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INTRODUCTION

This Essay examines the role of private institutions in promoting strong securities markets. Recent scandals in the United States highlight both the importance and the fallibility of the securities market intermediary institutions to which investors typically turn for protection, such as auditors, analysts, and proxy advisory firms. From the perspective of investor welfare, this Essay discusses the various forms of institution failure and the efficacy of recently promulgated reforms.

A securities investment returns value only through intangible rights associated with the securities.[1] The value of these intangible rights depends on information related to the company, including information relating to earnings, strategic business plans, among others. Not all investors are on an equal informational footing. Insiders, for example, systematically enjoy an information advantage over outside investors. Even among outside investors disparities exist. Large institutional investors, including mutual funds and public and private pension funds, often expend significant resources on researching securities. Individual investors typically lack the ability to engage in the same level of research.

Collective action problems stand in the way of investors as a group coordinating in researching and overcoming informational asymmetries. This lack of coordination leads to at least three problems. First, individual investors who systematically engage in trades opposite to insiders and other informed investors face reduced returns. Second, confronting the possibility of information disparities, institutional investors may expend costly resources to gain a trading advantage over each other (or, alternatively, to avoid being at an information disadvantage). While privately beneficial, often such duplicative expenditures are socially wasteful.[2] Third, when outside investors lack

* Roger J. Traynor Professor of Law, University of California, Berkeley (Boalt Hall). Special thanks to Un Kyung Park. Thanks to the participants of the East-West Center and KDI Conference on Corporate Efficiency in Korea (2003) and the symposium on "The Role of Law in Promoting Long-term Value for Shareholders," sponsered by the Berkeley Business Law Journal and the Mercatus Center (2003) for helpful comments and suggestions.

1. Common stock, for example, typically gives investors the right to share pro rata in dividends and the right to elect directors to a corporation's board of directors.

2. *See* Jack Hirshleifer, *The Private and Social Value of Information and Reward to Inventive*

information on corporate activities, managers and insiders enjoy a greater leeway to expropriate private benefits of control.[3] Through the expenditure of costly resources, any single investor may monitor and work to discipline underperforming managers. To the extent the benefit from monitoring and disciplining managers accrues to all investors, however, no single investor will have full incentives to engage in such activities.[4]

Solutions exist to information problems in the capital markets. La Porta, Lopez-De-Silanes, Shleifer, and Vishny (LLSV) provide cross-country comparison evidence across a series of papers demonstrating a statistically significant correlation between strong legal protections for minority shareholders (as well as a common law legal tradition) and various measures of financial development.[5] The evidence that laws matter, however, leaves open the question of exactly what laws are important and how laws interact with norms and institutions.[6] Standing alone, for example, a legal requirement of mandatory disclosure may not provide much benefit for individual investors. Even with disclosure, individual investors face the daunting task of interpreting the information, determining its credibility, and collectively pursuing their shareholder rights.[7]

Crucial to the operation of legal protections for investors is the presence of securities market intermediary institutions, such as institutional investors, auditors, and analysts among others. Intermediary institutions play a key role in interpreting disclosed information, assessing the value of companies, and collectivizing the actions of shareholders, thereby increasing investor welfare.

Activity, 61 AMERICAN ECON. REV. 561, 562–66 (1971) (providing a model where information research works only to accelerate the disclosure of information in a pure exchange economy and, therefore, generates no net social value).

3. *See* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1051 (1995).

4. Even well-informed public shareholders have few levers available to them—outside of a fiduciary duty lawsuit—to stop controlling shareholders from shifting value to the controlling shareholders. Importantly, the presence of a controlling shareholder is endogenous. The inability of firms to sell large amounts of securities to the public (leading to a concentrated control group) may be precisely due to the lack of institutions able to provide credible information as well as to assist in collectivizing the actions of shareholders in disciplining underperforming managers.

5. *See* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1116 (1998); Rafael La Porta et al., *Corporate Ownership Around the World*, 65, J. FIN. 471 (1999); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Rafael La Porta et al., *Agency Problems and Dividend Policies around the World*, 55 J. FIN. 1 (2000); Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 58 J. FIN. ECON. 3, 4-6 (2000). Correlation, of course, does not necessarily mean causation. Questions remain as to the exact causal relationship between protections for minority shareholders and measures of financial development.

6. *See also* John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 4 n.6 (2001) ("By no means is it here implied that [LLSV's measured] rights are unimportant, but they seem to supply only partial and sometimes easily outflanked safeguards, which have little to do with the protection of control and the entitlement to a control premium.").

7. Of course, small, individual investors may look to the market price for securities that trade on an efficient market. Not all companies, however, trade on an efficient market. *See infra* notes 37-39 and accompanying text.

Institutional investors, including mutual funds, help to aggregate the interests of a large number of smaller, individual investors. Auditors provide certification and verification of a company's financial statements. Analysts give the investing public information on the value of particular investments. Proxy advisors, such as Institutional Shareholder Services (ISS), give primarily institutional investors information on how to vote their proxies.[8] Underwriters in a public offering work, at least in part, to certify the quality of the offering.[9] Mutual funds help collectivize investment research (and decisionmaking) for investors, among other services.[10]

Despite the importance of institutions, examples of institutional failure exist, as exemplified recently within the United States. Arthur Andersen, for instance, failed to catch and report the off-balance sheet financial schemes in Enron.[11] Merrill Lynch and other Wall Street firms allegedly put forth overly optimistic reports on particular companies that provided investment banking revenues for the firms.[12] The response on the part of regulators in the United States has been one of regulation in the form of Regulation FD, the Sarbanes-Oxley Act of 2002 and the recent settlement between Wall Street brokerage firms and the SEC together with Eliott Spitzer, the New York State Attorney General (the "Spitzer-SEC Settlement").

This Essay provides two contributions. First, the paper provides a taxonomy of the various forms of securities market intermediary institution failure. More than one reason exists for why private market intermediaries fail in their function to protect the interests of investors. Understanding these separate reasons is important in assessing the present regulatory response as well as considering possible reform. Second, the paper compares the failings of the market against the fallibility of regulators. Not all regulations are the same—a series of possible interventions into the securities market exists ranging from merit regulation at one extreme to the provision of optional

8. For information on ISS's services, see http://www.issproxy.com (last visited Feb. 4, 2004).

9. A hierarchy of prestige exists among underwriters, with higher quality offerings typically associated with higher prestige underwriters. For a study examining the prestige hierarchy among underwriters, see Richard B. Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 J. FIN. 1045, 1056-66 (1990); Richard B. Carter et al., *Underwriter Reputation, Initial Returns, and the Long-Run Performance of IPO Stocks*, 53 J. FIN. 285 (1998).

10. Mutual funds may also obtain large scale economies in securities transactions unavailable to most individual investors.

11. For a discussion of the Enron scandal, see William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002); John C. Coffee Jr., *Understanding Enron: It's the Gatekeepers, Stupid*, 57 BUS. LAW. 1403 (2002); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002); Larry E. Ribstein, *Market Versus Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 IOWA J. CORP. LAW 1 (2002).

12. *See* Charles Gasparino, *Merrill Lynch to Pay Big Fine, Increase Oversight of Analysts*, WALL ST. J., May 22, 2002, at A1 (noting that "[i]n one e-mail, a Merrill analyst referred to an Internet stock the firm was touting as a 'piece of s—').

investor education materials at the other.[13] Some forms of market failures require less intervention (with a corresponding reduced cost of regulatory error and capture). Lawmakers often regulate first and ask questions later, ignoring both the potential downsides of regulation as well as the possibility of market-based alternative solutions to market failures. The presence of market-based solutions allows regulators to intervene less stringently into markets, leaving the market with some degree of choice in how to address particular intermediary defects.

Part II provides the taxonomy of institutional failure. Part III surveys the laws in the United States which directly affect the role of institutions in overcoming information asymmetries in the capital markets. The Part also discusses the impact of the recent regulatory reforms. Part IV sets forth a framework to consider the optimal form of regulatory intervention to correct for defects in the intermediary market. The Part proposes that regulatory reforms should instead follow a more market-assisting rather than supplanting approach when possible.

I. TAXONOMY OF INSTITUTIONAL FAILURE

The Essay focuses on securities market intermediary institutions that supply collectivizing services for investors, including the provisions of information and advice to investors (as well as verification and certification of information) and services designed to reduce the cost of collective action. Intermediary institutions, in theory, profit from protecting investors. Intermediaries, including independent analysts, may sell services directly to investors. Even intermediaries paid directly by the issuer gain when they protect investors. Investors, for example, will increase their willingness to pay for securities of an issuer associated with particular intermediaries, such as high-reputation auditors, who work in the best interests of investors. Issuers will then pay a correspondingly higher fee to such intermediaries.

Investors, nonetheless, confront the risk that an intermediary institution may fail to protect them. This Part examines various causes for failure in the

13. *Cf.* Simeon Djankov et al., *The New Comparative Economics*, NAT'L BUREAU OF ECON. RESEARCH (2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=390760 (last visited Jan. 28, 2004).

Djankov et al. posit that regulatory intervention balances two concerns. On one hand, private ordering alone may lead to excessive disorder (particularly where property rights and contracts are not respected). On the other hand, too stringent government intrusion in the economy opens up the risk of governmental expropriation of value (leading people to spend more time hiding their wealth as opposed to accumulating new wealth). They argue that varying forms of regulation strike different balances between disorder and order. Moreover, what is optimal for a particular country may differ from other countries (and be dependent on the history and cultural background of the country). In the context of the securities markets, Djankov et al.'s analysis requires more nuance. Within the U.S., property rights and contracts are well respected. Instead, a variety of failures affect the market, as discussed in this article, that individually may require a different balance between allowing private ordering versus regulatory intervention.

securities markets including (A) financing problems of intermediaries; (B) conflicts of interests plaguing some intermediaries; (C) agency problems among individual members of a securities intermediary; and (D) unsophisticated investors in the market.

A. Financing Problems

Overcoming information asymmetries is costly. Investors attempting to research a company's securities encounter well-known collective actions problems. These problems can lead to both too great and too little incentives on the part of dispersed investors to expend resources in researching the companies in which they invest. Where investors research information to obtain a trading advantage, they may have too great incentives to become the very first with such an advantage (and thereby enjoy a trading profit) from the perspective of social welfare.[14] Conversely, where investors must vote as a group to ratify various corporate transactions or elect directors, individual shareholders may lack the incentive to invest in determining how to vote (or in convincing others how to vote). While an individual shareholder bears all the costs of such activities, they benefit only pro rata with other shareholders to the extent the vote increases overall corporate welfare.

Intermediary institutions help reduce such collective action problems. However, collectivizing activities are not cost free. Both sell-side analysts working for brokerage firms as well as buy-side analysts in the employ of institutional investors must invest in researching information on the covered issuers. Analysts then synthesize such information, drawing upon their experience and expertise, in coming up with a recommendation for investors. Auditors must expend large resources in going through a company's books, assessing the company's system of internal controls, and spot-checking to ensure financial accuracy. Proxy insurgents, similarly, bear large costs. Not only must they distribute a formal SEC proxy filing to the SEC as well as to all solicited investors, the insurgent must often expend resources directly communicating with (and often entertaining) a company's largest shareholders.

Many intermediaries turn directly to investors for financing. Several independent analysts, including Value Line and gimmecredit.com, obtain funds directly from investors.[15] Buy-side analysts working for institutional investors,

14. For a discussion of the various positive and negative societal impacts from securities research, see Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313, 328-35 (2003). Alternatively, to the extent information research results in a more accurate securities price (benefiting not only investors but also society), dispersed investors may have too few incentives to engage in research. Nonetheless, for many types of information about to be released soon to the market in any case (such as information internal to a company relating to earnings and other matters), the benefit from accelerating disclosure is likely small. *See id* at 363-64.

