2013

Fee Effects

Kathryn Judge
Columbia Law School, kjudge@law.columbia.edu

Fee Effects

Kathryn Judge[*]

---

* Associate Professor of Law, Columbia University. The author is grateful to Peter Conti-Brown, Jeffrey Gordon, Scott Hemphill, Robert Jackson, John Morley, Richard Posner, Alex Raskolnikov, Robert Scott, and participants at the New York Junior Faculty Forum for helpful comments on earlier drafts. Priya Merrill, Lena Qiu, and Jennifer Gaudette provided very helpful research assistance. Special thanks to The William S. Friedman Faculty Research Fund.

INTRODUCTION

It is firmly established that transaction fees act as a friction.[1] Transaction costs—the costs two parties incur finding one another, overcoming information asymmetries, and negotiating the terms of a transaction—reduce net welfare gains, making it less likely that an otherwise value-creating transaction will occur. But, preventing transactions from occurring is not the only impact of transaction fees. Because transaction fees are revenue to the intermediaries to whom they are paid, intermediaries prefer transactions that entail greater transaction fees. As a result, in environments where intermediaries can influence decision-making, high transaction fees can also increase the probability that a particular transaction will go forward. This is the "underside" of transaction fees. While pulling in opposite directions, the two effects of transaction fees are not inconsistent. The tendency for transaction fees to act as a friction constrains the range of possible transactions. Parties will not engage in a transaction unless they believe that the transaction will create value in excess of the associated costs.[2] Oftentimes, however, the requirement of net value creation does not reduce the range of possible transactions to just one. A company seeking to raise capital for a new project, for example, may have the option of issuing new debt in a public offering, issuing new equity in a public offering, or issuing securities with features of both in a private offering.[3] Each mode of financing may enable the company to obtain the capital it needs at a cost below the expected value of the project, taking all transaction fees into account. In such circumstances, the underside of transaction fees comes into play. Generally, a company seeking capital will work with intermediaries, including an investment bank and outside counsel, in determining how to proceed.[4] Through the range of transactions they propose, the advice they provide, and otherwise, the intermediaries can influence which transaction

---

1. OLIVER E. WILLIAMSON, ECONOMIC ORGANIZATION: FIRMS, MARKETS AND POLICY CONTROL 176 (1986) ("Transaction costs are the economic equivalent of friction in physical systems."). This Article generally uses the term "transaction fees" to reflect that while the fees are costs to the principals, they are revenue to intermediaries.

2. The requirement here is only that the parties believe the transaction creates value; not actual value creation. A variety of factors, including cognitive biases and inadequate or incorrect information, can cause parties to proceed with transactions that are not welfare enhancing. *See, e.g.*, *infra* note 44 and accompanying text.

3. *See, e.g.*, K & L Gates Practice Guide Editors, *Securities Practice Guide Excerpt: Conducting a PIPE Offering*, LEXISNEXIS (Aug. 28, 2009, 2:20 PM), http://law.lexisnexis.com/author-center/K-&-L-Gates-Practice-Guide-Editors/Conducting-A-PIPE-Offering (examining "some of the legal and strategic considerations that an issuer conducting a PIPE offering should take into account during the various stages of the transaction as well as the mechanics of conducting a PIPE offering").

4. Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 787 (2001) ("Most American investors still expect financial statements to be audited, shares to be underwritten by an investment banker, and the prospectus to be prepared by securities counsel.").

is ultimately consummated. And, as profit-maximizing entities, we can expect that intermediaries will use their influence in a way that serves their bottom line.[5]

The claim is not that intermediaries blindly promote the transaction that yields the highest fees. Intermediary influence is subject to a number of internal and external constraints. Factors like the value of a good reputation and competition constrain how intermediaries use their influence. Other factors, such as the nature of the intermediary's role, can further reduce an intermediary's capacity to affect which transaction is consummated. Nonetheless, whenever parties use an intermediary in connection with a transaction, that intermediary can be expected to seek to maximize its profit subject to these constraints. As a result, the use of a specialized intermediary introduces a new market force into the process through which the transaction is chosen and consummated. This Article explores the significance of this under-examined market force.

The aim of this Article is twofold. First, the Article draws attention to the underside of transaction fees as a pervasive phenomenon, present in every transaction involving an intermediary. Scholars have long recognized that intermediaries are self-interested actors whose interests do not align perfectly with the interests of the parties they assist. They have also developed a number of helpful conceptual frameworks, including agency costs, gatekeepers, and two-sided markets, to explain many of the benefits and costs of relying upon intermediaries.[6] Yet, the overlap between the underside of transaction fees and each of these alternative frames is imperfect.[7] No other work has yet broadened the lens beyond specific settings while remaining focused on the way that intermediary influence affects the probability that a particular transaction will be consummated. In

---

5. Recognizing that intermediaries seek to maximize profits, not revenue, this Article uses the underside of transaction fees as a shorthand for the tendency of an intermediary to favor the transaction that yields the greatest profit. *See infra* Part I.A.

6. *See, e.g.*, JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 15–47, 55–56 (2006); FINANCE, INTERMEDIARIES, AND ECONOMIC DEVELOPMENT (Stanley L. Engerman et al. eds., 2003) (compiling essays that examine the way that the movement of capital in a particular time and place sheds light on various aspects of financial intermediation generally); George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986); Hayne E. Leland & David H. Pyle, *Informational Asymmetries, Financial Structure, and Financial Intermediation*, 32 J. FIN. 371 (1977); Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, *in* FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59 (Yasuyuki Fuchita & Robert E. Litan eds., 2006); Daniel F. Spulber, *Market Microstructure and Intermediation*, J. ECON. PERSP., Summer 1996, at 135; Merritt B. Fox, *Gatekeeper Failures: Why Important, What to Do*, 106 MICH. L. REV. 1089 (2008) (reviewing COFFEE, *supra*); Thomas Philippon, Finance vs. Wal-Mart: Why Are Financial Services So Expensive? (2012) (unpublished manuscript), *available at* http://www.russellsage.org/sites/all/files/Rethinking-Finance/Philippon_v3.pdf.

