit{See supra} text accompanying notes 199-200 (describing the Arizona school scholarship program).

\footnote{258} \textit{See ACKERMAN & AYRES, supra} note 202, at 76-78. Significantly, Ackerman and Ayres
ground their differentiation of vouchers in large part on the need to protect the present separation
of powers within the federal government. \textit{See id.} at 76. (“Each elected institution has its own
constitutional dignity; each performs interdependent functions. If one remains starved of public
funds, this will affect the entire system.”)). Voucher financing for securities market intermediaries
has no overarching goal of protecting the independence of different types of intermediaries.
Instead, investors rely on various types of intermediaries (and to varying extents) solely to
increase the expected returns from their investments.

\footnote{259} On the other hand, using differentiated vouchers may force shareholders to consider the
importance and role of the services provided by different intermediaries. Nonetheless,
shareholders actively allocating vouchers may already appreciate the role of different
intermediaries and, indeed, actively weigh intermediaries against one another in determining
which intermediaries generate a greater return for the shareholders. Creating an artificial
distinction among intermediaries may then work only to restrict the ability of shareholders to shift
funding to those intermediaries that, at any given point in time, provide the most value.
2. Exclusivity and Intermediary Corruption

Intermediary corruption is a concern for any financing mechanism. The capacity of voucher financing to eliminate intermediary corruption depends on its implementation. One risk is that company managers will be able to influence intermediary services. Managers intent on expropriating value from their companies could 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. As a condition of registration, the SEC could require RIIs to agree to accept only voucher dollars. Those intermediaries that wanted to solicit market-based payments—from investors, issuers, or other sources—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 subsidization through selective disclosure, would effectively preclude management from paying RIIs in order to influence their services.

There is reason to be cautious, however, about precluding managers from supplementing voucher dollars with corporate funds. First, to the extent that regulators misjudge the amount of the issuer levies, our proposal may result in an underfunding of intermediaries. Issuers, in theory, still retain an incentive to maximize the value of their stock for shareholders. Some managers may therefore want to provide continued subsidies to remedy underfunding. Curtailing the ability of managers to direct corporate resources to intermediaries may therefore increase the cost of error in implementing our proposal.

Second, the ability of managers to corrupt intermediaries is reduced under our proposal. To the extent that 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 issuers. Managers may attempt to corrupt certain intermediaries, but competition from the newly funded independent intermediaries will reduce the effectiveness of manager-funded intermediaries. A pro-management recommendation from an intermediary known to receive funds from managers will carry little weight in the face of a competing negative recommendation from a voucher-financed independent analyst. Indeed, once investors have voucher-funded alternatives, intermediaries receiving financing through manager-determined subsidies will be forced to take extra efforts to convince investors of their credibility in order to remain competitive.
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 can use this information to distinguish among intermediaries.

A second possible form of intermediary corruption is rebates or kickbacks.\(^{260}\) An intermediary might rebate a portion of the funding that it receives to shareholders, particularly institutional investors, in exchange for the allocation of voucher dollars to that intermediary. The rebate would have the effect of inducing the investor to act out of an interest in maximizing its rebate revenue rather than allocating its voucher dollars to the intermediary most likely to increase shareholder wealth. This problem could be addressed, in part, through a requirement that intermediaries describe, in sufficient detail, how they use their voucher dollars.\(^{261}\) Although kickbacks could arguably be disguised in the form of payments for business services, the problem could be reduced by prohibiting investors from allocating vouchers to firms with whom they have other business relationships.

Alternatively, a requirement of anonymity in funding could reduce the potential for kickbacks.\(^{262}\) Anonymity could make opaque the company ultimately funding the vouchers as well as the investors allocating the vouchers. In particular, if vouchers are distributed through a central system administered under the direction of the SEC, there is no need for intermediaries to learn the source of shareholder allocations. Absent an ability to identify themselves credibly, shareholders will have difficulty extracting kickbacks. Importantly, however, an anonymity requirement has costs as well as benefits. Preventing disclosure of intermediary funding sources reduces information to the market and precludes efficient free riding by smaller investors on the allocation decisions of institutions. Anonymity may also reduce intermediary accountability by reducing the transparency of any relationships between intermediaries and their funding sources. Accordingly, although we recognize the potential value of

\(^{260}\) The rebates provided by ADP to brokerage firms in order to attract their proxy processing business are similar to this type of payment. See supra note 161 and accompanying text.