15. Investors may purchase a one-year online subscription to the Value Line Investment Survey for $598. *See* Valueline.com Homepage, *at* http://www.valueline.com (last visited Jan. 28, 2004). The

as well, receive funding from investors (indirectly through mutual fund fees).

Significantly, because information is a public good, many institutions may fail to obtain funding from dispersed investors commensurate to the benefit they provide to the group of all investors.[16] Without some ability to finance their activities, intermediaries will at best provide less (if any) of the service. Sell-side (as well as purely independent) analysts, for example, may not provide the level of research and breadth of distribution that maximizes societal welfare. Simultaneous and broad distribution of research increases price accuracy while reducing the incentive of dispersed investors to engage in their own duplicative (and therefore wasteful) research.[17] Analysts seeking to sell their information, however, will not want to distribute the information at once to all investors (doing so eliminates the trading advantage). Without a trading advantage, the broad and simultaneous distribution of information results in valueless information to investors, who will then pay a correspondingly reduced (zero) amount to analysts.[18]

B. Conflicts of Interests and Intermediary Corruption

As a solution to the financing problem, some intermediaries seek financing directly from publicly-traded firms. Auditors receive financing directly from issuers. Many sell-side analysts obtain funding through cross subsidies from the investment banking business within the same brokerage firm.[19] Cross subsidies, in turn, are made possible from elevated investment banking fees charged to publicly-traded firms (and therefore indirectly to the shareholders of the firms).[20]

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gimmecredit.com analyst firm provides bond research to institutional investors at a price of $18,000 per year. *See* Gimmecredit.com Homepage, *at* http://www.gimmecredit.com (last visited Jan. 28, 2004).

16. A lack of financing may result in intermediaries seeking goals other than purely investor welfare. Proxy insurgents, for example, have a difficult time recouping their expenses, typically getting reimbursed only if they win (and only to the extent the shareholders vote to make such a reimbursement). *See* Edward Robinson, *Sam Wyly, Cowboy Investor*, BLOOMBERG MARKETS MAGAZINE, Sept. 2001 (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"), *available at* http://www.bloomberg.com/marketsmagazine/ft3_0109.html (last visited Dec. 23, 2002). As a result, some proxy insurgents able to bear the expense of such a contest may do so not to maximize overall shareholder value but to obtain private benefits of control for itself.

17. *See* Stephen J. Choi, *The Need to Subsidize Even Wasteful Analyst Research* (2003) (unpublished manuscript, on file with The Berkeley Business Law Journal).

18. For example, an investor may learn that Apple is about to enter into a contract with Sony Music to distribute music online. However, if everyone else simultaneously learns of the same information, the investor will not have a trading advantage over others.

19. *See also* Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1045-54 (2003) (describing cross subsidies for sell-side analysts).

20. Indeed, without such cross subsidies, analysts may choose not to cover certain firms. After Antigenics, a biotechnology company, decided to use another investment bank for its upcoming seasoned stock offering, U.S. Bancorp Piper Jaffrey cut off its analyst coverage of Antigenics. *See* Randall Smith & Geeta Anand, *Antigenics Says Piper Jaffray Halted Coverage of Shares To Punish Banking Switch*, WALL ST. JOURNAL, Apr. 16, 2002, at A1.

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The funding connection between publicly-traded firms and institutional intermediaries in the securities markets has provided corporate managers an avenue to influence the information provided through the intermediaries to the market. At worst, managers may threaten to withhold investment banking business to obtain more favorable analyst ratings for their firms than warranted. Managers may also threaten to terminate non-audit-related consulting business with auditors to influence an audit. Auditors, analysts, and other intermediaries receiving funding either directly or indirectly from a corporation may therefore choose to sacrifice the quality of their information services to please corporate managers. Over the 1990s, in particular, the problem of manager-directed corruption of intermediaries increased rapidly, culminating in Enron and other scandals.[21]

Certainly, conflicts of interest pose an identifiable problem within the securities intermediary market. Understanding the conflicts of interest problem in the context of the overall financing problem, however, leads to a policy dilemma.[22] Simply prohibiting conflicts of interest alone does not address the underlying financing problem. Indeed, the financing problem is made worse to the extent intermediaries lose the ability to seek funds from publicly-traded firms due to conflict of interest prohibitions. Regulators that attempt to separate analysts completely from investment banking may very well reduce conflicts of interests facing analysts. However, such a separation may also result in a drop in the available financing for analysts, thereby reducing the amount of sell-side analyst research provided into the capital markets.[23]

The market already provides one solution to the possibility of intermediary corruption. Intermediaries may seek to develop a reputation for providing high quality services for investors. Auditors with high reputations among investors are more valuable to public companies than auditors with poor reputations. Auditor certification helps assure investors that the financials of a public firm are credible, leading investors to pay a higher price for the firm's stock. From this reputation, an intermediary is able to charge a higher fee for its services. Intermediaries that earn super-competitive profits (from the elevated fees) will lose a great deal, to the extent investors sour on the particular intermediaries.

21. Jack Coffee has argued that the incentive of managers to corrupt intermediaries to obtain even a short-term boost in share price rose over the 1990s due to the increased use of stock options. *See* Coffee, *supra* note 11, at 1413-14. Managers holding large numbers of options profited greatly from exercising their options at times when their stock price was even temporarily elevated. *See also* Gordon, *supra* note 11, at 1245-47 (noting that managers compensated with a large amount of options "have incentives to increase the riskiness of the firm, including projects that offer lower expected returns but higher variance").

22. For a further development of this argument, see Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 304-12 (2003).

23. Intermediaries, of course, may become corrupt even without inducements from corporate managers. As discussed later, individual agents working at an intermediary may sacrifice the best interests of both investors and the intermediary itself for the agents' own personal self-interest.

The prospective flow of super-competitive profits then bonds the high reputation intermediaries to remain credible in the information they provide.

Even when reputation works perfectly to ensure that an intermediary will not sacrifice the best interests of investors (and, as discussed below, perfection is hard to obtain), the reliance on reputation is not cost free. In equilibrium, fewer competitors will operate in the market for intermediary services where reputation is used as a bonding mechanism leading to higher profitability. Higher profitability imposes a greater penalty on those intermediaries which choose to sacrifice their reputation. Less competition, however, means a lower incentive on the part of intermediaries to innovate in ways to protect investors. Furthermore, investors indirectly pay more for investor protections derived from such intermediaries.

C. Agency Problems

Not all those associated with an intermediary work in the best interests of the intermediary. An agent of the intermediary may only partially consider the best interests of the intermediary, taking into account the agent's own self-interest in making decisions. An intermediary's high reputation, moreover, is not a remedy for agency problems. Arthur Anderson's relatively high reputation pre-Enron resulted in the auditor obtaining large rents, as issuers sought to obtain an audit from Arthur Anderson to boost their own credibility. Nonetheless, individual audit partners within Arthur Anderson did not internalize the full value of Arthur Anderson's reputation. John Coffee and Jeffrey Gordon have separately argued that David Duncan, the Houston partner of Arthur Anderson, reduced the standards of the audit in an effort to increase his own revenues at the expense of Arthur Anderson's overall reputation.[24] Indeed, when a high-reputation institution helps to assist fraud, investors are harmed to a much greater extent than when the investors are already on guard.[25]

Setting aside self-interest, agents within securities market institutions may also suffer from a variety of behavioral biases that may lead to institution failure. Overconfidence, for example, may cause some audit partners to believe that they can get away with less-than-complete audits while still protecting investor interests. Similarly, analysts and money managers may become

24. *See* Coffee, *supra* note 11, at 1415-16 (describing the possibility that audit partners and consultants both were aligned in keeping "their mutual client satisfied, and together they would form a coalition potentially able to override the protests of their firm's internal audit unit (if it felt that an overly aggressive policy was being followed)"); Gordon, *supra* note 11, at 1239 (noting that "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").

25. The fact that investors missed obvious (at least using hindsight) warning signs related to Enron supports the notion that investors may be more at risk when dealing with supposedly high-reputation institutions. *See* Gordon, *supra* note 11, at 1240 ("The only compelling reason not to assume the worst about Enron's deliberately obscure financial statements was because of Andersen's certification, yet the market 'knew' that the certification had little value.").

overoptimistic about the stock market.[26] Alternatively, analysts and money managers may come under an availability bias, focusing too closely on more recent information.[27] Short-term upswings in the stock market and in corporate earnings may lead analysts to overstate the value of stocks.[28]

The agency problem facing intermediary institutions interacts with the need of institutions to develop a reputation for credibility. To the extent that institutions must maintain a large market share (thereby generating super-competitive profits) to bond themselves to remain credible, organizational problems will increase within the institution. As client-firms grow multinational, the need for an international presence also exacerbates the organizational problem facing intermediary institutions. For example, as auditors grow international in size and scope, the possibility of a single auditing partner located in a specific geographical region putting his own self-interest above those of his other partners, thereby sacrificing the reputation of the entire international entity, becomes more acute.

D. Uninformed and Irrational Investors

In theory, rational and fully-informed investors should provide a natural disciplining influence on poorly-performing intermediaries. Intermediaries earn a return directly based on their reputation. An analyst with a poor reputation among investors, for instance, will not find a large audience for its research. Similarly, publicly-traded firms that hire auditors with a poor reputation send a negative signal to the market and thus will face a reduced share price. Firms trading in markets with pervasive information asymmetries and collective action problems will experience a large discount in their share price. Companies, therefore, may internalize the cost of being unable to reduce the

26. Experts, such as auditors and analysts, are not immune to overconfidence or overoptimism. *See* Dale Griffin & Amos Tversky, *The Weighing of Evidence and the Determinants of Confidence*, 24 COGNITIVE PSYCHOL. 411 (1992). *Compare* John Jacob et al., *Expertise in Forecasting Performance of Security Analysts*, 28 J. ACCT. & ECON. 51 (1999) (providing evidence that analyst forecast accuracy does not increase with experience) *with* Michael B. Mikhail et al., *The Development of Expertise: Do Security Analysts Improve their Performance with Experience?*, J. ACCT. RES. 131 (1997) (finding a statistically significant decline in analyst forecast errors as their firm-specific experience increases).

27. Many other behavioral biases have been documented. For example, under the confirmation bias, people tend to confirm prior decisions regardless of whether the decisions were correct at the time they were made. *See, e.g.*, R. Forsythe et al., *Anatomy of an Experimental Political Stock Market*, 82 AM. ECON. REV. 1142 (1992); Charles G. Lord et al., *Biased Assimilation ant Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 J. PERSONALITY & SOC. PSYCHOL. 2098 (1979).

28. Social norms may also affect the magnitude of agency costs in different countries. In a country where the norm is for agents to adhere faithfully to the interests of principals and those found deviating from the norm are shamed in their communities, agents may be much less likely to engage in self-interested behavior. On the other hand, in countries where agents routinely sacrifice their principal's best interest (by taking bribes, for example) and people commonly treat such practices as part of the business culture, agents are far more likely to act with self-interest.

risk facing investors when they seek to raise capital in the market.[29]

Not all investors, however, are rational and fully informed. Particularly smaller, individual investors may lack the information and expertise to assess the credibility of specific intermediaries. Bernard Black, for example, has made the argument that some intermediaries may free ride on the reputation of other intermediaries.[30] Where investors generally are not able (or find it prohibitively costly) to distinguish precisely among different intermediaries, a high-quality intermediary may find that other, more low-quality intermediaries benefit from the high-quality intermediary's investment in reputation. Consequently, intermediaries face a reduced incentive to invest in building their reputation.

A related observability problem exists. Audits sometimes turn out inaccurate, and analysts occasionally (in recent memory, often) are wrong in their recommendations. Institutional investors may make poor investment choices. Whether such unfortunate events are due to unforeseeable circumstances or, instead, are due to failure on the part of the intermediaries to take actions in the best interests of investors is sometimes unclear to the market. Where the market believes, for instance, that a positive probability exists that a bad event is not due to intermediary failure, intermediaries that fail investors will not suffer the full hit to their reputations.[31] On the other hand, intermediaries that perform up to their ability in protecting investors but simply get unlucky will get penalized to the extent the market is unable to distinguish them from poor quality intermediaries.

Some investors may suffer from a variety of behavioral biases, in addition to informational problems. Individuals, for example, may act with overconfidence in their ability to pick investment "winners."[32] Individuals may also make decisions subject to framing effects. For instance, they may purposefully avoid selling losing stocks longer than warranted to avoid realizing a loss on their investment (loss aversion).[33] Conversely, investors may treat gains as "house money," making overly risky investment decisions with the gains. Investors suffering from behavioral biases (or otherwise irrational decision-making) may not properly account for the risks of relying on particular intermediaries. Overconfident investors, for example, may simply

29. *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

30. *See* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 788 (2001).

31. *See* Coffee, *supra* note 11, at 1415.

32. *See* Brad Barber & Terrence Odean, *Boys Will Be Boys: Gender, Overconfidence, and Common Stock Investment*, 116 Q. J. ECON. 261 (2001) (providing evidence that male traders—particularly young males—engage in frequent trades and experience reduced returns).

33. *See* Hersh Shefrin & Meir Statman, *The Disposition To Sell Winners Too Early and Ride Losers Too Long: Theory And Evidence*, 40 J. FIN. 777, 788 (1985) (reporting evidence that investors sell stocks with gains too quickly and hold on to stock with losses too long, thereby suffering from a higher tax liability than necessary).

follow the buy recommendations of analysts, regardless of the possible conflict of interest risk.[34]

Social norms may interact with investor behavioral biases. Where a deeply-rooted active investor norm arises, more investors may become pulled into engaging in active investment (often to their detriment). For instance, in the U.S. during the internet boom, discussions of investments became popularized in web sites such as those hosted by The Motley Fool.[35] While perhaps only a correlation, large numbers of investors also took up day trading during the same time period.[36]

Firms whose securities trade in an efficient market provide some amount of protection for the unsophisticated and behaviorally challenged. To the extent larger, more sophisticated investors price the value of particular securities, even those investors lacking information or operating under a behavioral bias may pay a price commensurate with the value of the securities which they purchase. Not all securities, however, trade in an efficient market.[37] Securities of smaller firms or firms which trade in less-developed markets may lack an efficient market. Even for firms whose securities do trade in larger, well-developed markets, herding and other forces may cause market prices to move away from the efficient price point.[38] Case in point, if large numbers of investors exhibit overconfidence in their trades and are unaware of possible conflicts of interest of the part of analysts, sophisticated investors may find it more profitable to follow an upward trend in price (due to the analysts' positive recommendations) than to arbitrage against that trend.[39]

In sum, the starting point in determining failures on the part of intermediary institutions to protect investors is financing. Intermediaries may react to inadequate financing with less than desirable amounts of information services (from the perspective of investor and social welfare). For intermediaries that receive financing directly or indirectly from a publicly-traded firm, a different sort of problem arises: managers may use their power to direct funds as a

34. For a general discussion of the implications of investor behavioral biases, see Stephen J. Choi & A. C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003).

35. The Motley Fool maintains several discussion boards devoted to investing, *at* http://boards.fool.com (last visited Feb. 4, 2004). Investors can find discussion devoted to retirement investing, day trading, and other topics. *See id.*

36. Since the end of the latest bull market, the number of day traders have diminished. *See* Aaron Elstein, *Yes, Day Traders Still Exist, They Just Keep a Lower Profile*, WALL ST. J., Oct. 17, 2002, at D4 (reporting a fall in the number of full-time day traders from 20,000 to 7,500).

37. Indeed, Gordon uses the collapse of Enron (and the market's inability to foresee many of the failures leading to the collapse) as evidence of a lack of inefficiency in the market. *See* Gordon, *supra* note 11, at 1235-40.

38. *See* J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703, 703 (1990) ("The unpredictability of noise traders' beliefs creates a risk in the price of the asset that deters rational arbitrageurs from aggressively betting against them.").

39. *See* J. Bradford DeLong et al., *Positive Feedback Investment Strategies and Destabilizing Rational Speculation*, 45 J. FIN. 379 (1990).

means to corrupt the intermediaries. Reputation provides one solution to the problem of corruption. Nonetheless, relying on reputation results in more concentrated intermediary services markets (with correspondingly higher fees). Moreover, reputation may fail due to both individual agency problems within an intermediary and an inability on the part of investors to distinguish among intermediaries.

II. INSTITUTION-FOCUSED REGULATION IN THE UNITED STATES

Institutions within the United States do not operate in a completely free market. Instead, securities market intermediaries are regulated pursuant to the federal securities laws, among other regimes. In theory, regulation may provide a more effective means of addressing the various forms of securities intermediary failure than the market. The government enjoys a monopoly on certain forms of sanctions, including criminal penalties. Furthermore, the government, as a centralized actor, may have economies of scale in monitoring the securities market as well as disseminating information to investors.

A vast array of U.S. regulations deals with securities intermediary institutions. John Coffee has observed that various regulations dealing with the securities fraud liability of intermediaries (including in particular auditors) have moved toward reduced liability over the 1990s.[40] This Part discusses three recent regulatory reforms in the United States aimed at shoring up the role of securities market intermediary institutions in protecting investors: (A) Regulation FD, (B) the Sarbanes-Oxley Act, and (C) the Spitzer-SEC Wall Street Settlement.

A. Regulation FD

Selective disclosures occur when managers of a firm distribute material, non-public inside information to a select group of favored outside investors and analysts. For many years, the SEC attempted to classify selective disclosures as impermissible "tips" under the insider trading laws. The Supreme Court in *Dirks v. SEC*, however, held that tippees violate the insider trading laws only when they receive information from a tipper in a situation where the tipper violates his fiduciary duty and the tippee knew (or should have known) of the breach.[41] Importantly, the Court required that the fiduciary breach result in a

40. *See* Coffee, *supra* note 11, at 1409-12. Coffee theorizes that the rise in intermediary failures is due, in part, to the reduction in antifraud incentives. *See id. But see* Ribstein, *supra* note 11, at 33-34 (questioning the impact of the reduction in antifraud liability over the 1990s).

41. The Court stated:

> [A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

Dirks v. SEC, 463 U.S. 646, 660 (1983).

personal benefit from the tipper.[42] In doing so, the Court was particularly concerned with giving corporate officers the ability to pass inside information freely to analysts.[43] While the SEC has attempted to characterize selective disclosures to analysts within the confines of the *Dirks* definition of insider trading,[44] in 2000 the SEC utilized its rulemaking authority to promulgate Regulation FD, constraining further the ability of corporate officers to provide information selectively to outside analysts among others.[45]

Regulation FD is limited in application to only Exchange Act reporting U.S. companies[46] and those working on behalf of Exchange Act reporting companies.[47] Regulation FD, moreover, does not restrict selective disclosure to all possible recipients; instead, it prohibits selective disclosure of non-public material information to broker-dealers, investment advisors, investment companies, and any investor that is reasonably expected to trade on the information must also disclose the information to the market at large.[48] Foreign issuers are exempt from the coverage of Regulation FD.[49]

Unlike many other provisions of the U.S. securities laws, private antifraud

42. *See id.* at 662 ("[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders."). *See also id.* at 664 ("The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.").

43. *See id.* at 659 n.17 (discussing the concern that too broad a reach for insider trading liability may have an "inhibiting influence on the role of market analysts").

44. The SEC in *SEC v. Stevens* attempted to characterize a tip from a corporate CEO to an analyst as involving personal benefit, because the officer enhanced his reputation from the tip. *See* SEC v. Phillip J. Stevens, Litigation Release No. 12813, 1991 SEC LEXIS 451, at *2 (Mar. 19, 1991). The CEO settled with the SEC, however, and the case never reached court. Commentators, however, have criticized the SEC's position. *See* John C. Coffee, Jr., *Is Selective Disclosure Now Lawful?*, N.Y.L.J., Jul. 31, 1997 at 5. *See* Fisch & Sale, *supra* note 19, at 1061 (noting that after *Stevens* the SEC "stopped bringing selective disclosure actions based on section 10(b)").

45. *See* Securities and Exchange Commission, *Selective Disclosure and Insider Trading*, Rel. No. 34-43154, Aug. 15, 2000, 2000 WL 1201556 (S.E.C.) [hereinafter SEC Promulgating Release].

46. The Exchange Act imposes periodic information reporting requirements (including annual Form 10-K and quarterly Form 10-Q filings) for certain issuers, commonly known as "Exchange Act reporting companies." *See* 15 U.S.C. §§ 78a-78mm (2003) [hereinafter Exchange Act]. Companies listed on a national securities exchange must register and comply with the SEC's periodic information disclosure requirements. *See* Exchange Act §§ 13(a), 12(b); *see also* Exchange Act § 13(a)(1) (defining "exchange" for the purposes of the Exchange Act). Additionally, companies whose total assets exceed $10 million and have a class of equity security (other than an exempted security) held of record by more than 500 shareholders must register the securities under the Exchange Act and thereby come under the periodic reporting requirements of Section 13(a). *See* Exchange Act §§ 13, 12(g); *see also* Rule 12g-1 (raising the asset requirement to $10 million). Companies which recently filed a registration statement that has become effective under the Securities Act must also comply with the periodic reporting requirements. *See* Exchange Act § 15(d).

47. *See* Rule 101(b), Regulation FD (defining "issuer" to encompass primarily Exchange Act reporting companies).

48. *See* Rule 100(b)(1), Regulation FD.

49. *See* SEC Promulgating Release, *supra* note 45, at *6. For a discussion of the advisability of applying Regulation FD to foreign issuers, see Merritt Fox, *Regulation FD and Foreign Issuers: Globalization's Strains and Opportunities*, 41 VA. J. INT'L L. 653 (2001).

liability does not follow from a violation of Regulation FD.[50] Violators face only SEC enforcement. Intentional selective disclosure requires the issuer to disclose the same information simultaneously to the public.[51] In cases of unintentional selective disclosures, Regulation FD requires the issuer to disclose the information publicly within twenty-four hours or by the time trading commences in the NYSE (whichever is sooner).[52] Moreover, violation of Regulation FD does not affect the ability of issuers to employ Forms S-2 or S-3 for a public offering, as well as investors to use Rule 144 of the Securities Act to sell restricted securities.[53]

Removing the ability of firms to make selective disclosures works to level the playing field for analysts and outside investors. The playing field, of course, is still not completely level. Analysts and certain outside investors may expend (often considerable) resources in securities research to obtain an information advantage. Nonetheless, information advantages obtained at relatively low cost from corporate managers is curtailed under Regulation FD. At first glance, removing such advantages may strike some as intuitively fair.[54] Taking into account the various categories of institutional related problems, however, gives a more mixed picture on the value of Regulation FD in protecting investors.

From a financing perspective, the prohibition on selective disclosure removes a mechanism for firms to subsidize analysts. Selective disclosures help finance favored analysts to the extent the analyst is either able to trade based on the information or sell the information to its clients.[55] Particularly smaller firms without a large following of analysts may face a need to subsidize an analyst to initiate coverage on the firm. Analysts earn a return based on the ability to sell information to investors. For smaller firms in less-traded markets, fewer investors may actively follow such companies—giving analysts reduced profitability. Without the ability to give selective disclosures, therefore, an issuer may find itself with reduced analyst coverage.[56]

The ability of issuers to use selective disclosures to finance analysts,

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50. *See* Rule 102, Regulation FD.