\(^{261}\) Indeed, this requirement may be independently necessary in order to provide shareholders with sufficient information.

\(^{262}\) Ackerman and Ayres propose a similar anonymity requirement for nonvoucher campaign contributions under their campaign voucher proposal. See ACKERMAN & AYRES, supra note 202, at 27-28 (contending that with a “secret donation booth” a “candidate is less likely to sell access or influence if he can’t be sure that the buyer has actually paid the price”); see also id. at 25-44.
anonymous funding, we do not propose that it constitute part of the voucher financing mechanism as initially implemented.

A final source of distortion in the intermediary market may result from problems with shareholder incentives. Although voucher financing reduces corruption by vesting shareholders rather than management with the allocation decision, it may be argued that shareholders are nonetheless imperfectly positioned with respect to some allocation decisions. One might argue, for example, that because they already own stock, shareholders will favor optimistic analysts rather than those whose evaluations are less favorable but more accurate. This may lead to systematically biased recommendations.

Several responses are possible: First, many investors will not have an incentive to reward analyst overvaluations. Buy-and-hold shareholders in companies that are not about to raise capital benefit from stock prices that discipline management accurately. Shareholders who constantly are both buying and selling, including most institutional investors with diversified portfolios, will not have a systematic incentive to favor overvaluing shares. Moreover, active traders will favor increasing market accuracy because of its value in reducing the risk facing market makers and thereby the bid-ask spread.

Second, even if some investors have an incentive to favor optimistic analysts, voucher financing will enable the funding of other, more independent analysts. Voucher financing will allow at least some analysts to maintain objectivity and, therefore, to build a reputation not possible under current law, under which the potential sources of intermediary

263. Even if the market eventually learns of the overoptimism (and reduces the price of a company accordingly), investors may benefit in at least two ways from temporary periods of overvaluation. First, the company itself may have the ability to sell securities at a higher price (increasing value for preoffering shareholders) or use less of its stock to acquire other companies (again benefiting preexisting shareholders). Second, shareholders intending to sell shares benefit from temporary periods of overvaluation. See, e.g., Lucian Arye Bebchuk & Oren Bar-Gill, Misreporting Corporate Performance 2 (SSRN Elec. Library, Working Paper No. 354,141, 2003), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=354141.

264. Moreover, even if a company is about to raise capital, diversified buy-and-hold investors will not benefit if one particular (low-quality) company is able to raise capital more cheaply due to misrepresentations. To the extent the market discounts all companies for the risk of this misrepresentation, other (higher-quality) companies in the diversified investor’s portfolio will receive a correspondingly smaller amount of capital from their sales (due to the discount). Thus, the possibility of overly optimistic analyst reports will not benefit the diversified buy-and-hold investors. Indeed, to the extent capital is shifted to less valuable uses, the resulting inefficiency will reduce the value of a diversified investor’s entire portfolio.

265. Less accurate stock prices leave open the possibility that some traders may enjoy greater informational advantages over other traders. Market makers will react to this increased risk with a larger bid-ask spread, increasing transaction costs for all investors. For a summary of evidence on the relationship between asymmetrical information advantages in the market and higher bid-ask spreads, see Laura Nyantung Beny, U.S. Secondary Stock Markets: A Survey of Current Regulatory and Structural Issues and a Reform Proposal To Enhance Competition, 2002 COLUM. BUS. L. REV. 399, 438-40.
funding remain unknown. Indeed, vouchers may generate an easily observable separation in the market because truly objective analysts will advertise both their objectivity and the quality of their results. SEC disclosures will facilitate the transparency of intermediary funding and performance.\textsuperscript{266} Even if some shareholders direct money to corrupt analysts, those analysts will have a diminished effect as the market focuses more attention on high-reputation analysts.