51. *See* Rule 100(a)(1), Regulation FD (requiring simultaneous disclosure in the case of intentional selective disclosure).

52. *See* Rule 100(a)(2), Regulation FD (requiring disclosure "promptly" in the case of unintentional selective disclosures); Rule 101(d), Regulation FD (defining "promptly").

53. *See* Rule 103, Regulation FD.

54. SEC For example, the SEC has explained that:

> [it] believes that the practice of selective disclosure leads to a loss of investor confidence in the integrity of our capital markets. Investors who see a security's price change dramatically and only later are given access to information responsible for that move rightly question whether they are on a level playing field with market insider.

SEC Promulgating Release, *supra* note 45, at *2.

55. *See* Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and "Negative" Property Rights in Information*, 87 VA. L. REV. 1229, 1268-69 (2000).

56. For a discussion of companies without analyst coverage, see Sanford B. Kaynor Jr. & Michael Pereira, *Orphan Story*, THE DAILY DEAL (N.Y.), Aug. 29, 2001, at 22.

however, comes with the risk of corruption. The SEC feared that managers were using selective disclosures to pressure analysts into giving better-than-warranted recommendations.[57] Regulation FD, therefore, highlights the tension between financing and conflicts of interest. To reduce analyst corruption, the SEC cut off an avenue of funding for many analysts. What is uncertain is whether this tradeoff results in an overall increase or decrease in investor welfare.

Regulation FD also has an ambiguous impact on the problem of unsophisticated and uninformed investors. On the one hand, firms may react to the prohibition on selective disclosures through greater disclosures to the marketplace.[58] In such a case, more information is revealed to investors, leading to more accurate prices and lower research costs generally on the part of dispersed investors. Another possibility exists, however. Firms may react to Regulation FD through a reduction in the overall amount of information they provide to the market.[59] Analysts may then face more obstacles in ferreting out potential fraud within companies.[60] Some outside investors and analysts may also expend greater (and duplicative) resources in determining the content of information that otherwise might have been disclosed by the company prior to the promulgation of Regulation FD.

B. Sarbanes-Oxley Act of 2002

In the wake of scandals at Enron, WorldCom, Tyco, Global Crossings, and

57. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 42,259 (proposed Dec. 20, 1999) (to be codified at 17 C.F.R. parts 230, 240, 243, 249), 1999 WL 1217849, at *4 ("[A]nalysts are likely to feel pressured to report favorably about particular issuers to avoid being 'cut . . . off from access to the flow of non-public information through future analyst conference phone calls' or other means of selective disclosure.").

58. Evidence exists that the information environment post-promulgation of Regulation FD has not been negatively affected. *See* Frank Heflin et al., *Regulation FD and the Financial Information Environment* (undated manuscript) (focusing on the information environment prior to an earnings disclosure and reporting no evidence that Regulation FD resulted in a reduction in the quality of this information environment), *available at* http://ssrn.com/abstract=276768 (last visited Jan. 28, 2004).

59. *See* Cheryl Winokur Munk, *SEC Disclosure Rule Dims Appeal of Conferences*, WALL ST. J., Feb. 27, 2001, at C16 (reporting that Regulation FD "has made companies less likely to share juicy tidbits in breakout sessions and in general presentations at these conferences" and thereby resulting in drop in attendance at investor conferences).

60. *See* Ribstein, *supra* note 11, at 50 (noting that "private disclosures to analysts encourages them to formulate and ask follow-up questions that they would not ask in public calls because it would reveal their research to competitors"). Regulation FD, therefore, may adversely impact the ability of analyst firms—which previously enjoyed selective disclosures—to provide accurate forecasts and recommendations. *See* Partha Mohanram Shyam V. Sunder, *Has Regulation Fair Disclosure Affect Financial Analysts' Ability to Forecast Earnings*? (2002) (working paper) (reporting evidence that analyst forecast errors and forecast dispersion increased after the promulgation of Regulation FD), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=297933; Andreas Gintschel & Stanimir Markov, *The Effectiveness of Regulation FD* (May 5, 2003) (working paper) (reporting evidence that analysts earnings forecasts and recommendations after the promulgation of Regulation FD resulted in a lower price impact upon release), *available at* http://papers.ssrn.com/ abstract=319423 (last visited Jan. 28, 2004).

other corporations, Congress enacted the Sarbanes-Oxley Act of 2002, a series of somewhat disjointed reforms targeting securities market intermediary institutions.[62] Sarbanes-Oxley first established a new Public Company Accounting Oversight Board (the "Oversight Board") to oversee the auditing profession. Under the Act, the Oversight Board consists of five members, two of whom must be (or have been) certified public accountants, while the remaining three must not be CPAs.[61] Following the tactics taken in other areas of securities regulation, Congress established the Oversight Board as a self-regulatory organization—relying on the expertise of industry members to guide the regulation of auditors.[62] As with other SROs, the SEC has oversight responsibility over the Oversight Board.[63] The Act also provides for a greater direct role for the SEC in monitoring public company filings (with a corresponding increase in the SEC's budget).[64]

Despite the willingness of Congress to leave much of the regulation of auditors and corporate financial statements to the new Oversight Board and the SEC, Congress did make a number of targeted substantive interventions dealing with the provision of non-audit related consulting services.[65] The Sarbanes-Oxley Act prohibits an auditor from providing a delineated list of non-audit services contemporaneous with an audit.[66] The prohibited services include financial information systems design, management services, and legal services, but, significantly, do not include tax consulting.[67] Auditors, after pre-approval on the part of the issuer's audit committee, may continue to provide non-audit related tax consulting.[68]

To reduce the possibility of individual conflicts of interest, Sarbanes-Oxley requires the lead partner and reviewing partner of the auditor to rotate at least once every five years.[69] Similarly, the Act mandates that several top officers of

61. *See* Sarbanes-Oxley Act.

62. Among other things, the Public Company Accounting Oversight Board must:

(2) establish, or adopt, by rule, "auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers;" (3) conduct inspections of accounting firms; (4) conduct investigations and disciplinary proceedings, and impose appropriate sanctions. . . .

Sarbanes-Oxley Act § 103 .

63. *See* Sarbanes-Oxley Act § 107.

64. *See* Sarbanes-Oxley Act §§ 408, 601.

65. Congress also provided for specific reporting requirements for off-balance sheet transactions in Section 401(a) of the Sarbanes-Oxley Act. The Act also provides for more rapid reporting of corporate filing information. *See* Sarbanes-Oxley Act § 409.

66. *See* Sarbanes-Oxley Act § 201.

67. *See id.*

68. *See id.* Sarbanes-Oxley follows up on the SEC's earlier efforts in 2000 that, among other things, required companies in their proxy disclosures to report aggregate audit and non-audit related fees. *See* Final Rule: Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,009 (Dec. 5, 2000).

69. *See* Sarbanes-Oxley Act § 203.

the issuer (including the CEO, Controller, CFO, and Chief Accounting Officer) not be employed by the issuer's auditor within the one year period preceding the audit.[70]

Sarbanes-Oxley also focuses on the composition of the audit committee of a corporation's board of directors. The Act requires the SEC to prohibit the securities exchanges and Nasdaq from listing companies without a separate audit committee on the board of directors.[71] The Act requires that each member of the audit committee be "independent," defined as "not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof."[72] The Act also makes clear that the audit committee has responsibility for the selection, compensation, and oversight of the public accounting firm for the issuer.[73]

To bolster further the credibility of corporate reporting, Sarbanes-Oxley imposes on the CEO and CFO a duty to certify personally the audit report.[74] The Act also requires those officers to certify all financial statements filed with the SEC as well as the company's system of internal controls.[75] The certification of financial statements must state that the disclosures fully comply with the Exchange Act reporting requirements and that the "information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer."[76] Knowing and willful violation of the CEO and CFO financial statement certification requirement results in a fine of up to $5 million and imprisonment of up to 20 years.[77] Sarbanes-Oxley makes explicit that: "It shall be unlawful . . . for any officer or director of an issuer to take any action to fraudulently influence, coerce, manipulate, or mislead any auditor engaged in the performance of an audit for the purpose of rendering the financial statements materially misleading."[78] The Act also provides penalties requiring that the CEO and CFO must "reimburse the issuer for any bonus or other incentive-based or equity-

70. *See* Sarbanes-Oxley Act § 206.

71. *See* Sarbanes-Oxley Act § 301.

72. *See id.*

73. *See id.*

74. *See* Sarbanes-Oxley Act § 302. The CEO and CFO, in particular, must attest to the "appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer." *Id.* Section 408 of the Sarbanes-Oxley Act also provides for increased SEC review of corporate filings. *See* Sarbanes-Oxley Act § 408. A related measure in the Sarbanes-Oxley Act focuses on the corporate ethics code (if any) of public corporations. Section 406 of the Act requires Exchange Act reporting companies to disclose whether they have a corporate ethics code for senior financial officers and also to disclose any changes or waivers in the code for such officers. *See* Sarbanes-Oxley Act § 406.

75. *See* Sarbanes-Oxley Act § 302

76. *See* Sarbanes-Oxley Act § 906(a), Tit. IX (codified in 18 USC § 1350).

77. *See id.*

78. Sarbanes-Oxley Act § 303.

based compensation received" during the twelve month period after the issuance or filing of the materially non-compliant document and "any profits realized from the sale of securities of the issuer" during that period.[79]

While Sarbanes-Oxley has a wealth of provisions targeting auditors and financial reporting more generally, the Act says relatively little about securities analysts. Section 501 of the Act simply leaves it to the SEC to adopt conflict of interest rules governing analysts recommending equity securities.[80] The Act, instead, directs more attention toward attorneys, imposing an affirmative duty on attorneys to disclose corporate fraud.[81] In a similar vein, the Act provides more stringent protections for whistleblowers.[82]

Sarbanes-Oxley finally provides a number of provisions aimed at enforcement. The Act first makes it a felony for someone who "knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct or influence" any federal investigation.[83] Sarbanes-Oxley provides for a number of penalty enhancements for white collar crime[84] and reduces the standard which the SEC must meet to ban corporate officers and directors from serving in publicly-traded companies.[85] The Act also extends the statute of limitations for fraud claims.[86]

As with Regulation FD, Sarbanes-Oxley does not address all of the problems facing intermediary institutions equally well. Sarbanes-Oxley exhibits the tension between financing and conflicts of interest. Congress, in writing the Act, focused primarily on the more visible conflicts of interest problem. While prohibiting auditors from providing a large number of non-audit related

79. Sarbanes-Oxley Act § 304. On a related note, the Act also prohibits the issuer from making personal loans to the directors and executive officers. *See* Sarbanes-Oxley Act § 402(a).

80. *See* Sarbanes-Oxley Act § 501. Among other things, Sarbanes-Oxley requires that the SEC adopt rules which restrict the "prepublication clearance or approval of research reports by persons employed by the broker or dealer who are engaged in investment banking activities . . . ." *Id.* at § 501(a). The SEC adopted Regulation AC in February 2003, which requires analysts to disclose their compensation related to their recommendations and to certify the accuracy of the opinions in their research reports. *See* Regulation Analyst Certification, Sec. Act. Rel. No. 33-8193 (Feb. 20, 2003), *available at* http://www.sec.gov/rules/final/33-8193.htm (last visited Aug. 5, 2003).

81. *See* Sarbanes-Oxley Act § 307 (requiring the SEC to implement rules mandating that attorneys representing issuers "report evidence of a material breach of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof. . . .").

82. *See* Sarbanes-Oxley Act § 806.

83. Sarbanes-Oxley Act, Tit. VII. The Act also extends the statute of limitations for securities fraud and makes a new crime for securities fraud with up to a 10 year imprisonment. *See id.*

84. *See* Sarbanes-Oxley Act Tit. IX. Among other things, the maximum criminal penalty for mail and wire fraud was increased from 5 to 20 years. *See id.*

85. *See* Sarbanes-Oxley Act § 1105 (giving the SEC power to ban a person from serving as a corporate officer or director of an Exchange Act reporting company "if the conduct of that person demonstrates unfitness to serve as an officer or director of any issuer").

86. Sarbanes-Oxley Act § 804 (extending the statute of limitations for private fraud claims to the earlier of "2 years after the discovery of facts constituting the violation . . . [or] five years after the violation.").

consulting services contemporaneously to audit clients reduces the possibility of conflicts, it also lessens the ability of auditors to obtain profits from their audit relationship.

A question exists why auditors require compensation through non-audit related services to help finance a quality audit. John Coffee and Jeff Gordon separately have made the argument that managers aiming to corrupt auditors have purposefully structured relationships with auditors to include highly profitable non-audit consulting services as a means of increasing the ability of managers to reward (and punish) auditors.[87] U.S. securities regulation requires firms to disclose when they terminate a firm's auditor in a Form 8-K filing.[88] Managers seeking to discipline auditors that go against management's wishes through the outright termination of the auditor send a large negative signal to the public marketplace. Termination of an auditor's non-consulting services, on the other hand, is relatively non-transparent to the investing public.[89] Managers can thus punish auditors that fail to follow the managers' wishes through a reduction in the non-audit related consulting services.

Of course, the question remains why auditors that value their reputation would allow themselves to get pushed into a position where managers are able to discipline the auditors through low-visibility sanctions, such as the termination of non-audit related consulting services. One possible answer is that self-interested audit partners may have intentionally made the provision of audit services a loss leader, given that individual partners typically receive compensation from non-audit consulting revenues. Another answer is that the lack of competition in the audit business overall has generated complacency. At the very least, firms that do not guard jealously their audit reputation are not punished to the extent they would be if there were numerous competitors waiting to take audit business away from incumbent firms.[90]

The Sarbanes-Oxley Act's express prohibition on a wide variety of non-audit related services thus provides a means of blocking low visibility methods of auditor corruption. Nonetheless, the prohibition is not cost-free. Auditors may enjoy scale economies in providing certain forms of consulting services (including, for example, information systems design). Blocking auditors from providing such services may simply increase costs for issuers.[91]

The solution that the Sarbanes-Oxley Act provides with respect to agency

87. *See* Coffee, *supra* note 11, at 1411-12; Gordon, *supra* note 11, at 1237-38.

88. *See* Item 4, Form 8-K.

89. Both Coffee and Gordon separately refer to termination of non-audit consulting services as a "low-visibility" means of sanctioning auditors. *See* Coffee, *supra* note 11, at 1411-12; Gordon, *supra* note 11, at 1237-38.

90. *See* Coffee, *supra* note 11, at 1414-15.

91. *See also* Ribstein, *supra* note 11, at 40-41 (noting that "prohibiting some links between monitors and firms, such as the performance of nonaudit services, may block 'knowledge spillovers' that give monitors access to valuable information").

problems within auditors is also unclear in its effect on overall investor welfare. The requirement that auditing partners and reviewing partners must rotate once every five years helps limit agency problems. Without the ability to enjoy the profits from a long-term relationship with the grateful management of a client, an auditing partner may think twice about subverting an audit in order to benefit management. On the other hand, mandatory rotation may reduce the ability of auditors to develop an in-depth knowledge of their client's financial situation through long experience. Without such knowledge, audits may become both more costly and less effective.

Sarbanes-Oxley's focus on independent audit committees is similarly ambiguous in its value for investors.[92] Of course, if boards (and committees of the board) are somehow energized to work diligently in the best interests of shareholders, then investor welfare will increase. However, even independent board members will face substantial time pressures from their full-time day jobs. Increased barriers against providing directors incentive-based stock option compensation may also leave directors more indifferent to the overall value of the company.[93] Simply removing the corrupting influence of managers thus will not affirmatively give directors the incentive to protect investor welfare.[94]

Likewise, pre-Enron CEOs and CFOs already had incentives—both due to their personal reputation as well as pre-existing requirements that they must sign the annual 10-K filings[95] (exposing them to potential securities antifraud liability)—to ensure that disclosed financial information was accurate.[96] Requiring explicit certification, while dramatic, may not add much in the way of added deterrence.[97] And even if deterrence is enhanced, to the extent they are personally liable, CEOs and CFOs may expend overly large amounts of effort verifying corporate disclosures, taking them away from focusing on

92. Jeff Gordon has made a related suggestion of creating "trustee" directors who would receive only flat, non-stock based compensation, be self-nominated by other trustee directors, and come with stringent prohibitions on side payments from management. *See* Gordon, *supra* note 11, at 1243-45.

93. NEW YORK STOCK EXCHANGE, NYSE LISTED COMPANY MANUAL § 303A(8) (requiring shareholder approval of all equity-based compensation for listed company employees), *available at* http://www.nyse.com/listed/1022221393251.html.

94. Ribstein makes the related argument that truly independent directors may lack the requisite experience and sophistication to monitor the company's management adequately. He claims:

> In order to avoid suspect relationships and connections, corporations may have to appoint more directors from outside the business community. Board members such as law professors with little hands-on business experience and no formal connections with a company may not be sophisticated enough to spot problems or be able or willing to stand up to a powerful executive.

Ribstein, *supra* note 11, at 27-28.

95. *See* Exchange Act § 13(a); Exchange Act, Form 10-K. CFOs must also sign the quarterly 10-Q filings. *See* Exchange Act, Form 10-Q.

96. *See* Ribstein, *supra* note 11, at 35.

97. Ribstein notes that the CEO and CFO certification requirements enhance deterrence in at least two aspects. First, the certification covers the system of internal controls. Second, Section 304 of the Sarbanes-Oxley Act requires the reimbursement of certain types of executive compensation after an accounting restatement. *See id.*

generating new business and increasing the profitability of their companies.[98]

Perhaps the most long-lasting effect of Sarbanes-Oxley is its provision of alternative mechanisms to help auditors bond themselves to remaining credible. In theory, the Oversight Board provides a lower cost mechanism for auditors to bond themselves to providing high quality audits. Rather than rely on reputation and the prospect of losing out on super-competitive profits, audit firms may point to possible investigation and sanction from the Oversight Board as a mechanism to bond the auditor's credibility. To the extent the Oversight Board provides a low-cost means for auditors to bond their credibility, the Oversight Board makes new entry more possible into the auditing business and, as a result, greater competition. What is uncertain, however, is how effective an institution the Oversight Board will become. Plagued with controversy in the selection of its chairman from the start,[99] the Oversight Board may come under the influence of the auditing industry, reducing its effectiveness.[100] Conversely, the Board may become detached from the needs of both auditors and investors and impose non cost-effective restrictions on auditors. Because the oversight role of the Oversight Board is mandatory, auditors unhappy with the cost-benefit of using the Oversight Board for bonding purposes will not have the ability to escape to any alternative.

Even less likely to succeed is the Act's attempt to turn attorneys into gatekeepers to protect investors through the requirement that attorneys must disclose corporate fraud. Unlike auditors—who play a natural gatekeeping role in protecting investors—attorneys function more like transaction cost engineers,[101] assisting corporate clients in structuring transactions to maximize their legal value. As transaction cost engineers, attorneys receive little compensation (and build only a negligible reputation) for their ability to protect investors.[102] Because revealing corporate fraud is against the attorney's financial interest (and does not directly enhance the attorney's reputation as a

98. *See also id.* at 37-39 (noting that executives may "reduce the variance in its expected returns, thereby reducing the change of an earnings 'surprise' that could trigger massive liability" and that "executives may under-report earnings on the theory that they are less likely to be held liable for overly conservative than for exaggerated earnings reports").

99. *See* Michael Schroeder, *Webster Makes It Official and Quits Accounting Board*, WALL ST. J., NOV. 13, 2002, at A3 (relating details on the controversy surrounding the selection of William Webster as the first chair of the new public accounting oversight board).

100. *See* Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L REV. 909, 913-14 (1994) (critiquing the SEC from a public choice perspective).

101 See Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L.J. 239, 252-56 (1984) (advancing the idea that lawyers act as "transaction cost engineers").

102. *See* Coffee, *supra* note 11, at 1417 (noting that "differences exist because lawyers specialize in designing transactions to avoid regulatory, legal, and other costly hurdles, but seldom provide meaningful certifications to investors").

transaction cost engineer), simply imposing a disclosure duty may result in less than full compliance. Moreover, corporations and their managers may react to the duty on the part of attorneys to disclose simply by cutting off disclosure of sensitive information.[103] Because attorneys do not provide the public any certification of information from the firm, cutting off disclosure of information to attorneys—unlike a similar shutdown of information to auditors—does not result in any penalty for the firm.

C. Spitzer Settlements

Parallel with recent reform efforts targeting auditors, regulators have focused separately on abuses within the analyst industry itself. In early 2002, Eliot Spitzer, the New York State Attorney General, uncovered evidence in a series of emails from Merrill Lynch that called into question the objectivity of analyst recommendations.[104] Spitzer's investigation eventually culminated in a settlement with many large Wall Street brokerage firms.

Towards the end of 2002, Spitzer announced a joint settlement between the New York State Attorney General's office, the SEC, the NASD, and ten Wall Street brokerage firms. Under the Spitzer-SEC settlement, Goldman Sachs, Merrill Lynch, and other Wall Street firms agreed to pay a total of $1.4 billion.[105] Under the terms of the settlement, $432.5 million is earmarked for independent securities analyst research.[106] Each settling Wall Street firm is required for a period of five years to contract with at least three independent research firms to provide securities research to customers of that firm. The Wall Street firms are required to give an "independent consultant" the final say in choosing the independent research firms.[107] Another $387.5 million is allocated for investor restitution.[108] The settlement specifies that a distribution fund administrator be appointed (subject to court approval) to apportion the restitution monies.[109] Most of the remainder is given to the states in the form of fines (often not directed back toward investors) as well as funding for investor education efforts.[110]

103. *See* Ribstein, *supra* note 11, at 32 ("Those involved in a fraudulent scheme are unlikely to discuss it with nonparticipants. The new rules may inhibit even innocuous conversations that might have helped indirectly in uncovering frauds by making them fodder for federal litigation and investigations.").

104. *See* Gasparino, *supra* note 12, at A1.

105. *See* SEC Joint Press Release, *available at* http://www.sec.gov/news/press/2003-54.htm (last visited Jan. 28, 2004). The list of other settling Wall Street firms includes Bear Stearns & Co. Inc, Credit Suisse First Boston LLC, Lehman Brothers Inc., J.P. Morgan Securities Inc., Morgan Stanley & Co. Inc., Citigroup Global Markets Inc., UBS Warburg LLC, and U.S. Bancorp Piper Jaffray Inc. *See id.*

106. *See id.*

107. *See id.*

108. For information on the investor restitution funds and distribution process, see SEC, Questions and Answers Regarding the Distribution Funds in the Analysts Cases, *at* http://www.sec.gov/news/press/globaldistqa.htm (last visited Jan. 28, 2004).