Third, even if shareholder incentives are imperfect, voucher financing must be measured against the alternatives. Although an omniscient social planner would be preferable, it is unlikely that anyone else will have the necessary information and incentives to make perfect allocation decisions. As our Article demonstrates, manager-directed subsidies and cross-subsidization through investment banking revenues create greater risks of analyst corruption. Regulatory alternatives substitute bureaucratic selection for a market-based process, with the resulting risks of capture and error.

Finally, the risk of systematic bias is limited to the funding of analysts. Investors will not have similar incentives to undermine the activities of proxy advisory firms, proxy insurgents, and other intermediaries, who do not voice an opinion on the value of a company but instead act in some other fashion for the collective benefit of all shareholders. While we believe that, on balance, voucher financing is desirable for analysts, this problem does not affect the application of our proposal to other types of intermediary services.

It is also possible that institutional investors in particular will have an incentive to fund privately (outside of the voucher financing system) those intermediary services from which they can benefit by excluding other investors. This incentive may lead institutions to allocate insufficient voucher dollars to fund those services, reducing the efficiency of the allocation process. Analyst research is the most likely example. Armed with their separate buy-side research (as well as their present superior access to sell-side and independent research), institutions may profit less if research is broadly disseminated to the market, leading them purposefully to allocate insufficient voucher dollars to fund publicly distributed research. Our proposal works by reducing the ability of any single investor group, even institutions, to capture a segment of intermediary services. To the extent that at least some investors allocate voucher dollars to broadly distributed independent research, the profitability (and thus amount) of institutional investor in-house research will drop compared with present levels. In turn,

\textsuperscript{266} See \textit{supra} text accompanying note 231 (describing our proposal to register securities market intermediaries with the SEC).
this should increase institutions’ incentives to fund research through voucher dollars.

3. Voucher Financing and Auditors

In the preliminary description of our proposal, we articulated a broad approach in which vouchers are used to fund all intermediaries that provide aggregating services for investors. Intermediaries differ dramatically, however, in the scope of their operations. The ideal candidates for voucher financing are those intermediaries whose services suffer most from free riding and spillover effects and those intermediaries that are underfunded by the present system due to collective action problems. In particular, although auditing services present the same financing dilemma as proxy advisors, analysts, and other types of intermediaries, we do not advocate substituting voucher financing for mandatory audits of publicly traded firms.

There are several reasons why voucher financing is not an appropriate substitute for the existing mandatory-audit requirement. First, there are particular administrative challenges to using voucher financing to fund firm audits. To the extent that a firm has only one “official” auditor, the use of voucher financing does not solve the problem of which auditor to select. Where some shareholders direct vouchers to auditor X and others to auditor Y, it is unclear which one, if either, should become the official auditor. Even if an alternative mechanism, such as the decision of the board’s independent audit committee, is used to select a single auditor, the allocation of voucher dollars remains problematic. It would be inappropriate either to reallocate voucher dollars that had originally been directed to a competing auditor or to allow an auditor to keep those dollars without the obligation to perform auditing services. Moreover, voucher financing leaves the auditor exposed to the risk that funding may vary over time and across firms due to the lack of coordination among shareholders on how to allocate vouchers. Auditors may respond with a less-than-comprehensive audit of the firm.

While we believe that the voucher coordination problem generally is not insurmountable, coordination presents a particularly acute problem for the selection and funding of a single official auditor. Moreover, to the extent that investors uniformly desire a quality audit at all publicly traded firms, there are few advantages to giving investors flexibility in directing financing across auditors and different portfolio companies. Audits of

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267. Thinking (incorrectly) that others will allocate sufficient vouchers to an issuer’s auditor, shareholders may distribute too many vouchers to analysts covering the issuer (at the expense of the auditor), for example. One could argue that the existing legal requirement results in excessive production of auditing services, an issue that is beyond the scope of this Article.
issuers also produce limited spillover effects. Although the general quality of the auditing process affects the value of all issuers, the quality of the audit performed at one specific issuer is of little value to investors of another issuer, again calling into question the need for voucher flexibility in funding auditors.