109. *See id.*

110. *See id.* The settlement gives $387.5 million to the states and $80 million for investor

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The Spitzer-SEC settlement also includes a number of internal reforms within the Wall Street firms designed to separate analysts from investment banking. Among other things, the settlement requires that research analysts are separated from the investment banking business "including prohibiting analysts from receiving compensation for investment banking activities and prohibiting analysts' involvement in investment banking 'pitches' and 'roadshows.'"[111] While the Wall Street firms participating in the settlement are allowed to retain analyst departments, they are required to keep such departments separate from investment banking (including preventing the flow of information).[112] Furthermore, the research department's budget as well as the compensation for analysts must be determined without regard to revenues obtained from investment banking.[113]

As with Regulation FD and the Sarbanes-Oxley Act, the Spitzer-SEC settlement focuses much of its force on obvious conflicts of interest with the securities analyst profession. Stopping short of completely separating analysts from the investment banking business, the settlement imposes a number of artificial walls within the Wall Street firms. Despite the continued indirect reliance of analysts on revenues brought in through investment banking, the settlement at least reduces more obvious conflicts. With a reduction in conflicts, however, comes the possibility that analysts—now more tenuously connected with financing sources—may become underfunded within brokerage firms. Why would a brokerage firm pour money into sell-side analyst reports (intended to be distributed for free or at low cost) if now such reports do not help win investment banking business?[114]

Unlike Regulation FD and Sarbanes-Oxley, the Spitzer-SEC settlement not only works to limit conflicts but also proposes an alternative financing scheme in support of independent securities analyst research. The total amount of the

education. *See id. See also* Gregory Zuckerman & Ruth Simon, *The Stock-Research Pact: How Should States Use Money?*, WALL ST. J., May 2, 2003, at C1 (reporting that "[s]tates around the country plan to use $495 million from this week's $1.4 billion stock-analyst settlement to pay for a variety of things that include filling potholes, building public schools and endowing a university chair in business ethics"). The Spitzer-SEC settlement also imposes lifetime bans on two formerly prominent securities analysts, Jack Grubman and Henry Blodgett, from the securities business. *See* Deborah Solomon & Randall Smith, *The Stock Research Pact: Wall Street's Deal Comes Under Fire*, WALL ST. J., May 8, 2003, at C1.

111. *See* SEC Joint Press Release, *supra* note 105.

112. *See id.*

113. *See id.* The settlement goes on to provide that "[r]esearch management will make all company-specific decisions to terminate coverage, and investment bankers will have no role in company-specific coverage decisions." *Id.* The settlement also provides that "the ten firms have collectively entered in to a voluntary agreement restricting allocations of securities in hot IPOs—offerings that begin trading in the aftermarket at a premium—to certain company executive officers and directors, a practice known as 'spinning.'" *Id.*

114. Higher brokerage commissions provide one possible answer. However, the end of fixed rate commissions in the 1970s and competition from discount brokerage firms have reduced the ability of analysts to turn to brokerage commissions for their source of funding. *See* Fisch & Sale, *supra* note 19, at 1046 (describing use of fixed commissions to subsidize analyst research).

subsidy, however, represents only a fraction of the total pre-tax profits of the securities industry. While the settlement calls for a $432.5 million subsidy over five years for independent research, in 2000, the pre-tax profits of the securities industry totaled to $21 billion.[115] As well, it is unclear why Wall Street firms should have to pay for analyst research. In theory, analyst research goes to benefit investors; any financing solution, therefore, should work to collectivize the interests of investors in providing funds for value-increasing analyst research.[116] A large question also exists as to how such funds will be allocated. To the extent securities firms are able to pick the "independent" research firm themselves (even with the final say of a consultant), the research firms may fall under the influence of such firms. At the very least, independent research firms which desire to be picked in future years may lean toward favoring the position of the securities firms.[117]

Also different from Regulation FD and Sarbanes-Oxley is the Spitzer-SEC settlement's explicit focus on the problems facing the more unsophisticated investors in the marketplace. While the settlement's allocation of $80 million for investor education arguably may help raise awareness among investors of the risks they face, it is uncertain how effective investor education will be in changing the securities market environment. Much of the trading volume in the markets is not due to small individual investors, but rather to large, sophisticated institutional investors. Greater investor education will not have much impact on the larger sophisticated investors. Even for small, individual investors, whether education will matter turns on the problem facing such investors. Deeply-rooted behavioral biases may be resistant to education efforts.[118] Moreover, if the problem is a failure on the part of intermediary institutions to protect investors, education will accomplish little, unless targeted toward informing investors of such failures.

III. A FRAMEWORK FOR REGULATORY INTERVENTION

Despite the varying promise of Regulation FD, the Sarbanes-Oxley Act, and the Spitzer-SEC settlement, legal intervention inherently carries risks. First, it is difficult to know exactly how legal intervention will impact the markets. As discussed above in Part II, the recent legal reforms all work, to some extent,

115. *See* SEC Joint Press Release, *supra* note 105.

116. *See, e.g.*, Choi & Fisch, *supra* note 22, at 342.

117. Earlier, Spitzer had proposed utilizing a quasi-regulatory analyst oversight board to select twenty independent analyst firms to provide investors with subsidized research. *See* Charles Gasparino & Randall Smith, *New Plan: Stock-Research Cops*, WALL ST. J., Oct. 25, 2002, at C1. For a more in-depth discussion of the Spitzer-SEC settlement, see Choi & Fisch, *supra* note 22, at 341-44.

118. On the other hand, it is possible for education to reduce some biases. *See* Gregory Mitchell, *Why Law and Economics' Perfect Rationality Should Not Be Traded for Behavioral Law and Economics' Equal Incompetence*, 91 GEO. L.J. 67, 165-66 (2002) (discussing the ability of learning to improve decision making).

to prohibit possible conflicts of interest between securities market intermediaries and corporate managers providing financing. Simply eliminating such conflicts, however, would also work to reduce financing for intermediaries. Whether investors overall are benefited or not, therefore, is unclear. In the worst case scenario, securities intermediaries—unable to find alternative financing—may simply close up shop.[119]

Second, legal intervention often displaces market-based investor protections. Installing the Public Company Accounting Oversight Board over the accounting profession may very well increase auditing standards. On the other hand, the Oversight Board represents a new layer of regulation, which may in fact chill private attempts to develop new accounting standards and practices. To the extent the Oversight Board may override private innovations at any time, private actors will have less incentive to invest in such efforts.

Third, once legal interventions take hold, they often take on a life of their own. The market and investors operate endogenously with the regulatory climate. Investors that come to believe they are protected through regulation may choose (either rationally or perhaps overoptimistically) to take greater risks with their investment dollars and take fewer precautions. As a result, regulatory protections for such investors become self-justifying. Once market-based institutions are displaced, they may have a difficult time regenerating. In the absence of market-based institutions, staying with status quo regulation may then maximize investor welfare (even if the initial displacement of the market did not). Once given more authority, regulators (as well as newly appointed members of the Oversight Board among others) may resist relinquishing this authority, especially where it results in greater prestige and compensation.

Markets, of course, may also experience failure. Market participants, nonetheless, have a strong market incentive to correct failures; regulators ensconced with monopoly power lack any such incentive.[120] Worse still, when regulators and politicians do focus on the securities markets, this focus is often episodic and prone to overreaction. In the wake of a scandal, politicians in particular may feel large pressure to be seen as "fixing the problem," regardless of whether investors in fact are benefited in the long term.[121] The Sarbanes-Oxley Act itself was passed hurriedly by Congress in response to Enron and

119. Likewise, Sarbanes-Oxley provides for more rapid disclosure of corporate information to the market. *See* Sarbanes-Oxley Act § 409. It is unclear how much extra information the markets obtain from such increased disclosure. Moreover, disclosure is not without cost. Imposing a rapid disclosure requirement may impose high costs of firms attempting to gather corporate information to meeting reporting deadlines.

120. *See, e.g.*, Choi & Pritchard, *supra* note 36, at 42-43.

121. *See generally* Stuart Banner, *What Causes New Securities Regulation?: 300 Years of Evidence*, 75 WASH U L Q 849, 850 (1997) (putting forth evidence that significant legal changes frequently occur after major scandals in the securities markets).

other instances of corporate fraud. Behavioral biases on the part of regulators (such as overconfidence) may exacerbate this tendency to regulate first and ask questions later.[122]

In weighing the relative merits of regulation compared with the market, regulators face a range of options with varying tradeoffs between the costs of regulation and the failings of the market.[123] Consider the setting of market standards of behavior (e.g., the requirement of mandatory disclosure, restricting certain investors from participating in a private placement, prohibiting certain conflicts of interest, and so on).[124] At one extreme, regulators could simply engage in merit regulation, completely supplanting the market in selecting only "good" securities for investors. Merit regulation has the greatest impact on investors and also the greatest risk of regulatory error (as well as the possibility of regulatory capture). At the other extreme is purely private ordering: regulators could simply leave investors to contract for desired protections from issuers. Private ordering provides the lowest possibility for regulatory mistake or abuse; on the other hand, investors are left without any alternative means of protection other than contractual damages. Between these two extremes are a range of alternatives striking different balances between regulatory intervention (and the risks of regulation) against private ordering (and the failures of the market).

An alternative that is one degree less intrusive than merit regulation, for instance, involves mandatory prohibitions on various marketplace activities (stopping short, however, of prohibiting investors from particular investments). The bar on many non-audit consulting activities placed on auditors under Sarbanes-Oxley provides an example of this form of mandatory prohibition.[125] Moving closer toward private ordering are regulations that force market participants (such as issuers) to provide information to investors (including mandatory disclosure requirements and antifraud rules, among others). This option is similar to many provisions under the current U.S. regime. With less control comes a decreased ability on the part of regulators to protect investors; nevertheless, the chance of mistake and regulatory malfeasance is lessened. An even less intrusive approach would require judges on a case-by-case basis to

122. *See* Choi & Pritchard, *supra* note 36, at 20-36 (discussing the behavioral biases within the SEC).

123. Djankov et al. provide a similar framework to examine the desirability of more (or less) stringent government intervention to control disorder in the economy. *See* Djankov et al., *The New Comparative Economics*, *supra* note 13 (arguing that the different levels of government intervention in the economy result in a tradeoff between disorder in the absence of government intervention, at one extreme, and the risk of government expropriation of wealth, at the other extreme, which involves stringent intervention in the market).

124. In addition to substantive standards, a range of enforcement possibilities also exists, spanning from public enforcement and monitoring of the market to greater reliance on private litigation (including possibly class actions).

125. *See supra* notes 68-70 and accompanying text.

determine aspects of the securities laws (such as the definition of materiality).[126] Judges may lack expertise, and deciding issues on a case-by-case basis may result in slow, uncoordinated changes to the securities regime. At the same time, judges may lack the same incentive as bureaucrats to expand their powerbase, thereby reducing public choice concerns. At the end of the spectrum closest to purely private ordering, regulators may simply attempt to influence the market through the provision of investor educational materials.

How should we balance the shortcomings of both markets and regulation and determine exactly the proper amount of regulatory intervention? The answer depends on the precise type of market failure that initiates the need for regulation. Regulators may use the range of available regulatory options as a framework to consider the optimal response given the presence (or absence) of market-based incentives to address a defect affecting securities market intermediaries. Where the market has an incentive to correct for any failings, less interventionist regulation is required. On the other hand, where the market failure is deeply-rooted, then more interventionist regulation may be justified. To simplify, this Essay divides intermediary market failures into those (A) where participants in the market have an incentive to find a solution to the market failure and those (B) where individual participants have less of an incentive to solve a particular failure.

A. Intervention in the Presence of Market Alternatives

Where market failures exist alongside incentives among individual market participants to ameliorate those failures, regulators may benefit investors more by assisting the market with minimal intervention. Rather than displacing the market, regulators, for example, may choose a less intrusive approach designed to assist market-based solutions. Market-based solutions provide greater flexibility than mandatory regulatory intervention. Particularly given the wide range of problems facing intermediary institutions, flexibility is valuable in crafting a series of solutions over time. Market-based solutions also help ensure actual benefits for investors. When regulators work to assist market solutions rather than intervene directly, the danger of regulators becoming attached to a certain level of regulatory authority (and thus resistant to unwinding regulation, if necessary) is lessened.