A decision to fund audits through discretionary shareholder allocations entails other substantial risks. Auditing quality is arguably the least transparent of all intermediary services and thus least suitable for shareholder choice. While investors may readily judge the accuracy of analyst recommendations on the basis of the covered firm’s subsequent performance, the quality of an audit is more difficult to evaluate. Even sophisticated institutional investors may lack the ability to determine audit quality unless the audited firm subsequently suffers financial difficulties. At the same time, although auditors are routinely accused of audit failure in cases of issuer fraud or bankruptcy, many such accusations are unfounded.268

Despite our reluctance to extend voucher financing to the funding of a firm’s official auditor, we recognize that allowing firms (and their managers) to control the funding decision for auditors (including the funding of related consulting services) poses an ongoing conflict-of-interest problem. Auditors are currently the focus of a variety of regulatory reforms. Self-regulatory organizations now require issuers to utilize an independent audit committee to oversee the appointment of the issuer’s auditors as well as the structure of the auditing process.269 Issuers routinely submit their selection of the company’s auditor for shareholder ratification, although to date shareholders have not used their voting power to play an active role in the selection process.270 A variety of new regulatory reforms, including several sections of the Sarbanes-Oxley Act, address auditor selection, compensation, and independence.271

These regulatory reforms nonetheless may be ineffective. As we have observed, efforts to address intermediary conflicts by mandating independence do not assure the provision of adequate quality or optimal


270. One factor limiting shareholder influence over auditor selection has been the ability of brokers to vote stock held in street name where the beneficial owner has failed to provide voting instructions. See Jennifer E. Bethel & Stuart L. Gillan, The Impact of the Institutional and Regulatory Environment on Shareholder Voting, 31 FIN. MGMT. 29 (2002) (exploring the impact of broker voting on the passage rates of management-sponsored proposals).

levels of intermediary services. The separation of auditing from consulting services, for example, may simply remove a source of subsidization and leave independent auditing underfunded. Moreover, to the extent that managers retain influence over the selection of the official auditor—for example, through their influence over the selection of the members of the firm's audit committee—the possibility of auditor corruption remains. As a result, while we would not change the present mandatory provision of auditing services, we would allow investors to allocate vouchers to intermediaries providing additional auditing services.

Supplementary voucher-funded auditing services may take many different forms. Shareholders may wish to fund forensic audits or to designate intermediaries to investigate particular types of accounting problems that appear to be widespread, such as earnings management. Voucher-funded auditors in turn might specialize in auditing either problematic companies or randomly selected companies. Regulators may assist such supplemental audits by providing voucher-funded auditors with mandatory rights to inspect corporate records. Supplemental auditing may also introduce a valuable mechanism for increasing competition in the auditor market by reducing the barrier to entry for smaller accounting firms.

C. 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 will also enable the provision of services that cannot be cross-subsidized through other business operations. In particular, we expect the voucher proposal to facilitate 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.

272. One can question why issuers and auditors in fact rely on cross-subsidies through consulting services. See, e.g., supra note 97 and accompanying text (discussing one possible reason identified by Jeffrey Gordon).

273. See David Henry, The Big Five Beats a Final Four, BUS. WK. ONLINE, Mar. 14, 2002, at http://www.businessweek.com/bwdaily/dnflash/mar2002/nf20020314_1688.htm (explaining how the need for a large amount of capital, an extensive and diversified client base, and international offices, prevents smaller entrants from competing with the Big Four).
Moreover, through vouchers, intermediaries will be free to experiment with new forms of activism. For example, vouchers may lead to more direct proxy solicitations, in which insurgents are not limited by the constraints of Rule 14a-8. Vouchers may be particularly helpful in creating a mechanism for greater shareholder participation in the selection of independent directors. Voucher-financed intermediaries could even play a role in identifying appropriate director candidates and sponsoring their nomination to compete with management nominees. By developing a reputation by virtue of their investigation and selection principles, such intermediaries can add credibility to the candidates they sponsor. In turn, investor endorsement of these actions, through financing, will give state courts greater 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.

Voucher financing may also reduce wasteful intermediary expenditures. Such expenditures can occur, under the current system, for several reasons. First, shareholders may be unable to coordinate their individual expenditures on certain types of services. The increased disclosure and centralization of voucher financing can reduce the coordination problem. Second, shareholders may be unable to control allocations by company managers that are inefficient or tainted by conflicts of interest. In either case, the result may be overproduction of services. Voucher financing diminishes the impact of manager-funded research, thereby reducing the incentive of managers to make such expenditures. Third, voucher financing, unlike the existing patchwork of regulatory and private market subsidies, allows investors to transfer funding from an overfunded area to a more desirable service. Thus, if analysts are currently overfunded, vouchers will enable investors to transfer dollars to other types of services, such as proxy advisors or technical support.

The quality of intermediary services should also increase. Market competition will cause quality intermediaries to receive higher levels of funding. Voucher financing will direct funding to intermediaries who

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274. Some commentators have advocated greater shareholder participation in director nomination. See Fisch, supra note 171, at 1162-65 (criticizing existing restrictions on shareholder proposals that relate to director elections); Carol Go forth, Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, but Not Too Late, 43 AM. U. L. REV. 379, 449-50 (1994) (proposing an amendment to Rule 14a-8 that would allow direct nomination of director candidates by shareholders).

275. This could also facilitate the development of a class of professional directors. See Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 STAN. L. REV. 863 (1991) (advocating a corps of professional directors as a means of improving corporate governance).
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 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 proxy 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. Competition may lead intermediaries to focus more on addressing internal agency problems that prevent them from focusing on investor protection; it may also make intermediaries less likely to succumb to the corrupting influences of management.

Coupling intermediary disclosure with a voucher funding system also creates a market-based mechanism for testing the impact of potential conflicts of interest on intermediary quality. In contrast, existing reforms aimed at separating intermediaries from potential conflict-inducing activities rely on regulators to determine the extent to which intermediary conflicts are permissible, creating 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 only ineffective window dressing. Finally, regulators are poorly situated to weigh the benefits of independence against the costs. In particular, economies of scale may sometimes 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 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. The disclosure required of RIIs will effectively bring such potential conflicts to the attention of investors making voucher allocation decisions.

The possibility of voucher financing also reduces the need for regulators to engage in other forms of regulatory intervention. Voucher financing applied to sponsors of proxy issue proposals and proxy contests, for example, reduces the need for mandated subsidies such as SEC Rule 14a-8. It thus frees regulators from the potential inefficiencies of regulatory meddling. Instead, shareholders will be able to reward an intermediary that sponsors value-increasing proposals and to refuse to support an intermediary that engages in wasteful activism. Similarly, voucher financing eliminates the need to regulate reimbursement of an insurgent’s expenses in a proxy election contest; intermediaries will be able to secure funding based on their ability to identify companies at which a change in management is appropriate and to locate suitable replacements. In addition, unlike regulatory solutions, which require affirmative government action to refine, voucher financing is capable of adjusting automatically to changes in intermediary structure or market needs. The responsiveness of voucher financing is particularly valuable in a dynamic market environment.

D. A Comparison to the Spitzer Settlement

The SEC, the NASD, and Eliot Spitzer, the New York State Attorney General, have recently pursued a regulatory reform that is similar to our voucher funding proposal. As part of a larger settlement with ten Wall Street firms and two individual analysts, the regulators obtained approximately $432.5 million to fund independent research. Under the terms of the final settlement, the individual Wall Street firms are responsible for contracting with independent research firms and for making the research of those firms available to their customers. The settlement does not specify criteria for evaluating a research firm's independence; instead, each Wall Street firm must use the services of an independent

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276. For another example of such an effort, see Bebchuk & Kahan, supra note 1, at 1134-35.
278. See SEC Fact Sheet, supra note 277.
consultant—who is required to report to regulators annually—to procure the research. 279

As originally proposed, the settlement would have employed a more formal procedure for identifying and evaluating independent research firms. Spitzer initially had called for the establishment of a new analyst oversight board that would have had the discretion to select and finance independent research. 280 The resulting independent research would then have been provided directly to the investing public. 281 In contrast to the final version of the settlement, the initial proposal vested authority for selecting independent analysts with the oversight board rather than the individual Wall Street firms.