Conflicts of interest and agency cost problems within securities intermediaries are examples of problems with potential market-based solutions. To the extent institutions are able to solve their conflict of interest and agency problems credibly, they will profit through higher fees (whether directly or indirectly from investors). Institutions, therefore, internalize the benefit of

126. *See* Basic v. Levinson, 485 U.S. 224, 238-39 (1988) (providing that materiality of a contingent event depends on the probability times the magnitude of the event).

addressing conflict of interest and agency cost problems. Nonetheless, the range of present market-based solutions through private ordering may be limited. Institutions may use both private contract and market based reputation as mechanisms to bond their fidelity to investors. Neither mechanism, however, is perfect. Relying solely on reputation, for example, is costly and often works only imperfectly to bond a firm's credibility.

Regulators may assist intermediaries in bonding their credibility in at least two ways. First, representing a level of intervention one step above purely private ordering, regulators may reduce the cost to investors of discerning the precise reputations of specific intermediaries. The SEC, for example, could maintain a centralized database of intermediaries and include disciplinary histories (or track record of complaints much like the Better Business Bureau).[127] The NASD already provides such a database for brokers. Within the NASD's CRD database, investors may look up the disciplinary history of a specific broker.[128] Greater information (at a lower cost) will allow investors to distinguish more accurately high performing intermediaries and provide a corresponding higher price of issuers associating with such intermediaries.

Second, regulators may increase the penalty to intermediaries that breach the trust of investors. Stronger penalties reduce the importance of market-based reputation bonding. Indeed, regulators may enjoy a comparative advantage in imposing penalties. Regulators have economies of scale in monitoring markets for intermediary failures. They also enjoy scale economies in maintaining an ability to enforce penalties across a wide variety of intermediaries. Regulators also may use penalties which intermediaries are unable to implement through private contract, such as imposing criminal penalties. Lastly, regulators are able to bind intermediaries to parties not in privity of contract with the intermediary.

The fact that regulators enjoy a comparative advantage in bonding intermediaries to protect investor welfare, however, does not mean that the bond must be made mandatory. Regulatory interventions incorporating aspects of private ordering are possible. The market may have a better sense than regulators of precisely the best combination of sanctions to impose on particular intermediaries that fail to protect investors. Mandatory solutions, in comparison, may lack comprehensiveness and flexibility. For example, while the Public Company Accounting Oversight Board provides an alternative bonding mechanism for auditors, it is limited in at least two respects. First, it covers only auditors. Second, as a quasi-regulatory entity, the Oversight Board may make mistakes or, worse still, come under the influence of management and auditors who profit from duping investors.

127. For more information on the Better Business Bureau, see BBB Homepage, *at* http://www.bbb.org (last visited Jan. 28, 2004).

128. Investors, for instance, may search for information on brokers at the NASD's public disclosure website, *at* http://pdpi3.nasdr.com/pdpi/Req_Type_Frame.asp (last visited Jan. 28, 2004).

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Regulators may improve on investor welfare by giving intermediary institutions the ability to pick and choose from various regulator-supplied bonding devices (termed "self-tailored regulation"). To the extent such choices are transparent to investors in the market, intermediaries that select value-increasing bonding mechanisms will experience an increase in their value to investors (and thus to issuers in the market). Importantly, self-tailored regulation allows intermediaries to adopt limits unavailable or ineffective through private contract, and to make the adoption both credible and transparent for investors. For example, intermediaries may self-tailor the level of government monitoring, enforcement, as well as the magnitude of penalties facing them for breaching their duty to investors (while possibly paying a fee to cover the regulator's additional costs). Upstart competitors may use self-tailored regulation to provide a credible means of bonding themselves to protecting investors, even without a large market share (and corresponding super-competitive profits).[129] Self-tailored regulation, therefore, may act as a mechanism to reduce the anti-competitive effects relying on reputation alone has on the intermediary market.

Intermediaries may also undo non-cost-effective prohibitions through a self-tailored regulatory system. While the Sarbanes-Oxley Act arguably moves in the right direction with its ban on auditing partners and review partners serving the same audit client for more than five years, such a flat ban may not maximize investor welfare across all types of intermediaries. Some audits may improve in quality when conducted under the supervision of an audit partner with more than five years of experience at a particular client. Allowing intermediaries to self-select into different forms of limits placed on agents gives intermediaries the ability to pick those prohibitions which maximize the joint value of the intermediaries and investors.

Of course, investors may fail to appreciate fully the selections on the part of intermediaries under a self-tailored regulatory system. Regulators may assist investors through disclosure of the self-tailored regime selected by each individual intermediary. Regulators may also constrain self-tailored regulatory choices to only increases in liability and monitoring above the present regime. Thus, if a specific intermediary desires more SEC monitoring and higher legal liability, regulators should provide a low-cost means for the intermediary to obtain such assurances for investors. That sort of one-way, ratchet-upward

129. Coffee notes that one of the costs of having little competition among intermediary gatekeepers is a lack of upstart competitors willing to push investor protection as a means of gaining business. *See* Coffee, *supra* note 11, at 1414-15. Coffee further writes:

> [I]f each of the Big Five were to prefer a strategy under which it acquiesced to clients at the cost of an occasional litigation loss and some public humiliation, it could more easily observe this policy if it knew that it would not be attacked by a holier-than-thou rival stressing its greater reputation for integrity as a competitive strategy.

Id. Self-tailored regulation overcomes one market barrier—the need to bond one's fidelity to investor protection—to the entry of new competitors.

approach to self-tailored regulation avoids the danger of intermediaries abusing choice to lower investor protections, while giving intermediaries that desire a low-cost means of bonding themselves the ability to do so.

Regulators may also go one step further and constrain the choices available to intermediaries to one of several well-defined options. Investors then will have an easy-to-follow range of possibilities (rather than the more open-ended nature of allowing intermediaries full freedom of choice in their regulatory regime). Moreover, regulators may harness the power of regulatory competition to determine this limited range. One possibility, for example, would be to give the securities exchanges and the NASD full freedom to determine their own individual rules for associated securities market intermediaries (allowing the exchanges and the NASD to utilize SEC enforcement resources as well as the full range of civil and criminal penalties).[130] Investors, issuers, and intermediaries could then select among the different regulatory regimes based on the maximization of their joint welfare, rewarding the exchange (or the NASD) with higher listing fees. To the extent a race-to-the-bottom is a concern, regulators could set a floor on the level of intermediary regulation, allowing the exchanges and the NASD to raise the level of regulation above the floor.[131] Notably, Sarbanes-Oxley moves in a different direction. Regardless of the specific merits of Sarbanes-Oxley, the Act is important for its federalization of many aspects of corporate governance.[132] To the extent Congress made the wrong cost-benefit analysis with the Act, federalization makes it difficult for the market to escape such provisions.

B. Intervention in the Absence of Market Alternatives

Where market failures are diffuse through the market and no one individual party has full incentives to find a solution, greater forms of regulatory intervention may be warranted. At least two forms of securities market failures

130. Under the current self-regulatory organization (SRO) system, neither the exchanges nor the NASD enjoy full freedom. Instead, the SEC must approve new SRO regulations, and the SEC retains the power to unilaterally change SRO regulations. *See* Securities Exchange Act § 19. The SEC may approve, disapprove, or modify SRO rules as it "deems necessary or appropriate to insure the fair administration of the self-regulatory organization" and among other things. *See* 15 U.S.C. § 78s(c) (2003).

131. While the evidence is not all one-sided, substantial evidence nonetheless exists supporting a race-to-the-top. For a survey, see Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 TEX. L. REV. 1657, 1702-26 (2002).

132. Ribstein addresses this importance in noting how the Sarbanes-Oxley Act's focus on:

> the composition of board audit committees, the activities of corporate counsel, protecting whistleblowers, regulating loans to officers, requiring reimbursement of bonuses and stock profits, mandating disclosures regarding particular types of transactions and of the issuer's code of ethics for senior financial officers, fixing responsibility on officers for corporate disclosures, and increasing the SEC's power to bar people from serving as officers and directors, all involve insertions of federal regulators in corporate governance.

Ribstein, *supra* note 11, at 57-58.

may fit into this category: (1) the financing problem facing intermediaries, and (2) the lack of sophistication among certain groups of investors. Even in such cases, however, the risk of regulatory error (or capture) may caution against moving too far along the spectrum toward more stringent regulatory approaches.

1. Financing Solutions

Because of the public goods nature of information, intermediaries looking directly to investors for funding often encounter free riders and are often unable to obtain full payment for the value of the services which they provide. Intermediaries, on the other hand, that turn to publicly-traded firms for financing may come under pressure from firm management to bias the information they provide investors in favor of management. Solving only the conflicts of interest problem without also addressing the financing problem runs the risk of simply drying up the market for intermediary services for investors.

No easy solutions exist, however, to the financing problem. Even issuers seeking to increase investor welfare may fail to provide adequate intermediary funding. To the extent some of the benefits from intermediary services accrue to large numbers of investors across different firms, no single issuer will have full incentives to provide funding.[133] Analysts covering a particular industry, for example, provide information on all companies in the industry. Proxy insurgents searching for poorly performing managers against which to launch a control contest provide a deterrent effect on managers at all firms. Furthermore, not all managers of issuers will seek to advance the interests of investors at the expense of the managers' own private benefits of control (particularly to the extent the firm is not about to raise capital in the markets). Even without free riding on intermediary funding, such managers will not choose to fund intermediaries that increase investor welfare.

Absent a voluntary solution on the part of issuers, regulatory intervention may be needed to impose a mandatory financing solution. Regulators may impose a levy on issuers and then reallocate the money to intermediary institutions, in a manner similar to that of the Spitzer-SEC settlement. Mandatory financing, nonetheless, leaves at least two possible areas for regulatory error. First, regulators may incorrectly set the size of the subsidy. Second, even if the size of the subsidy is correct, regulators may err in allocating the subsidies to different intermediaries. Due to the risk of regulatory error, not surprisingly, most mandatory subsidies found today in U.S. securities law exist in areas where the value of the subsidy is unambiguous and relatively uniform. For example, one justification for requiring a mandatory audit of

133. *See* Choi & Fisch, *supra* note 22, at 304-14.

public firms is that almost all public investors value such an audit. Moreover, the uniformity of investors' desire for an auditor makes it easy, from a regulatory viewpoint, simply to impose a single audit requirement on all publicly traded firms. Regulators need not decide precisely what kind of audit is required, to the extent a one-size-fits-all approach is sufficient to protect investors.

Most intermediary services, however, are not one-size-fits-all with respect to investor welfare. Government provision of subsidies to intermediaries is problematic and rarely occurs, despite the financing problem. Consider analyst subsidies. How are regulators to know which analysts to subsidize and by how much? What if the need to subsidize analyst research in particular industries varies over time?

The presence of even pervasive market failures, therefore, does not necessarily justify stringent intervention (including, at the extreme, merit regulation). Instead, regulators may move along the spectrum of regulatory possibilities toward greater levels of intervention, while taking advantage of extant market-based incentives. Put another way, the presence of some market-based incentives to correct for failures allows regulators to intervene with a less stringent form of regulation than in the situation where no market incentives exist at all.

Although obtaining subsidy dollars for intermediary services requires mandatory intervention, possible market-based solutions may exist at least for the problem of how to allocate subsidy dollars in situations where the optimal amount of the subsidy from the perspective of investors may vary across intermediaries (and across firms and time). Jill Fisch and I propose such a market-based allocation mechanism.[134] Under our proposal, regulators still face the challenge of determining the total size of intermediary subsidies (and how to levy firms to raise this subsidy amount). While difficult, regulators have levied firms for collectivizing services in other areas (including, most recently, to fund the Oversight Board under Sarbanes-Oxley).[135] Regulators, for example, may attempt to estimate the total amount spent on analyst research,

134. *See id.* at 314-41.