On the one hand, the Spitzer settlement demonstrates the political and practical feasibility of our voucher financing proposal. The Spitzer settlement recognizes the centrality of the financing dilemma and focuses on providing an independent source of financing in order to generate adequate research by imposing levies on financial firms. The settlement recognizes, as do we, the requirement that those responsible for allocating these funds be free from conflicts of interest, and attempts to effectuate that independence—in the initial proposal through the creation of an oversight board, and in the final version of the settlement through the use of independent research consultants.

Our proposal, nonetheless, is superior to the Spitzer settlement along a number of dimensions. As we have argued above, in comparison to individual financial firms, the issuer acts as a more natural source of collectivizing the interests of investors. Issuers, not financial services firms, benefit from the provision of intermediary services. In contrast, the Spitzer levy operates less as a collectivizing mechanism and more as a tax on the provision of financial services. As a result, the settlement provides little accountability with respect to the quality of independent research that will be provided to investors. In particular, the Wall Street firms who will be responsible for choosing the independent research firms have limited incentives to search for high-quality research. 282 The requirement that the firm consultants report annually to regulators may reduce corruption, but regulators are unlikely to possess the expertise to provide meaningful

279. See id. The Spitzer settlement also includes structural reforms to separate analysts from investment banking, as well as funding for investor education and enhanced disclosures, among other measures. See id.


281. See id.

282. Additionally, there is some question about the extent to which independent research firms will be willing to sell high-quality research to the investment banks. See Sidel & Craig, supra note 52. Such sales would reduce the exclusivity of the firms' product and possibly prevent the firms from continuing to sell to their regular clients. In addition, firms may fear the relationship would compromise their independent reputations. Id.
oversight of the quality and independence of the research provided through this process. Moreover, the $432.5 million fund is specifically anticipated to subsidize independent research for a five-year period. After the fund is exhausted, investors will lose their access to independent research.

Our financing proposal also extends more broadly than the settlement by providing funding for a range of intermediary services, from analysts to proxy contest insurgents. Our proposal gives shareholders the flexibility to shift funds toward those intermediaries that are providing the highest value for investors at any given point in time. Importantly, this reduces the cost of error in determining the appropriate subsidy level. Thus, while the Spitzer settlement might result in excessive or wasteful financing of analyst research, voucher financing enables investors to shift voucher dollars to a more valuable intermediary service.

Additionally, the Spitzer settlement creates troubling ambiguity about the factor that we identify as a key component of voucher financing: the allocation decision. The settlement offers limited guidance in identifying appropriate recipients of the independent research subsidy. Nowhere does the settlement appear to identify selection criteria for the independent research or to require that the independent research provided meet minimum standards of quality. At the same time, the settlement does not attempt to promulgate standards of independence. Despite the array of potential conflicts that can affect analyst research, the only conflict about which the settlement appears to be concerned is the one arising from analyst proximity to investment banking business. Indeed, by granting Wall Street research consultants the responsibility for allocating their firms' research subsidy, the settlement has the effect of shielding the subsidization decisions from public scrutiny, leaving investors with no information to evaluate the choice of an independent research firm. In contrast, voucher financing vests the allocation decision in the investing public and provides investors with the information necessary to make an informed decision.

We do not mean to suggest that customers would have been better served by Spitzer's initial proposal, which relied on judgments made by a rigid and politically vulnerable analyst oversight board. The issues that

283. But see Donaldson Speech, supra note 277 (stating that regulators will oversee the process of firm purchases of independent research “to insure the research is independent, of high quality, and useful to the firms’ various customer bases”).

284. See SEC Fact Sheet, supra note 277.

285. Even the use of a research consultant does not eliminate the potential influence of investment banking conflicts. To the extent that investment banks are largely responsible for determining where the settlement money goes, their business objectives may influence the research reports of those analysts hoping to receive settlement dollars. An analyst may anticipate, for example, that reports containing a large number of sell recommendations may not be attractive to an investment bank. Moreover, despite the fact that the allocation decision is ostensibly made by an “independent consultant,” that consultant is nonetheless an employee of the investment bank.
have arisen concerning the first appointments to the newly created accounting oversight board under the Sarbanes-Oxley Act highlight the risk that political factors may interfere with the selection process. Questions also exist as to the independence of an oversight board dependent on money from investment banks. Most importantly, as with the research consultant, the analyst board would have been faced with the task of evaluating both research quality and analyst independence in order to make decisions about where to allocate the levied funds. Regulators are unlikely to make these judgments effectively, as evidenced by their failure to identify and respond to the problem created by the relationship between analyst research and investment banking business.

We submit that the market—working through the collective preferences of investors—is better able to determine where to direct subsidy dollars than either an independent consultant or an insulated oversight board, both of which lack any direct financial stake in the allocation decisions. Although we are sympathetic to the appeal of allowing an idealized central planner to direct subsidy dollars, for the reasons described above, we are skeptical of the ability of a government body to act either directly as such a central planner or indirectly through the process of overseeing independent consultants. Competition among voucher recipients is more likely to ensure that funding is directed to those intermediaries providing the highest return for shareholders. The transparency of voucher financing also offers a more flexible approach for identifying and responding to new forms of intermediary conflicts of interest.

VI. CONCLUSION

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

286. See, e.g., Editorial, Is Washington Just Faking It?, BUS. WK., Nov. 4, 2002, at 156 (describing the initial decision of SEC Chair Harvey Pitt to support the appointment of John H. Biggs to head the accounting oversight board and the subsequent withdrawal of that support in response to accounting industry pressure); John R. Wilke, Webster Says He Will Likely Quit as Head of New Accounting Board, WALL ST. J., Nov. 12, 2002, at A1 (describing the controversy surrounding the “bitterly contested” appointment of William Webster to head the board).

287. The Wall Street Journal, for example, reported: “Scott Cleland, founder of Precursor Group, an independent research firm that could benefit from the [research] panel’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.” Jeff D. Opdyke, Stock Advice You Can Trust?, WALL ST. J., Oct. 31, 2002, at D1.
Shareholders of large publicly held corporations face a substantial collective action problem in monitoring managers and voting in proxy contests. Securities intermediaries aggregate the interests of investors by providing investment analysis, proxy contest advice, and other services. Intermediaries, however, are subject to the same collective action problems. In particular, the financing structure of securities intermediaries may undermine their efforts. Intermediaries unable to obtain compensation for the full benefit of their work may provide suboptimal levels of services. In some areas, financing problems may lead to the absence of valuable market services.

Although issuer-based subsidies and cross-subsidization offer solutions to the underfunding problem, they bring their own shortcomings. Issuer-based subsidies allow company managers to control the 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 corrupting analyst reports and recommendations. Moreover, 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. Thus, although regulators can prohibit the subsidization of research with investment banking revenues, this solution may simply result in fewer analysts providing information to the market.

Rather than tackle the conflict-of-interest problem separately, we focus directly on the financing problem. Solve the financing problem and the need for subsidies from the issuer disappears, alleviating the potential for conflicts of interest. The key motivating insight behind our voucher financing proposal is to separate the source of intermediary subsidies from the decision on how to allocate such subsidies. Theoretically, other mechanisms could provide the same separation. The government, for example, could impose a levy on publicly held firms and rely on regulators to apportion the proceeds among "worthy" intermediaries. But while we envision a potential role for the government in setting the level of mandatory payment on the part of issuers into the voucher financing system, we would rely more on the market—working through investor-driven allocation decisions—to decide which intermediaries receive voucher dollars. Well-known limits exist on the expertise and incentive of regulators to micromanage the market. We avoid these limitations through reliance on investors.

While the voucher financing proposal is radical, there is ample precedent for using issuer-based levies to subsidize collectively valuable market services. The NYSE, for example, could implement the voucher financing proposal for its listed firms along lines similar to the method by
which it sets the rates for ADP’s services. Broader implementation of our proposal could be achieved through legislation or SEC rulemaking. Indeed, in comparison to the recent corporate governance reforms implemented by the SEC and under the Sarbanes-Oxley Act, our proposal is quite modest. Importantly, unlike existing reform efforts, voucher financing does not place Congress, the SEC, or self-regulatory organizations such as the NYSE in the position of a central planner, charged with the task of designing an ideal structure to address 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 their most effective use in improving overall shareholder welfare.