135. Securities exchanges already impose listing fees on listed firms. The NYSE, for instance, charges a maximum original listing fee of $250,000 and a maximum continuing annual fee of $500,000. *See* NYSE LISTED COMPANY MANUAL § 902.02 (2002). To fund the new Public Company Accounting Oversight Board, the Sarbanes-Oxley Act imposes fees on public companies in proportion to their market capitalization. To fund the new Public Company Accounting Oversight Board, the Sarbanes-Oxley Act imposes fees on public companies in proportion to their market capitalization. The Act establishes that:

> The rules of the Board under paragraph (1) shall provide for the equitable allocation, assessment, and collection by the Board (or an agent appointed by the Board) of the fee established under paragraph (1), among issuers, in accordance with subsection (g), allowing for differentiation among classes of issuers, as appropriate.

Sarbanes-Oxley Act § 109(d)(2). *See also* Sarbanes-Oxley Act § 109(g) (allocating support fees according to relative market capitalization).

proxy advisory services, and other intermediary services (although we exclude auditors from our proposal) as a starting point in determining a total levy amount for firms.

We propose to give dispersed shareholders the ability—through vouchers—to self-direct subsidies to intermediaries, once funds are raised.[136] Shareholders would have the ability to redirect vouchers received from several firms to their highest value use. For example, shareholders holding diversified portfolios may assign all their vouchers to independent analysts covering the high technology industry. Alternatively, shareholders may save their vouchers and in a later year direct them to a proxy insurgent targeting a specific underperforming management team. Shareholder voucher allocation of subsidy dollars has the potential of flexibly and automatically redirecting dollars to their highest value use. Relying on shareholders to distribute vouchers also provides a feedback mechanism to assist regulators in setting the amount to levy issuers in funding the vouchers. Regulators, for example, may gauge the demand for intermediary services based on the total number of vouchers actually distributed, adjusting future voucher funding levels accordingly.

Problems of course exist with relying on vouchers and shareholders to allocate funding. Shareholders may lack full information on the value of different intermediaries and may also fail to coordinate in the distribution of vouchers. Solutions nonetheless exist for such problems. Institutional investors may come to coordinate over voucher allocation decisions. Specialized intermediaries may arise to assist investors in how to allocate their vouchers (taking their fee as a percentage of vouchers received from investors).[137] Importantly, the Choi-Fisch proposal would allow investors to give their vouchers to such specialized intermediaries who would then have the ability to redirect these vouchers to their highest value use (or alternatively save them for another year). The government may also reduce information costs for investors through the provision of information on intermediaries (including their disciplinary track record and use of voucher funds). Once the decision is made at a regulatory level to subsidize intermediaries, voucher financing represents a superior alternative, compared with error-prone mandatory regulation.[138]

136. *See* Fisch & Choi, *supra note* 22, at 314-41.

137. *See id.*

138. Simpler allocation methods exist. Regulators could pit certain classes of intermediaries against one another in a tournament. All analysts, for example, could form one group of competing intermediaries. Regulators could base the tournament on observable objective factors, such as how accurate the analyst's recommendations were during the past year. Regulators could then award a fixed percentage of the subsidy dollars to the top winners of the tournament (providing an ex ante subsidy to all participants of the tournament). In an unrelated area, Mitu Gulati and I have proposed installing a tournament of federal circuit court judges with elevation to the Supreme Court as the prize. *See* Stephen Choi & Mitu Gulati, *A Tournament of Judges?*, 92 CAL. L. REV. 299 (2004).

2. *Market Partitioning*

Relying on the market to protect investors imposes added risks on unsophisticated (and uninformed) investors. Relatively small, unsophisticated investors may ignore the consequence of different self-tailored regulatory choices on the part of institutions (including choices to reduce liability), leaving the investors more exposed than under a purely mandatory regulatory regime. For example, to the extent an auditor that selects a regime of no public enforcement and no private liability is not punished by the market, the auditor may very well make such choices at the expense of the unsophisticated investors who continue to rely on the auditor.

While more minimal intervention is possible to address unsophisticated investors (such as the SEC-Spitzer settlement's provision of investor education funds), it is unclear whether simply providing educational material to investors will improve their sophistication. Instead, a more interventionist approach involving the mandatory partitioning of investors based on sophistication may be necessary.

Partitioning the market based on the types of firms or investors may help reduce the informational complexity of relying on market choices for investors interpreting such choices.[139] To the extent certain investors are better equipped to assess investment risks and utilize the services of intermediaries, restricting investments in a certain company's securities to such investors may allow regulators to reduce more stringent regulatory protections. Similarly, to the extent investors are more sophisticated in such markets, giving institutions that service such investors the ability to tailor their own regulatory regime allows for the most cost-effective bonding of the institutions' credibility. Regulators may then focus their attention on companies that cater more generally to the broader segment of unsophisticated investors.

Partitioning the market based on investor sophistication already occurs, in part, under the present U.S. securities regime. On the one hand are the general public capital markets. Firms that wish to sell securities in the public capital markets generally must engage in a registered public offering.[140] The registered public offering process puts companies through a tightly controlled series of

139. Of course, the difficult question of exactly how to distinguish among investors exists. While the definition of a "sophisticated" investor is far from clear, certainly some clear areas exist. For example, large financial institutions are clearly more sophisticated than individual investors (and the present securities laws recognize such differences, labeling many large financial institutions as Qualified Institution Buyers, among other terms). *See* Securities Act, 17 C.F.R. § 230, 144A (2003) [hereinafter Securities Act]. *See also* C. Edward Fletcher, III *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081; Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291 (1994); *see also* Stephen J. Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279, 310-18 (2000) (proposing both mandatory and voluntary licensing schemes to distinguish among investors).

140. For a description of the public offering process, see JAMES D. COX, ROBERT W. HILLMAN, DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 205-326 (3d ed. 2001).

steps under which a company generates a mandatory disclosure document (the registration statement) and distributes a part of this document known as the prospectus to the public. Stringent private antifraud liability attaches to material misleading statements (as well as certain omissions) in the registration statement and prospectus.[141] Almost any investor (except for control persons of the issuer) may freely trade securities which have gone through the public offering process.

In contrast, securities in a non-registered offering in the U.S are generally restricted in the types of investors to whom securities may be offered and sold. Issuers have several different avenues to sell securities outside of the public offering process. One of the most common is through a private placement to a relatively small number of more sophisticated investors. Under Rule 506 of the Securities Act of 1933, for example, issuers may sell an unlimited amount of securities to an unlimited number of "accredited" investors as well as up to thirty-five sophisticated (either individually or with a representative) purchasers.[142] Initial purchasers then face resale restrictions for a period of up to at least one year. During this restricted period, a parallel resale market consisting of qualified institutional buyers may exist for some securities pursuant to Rule 144A of the Securities Act.[143] Thus, more sophisticated investors are able to both initially purchase as well as trade in securities of issuers which choose not to endure the public offering process. Note, however, that the partitioning in the U.S. markets is not permanent. After the first year, most restricted securities are allowed to be freely resold (and thereby enter into the general public market).[144]

C. *Comparison with the Present Reform Approach*

The present approach toward reform takes almost exactly the opposite approach from this Essay. In areas where regulators could simply assist the market with more minimal intrusion, such as for conflicts of interests, 'regulators have moved immediately to implement a wide variety of mandatory prohibitions. The Sarbanes-Oxley Act forbids auditors from providing many forms of non-audit consulting services to their audit clients. Regulation FD curtails relationships between issuers and analysts based previously on selective disclosures. While such measures may work to bolster the credibility of intermediaries, they may fail as well. Given the possibility of less intrusive regulation designed to enhance already existing market-based incentives to reduce conflicts, the question exists why we had to march down the road

141. *See* Securities Act §§ 11, 12(a)(2).

142. *See* Securities Act, Rule 506.

143. *See* Securities Act, Rule 144A.

144. Resales after one year for most outside investors may take place pursuant to Rule 144 of the Securities Act. *See id.*

toward mandatory reform in the first place.

Conversely, in areas where the market is less likely to provide solutions—including the financing of intermediaries and the presence of less sophisticated investors—reform efforts have been largely absent. Aside from the SEC-Spitzer settlement's provision for subsidies for independent analyst research and investor education efforts, the reforms over the past several years have simply ignored the financing needs of intermediaries, as well as the problem posed by less sophisticated investors. In part, the lack of reform effort may have public choice roots. Where dispersed investors suffer harm with no visible "bad guy" (as with the lack of intermediary financing), regulators may be slow to address the problem due to a lack of any concentrated political pressure. Nevertheless, where a small group of investors suffers a very visible and concentrated harm caused by, for example, a conflict of interest or a breach of trust on the part of a market intermediary (giving the public an identifiable "bad guy," such as Arthur Andersen), public demand for a stringent regulatory solution will not be far behind.[145]

CONCLUSION

Regulators attempting to develop strong securities markets face a difficult task. Academic studies have demonstrated a correlation between strong investor protections and the size of a country's capital markets and economic growth.[146] Questions remain, however, as to the causal relationship between strong legal protections and economic growth, as well as the exact legal protections which are important. Regulators, moreover, only have a limited set of policy options available to them. While they may change the laws on the books, changing the norms among investors and managers as well as the operation of private securities market institutions within a country is neither quick nor easy.

Because of the difficulties facing regulators, the possibility of mistake is high. The chance of mistake is heightened by the tendency of regulators often to take a narrow approach to perceived problems. In the U.S., for example, regulators and the financial press have focused a large amount of attention on conflicts of interest problems plaguing analyst and auditors, but pay far less

145. An extensive literature exists on the public choice implications on how concentrated versus dispersed parties interact with the regulatory state. *See* Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229 (noting with respect to the specific type of blue-sky legislation adopted in various states that "more dispersed interests such as farmers and progressives might have paid little attention to the details of the legislation compared to directly affected and concentrated interests such as banks and brokers"); Richard L. Revesz, *Federalism and Environmental Regulation: A Public Choice Analysis*, 115 HARV. L. REV. 553, 567 (2001) (stating that "additional resources . . . make it possible for concentrated industry interests to participate in more proceedings than do dispersed consumer and environmental interests").

146. *See supra* note 5 (citing the LLSV studies).

attention to the financing problem facing intermediaries. Unsurprisingly, much of the reforms—including Regulation FD and the Sarbanes-Oxley Act—have addressed primarily conflicts of interest without finding a replacement source of financing for intermediaries. While the Spitzer-SEC settlement does provide limited support for "independent" research, it does so in a manner unlikely to generate truly objective research.

This Essay has argued that regulators must first consider the underlying problems facing securities market intermediaries. Securities market intermediaries lie at the heart of generating a strong investor protection culture within a country's capital markets. These intermediaries, however, face separate financing, conflicts of interest, and agency control problems. Any attempt on the part of regulators to shore up the role of intermediaries in protecting investors must take into account these various problems concurrently.

Second, regulators should consider the entire range of available regulatory options. Too often, after the decision to regulate is made, regulators move immediately toward heavy-handed mandatory requirements and prohibitions, such as those contained in the Sarbanes-Oxley Act aimed at auditor conflicts of interests. Regulators, however, have a number of less intrusive forms of regulation designed to take advantage of existing market incentives to address various market failures. Where purely private ordering may fail to solve a market defect, investors with the assistance of regulators (whether through centralized information dissemination or self-tailored regulation) may generate value-increasing solutions to defects affecting intermediaries. The use of these less intrusive mechanisms provides the market more flexibility while avoiding many of the pitfalls of more mandatory regulation, including mistake and regulatory capture.