7. *See infra* Part I.C.

drawing attention to the "fee effects"—that is, the tendency for the underside of transaction fees to distort the frequency with which particular transactions are consummated—this Article draws attention to a commonly overlooked cost associated with the dramatic rise of specialized intermediaries. Its main contribution to the literature arises from this focus and the framework it introduces for assessing how great the fee effects are likely to be in a particular setting. This framing allows us to identify areas where fee effects are likely to outweigh the benefits associated with reliance upon a specialized intermediary, thus revealing a market failure. Yet the same frame also reveals situations where the costs are subtle, and the current market structural is entirely operational but less efficient than a viable alternative. Additionally, the proposed frame allows parallels to be drawn across domains often treated as wholly distinct, such as the sale of insurance to consumers and the sale of MBSs to sophisticated investors. While not denying the critical importance of context, the proposed framework allows us to see that the differences do not entirely swamp the similarities, and insights from one setting can help to reveal challenges and opportunities in others. The final value of this framework is that it sheds new light on how these costs may be reduced.

Second, the Article suggests that there are particular reasons to be concerned about the influence of intermediaries on the mix of transactions consummated in capital markets. There are two distinct reasons for concern. The first relates to the magnitude of the expected fee effects. As an initial matter, because financial intermediaries often play critical roles in helping to overcome information asymmetries, connecting investors with capital to companies in need of it, and establishing the terms upon which such transfers will occur, they are frequently in a position to exercise significant influence. Just as importantly, constraints on how intermediaries use their influence may be less robust in the financial domain than in other areas. Constraints take two forms. Internal constraints alter the incentive scheme facing the intermediary, generally by introducing a cost or benefit apart from the fees it receives in connection with the transaction. For example, an intermediary will reduce its expected return on a transaction if recommending the transaction would breach a fiduciary obligation the intermediary owes to one of the parties and the intermediary may be held liable ex post for making the recommendation. All other constraints, including institutional arrangements that limit the range of possible transactions, are external. The Article suggests that one of the most significant external constraints, competition, may be less robust in the financial markets than it is in other domains; and one of the primary internal constraints, reputation, may be less effective than many presume. The underside of transaction fees may thus have a greater tendency to alter the mix of transactions consummated in capital markets than in other domains.

The second reason for concern about intermediary influence in capital markets is that the resulting distortions can have effects that reverberate beyond the parties involved. In most fields, the fee effects that result are borne entirely by the parties involved, usually taking the form of a foregone gain.[8] However, when the transaction type in question facilitates the flow of capital, and (as often arises for historically contingent reasons) the transaction type tends to be used to facilitate the flow of capital to particular sectors of the economy or firm types, the underside of transaction fees can distort the allocation of capital in socially costly ways.[9]

While the primary aim of the Article is to draw attention to the underside of transaction fees and the ways this market force affects the flow of capital, the Article also sheds light on two puzzling phenomena that have never been fully explained. The first puzzle it addresses is the persistence of bubbles. This issue has been the subject of extensive debate, and scholars have provided a variety of theories that help to explain this seemingly surprising phenomenon.[10] This Article suggests that another dynamic, not captured in any of the existing frameworks, may also be an important factor contributing to bubbles. That dynamic is the underside of transaction fees in a context where a particular transaction type yields higher fees than alternative transactions and that transaction type tends to be used to fund specific types of firms or sectors of the economy. Both conditions tend to arise for path-dependent reasons, and the conditions need not persist indefinitely for distortions to arise.

As one example, this Article considers how rating agencies, an important informational intermediary, may have contributed to the real estate bubble that preceded the 2007–2009 financial crisis ("the Crisis"). The analysis begins with evidence suggesting that rating agencies earned exceptionally high fees for rating securitization transactions, like mortgage-backed securities ("MBSs") and collateralized debt obligations ("CDOs"), and that rating agencies used their discretionary authority to inflate the ratings given to the securities issued in such transactions. Further, recognizing that securitization transactions were primarily used to funnel capital to residential mortgages and other real estate loans suggests that the exceptionally high fees paid to rating agencies on securitization transactions may have contributed to the real estate bubble that preceded the Crisis. A corollary is that when firm types or sectors are funded in ways that are less profitable for the intermediaries involved, such firms and sectors are likely to receive less capital than is socially optimal.

---

8. The foregone gain here is the difference between the surplus that would have been created had the intermediary made an unbiased recommendation and the surplus created by the transaction that was actually consummated.

9. *See infra* Part I.B.

10. *See infra* Part III.

The second puzzle on which the Article sheds new light is the disparity between models of how reputational capital should affect intermediary behavior and first-hand accounts of what actually happens. On one hand, many economists and other academics have long argued that the value of a good reputation should ensure that intermediaries generally act honestly and place their clients' interests above their own.[11] On the other hand, a series of scandals and other first-hand accounts suggest investment bankers, credit rating agencies, accountants, and other intermediaries regularly prioritize their short-term interests in fee maximization, even when doing so is contrary to their clients' best interests.[12] As with asset bubbles, a number of explanations focusing on agency costs and other considerations have been offered to try to bridge this gap, yet the tension between theory and practice has never been fully reconciled.[13] By more closely examining the mechanisms through which an intermediary's actions affect an intermediary's reputation, the Article reveals why many troubling first-hand stories are not necessarily inconsistent with theory.

More specifically, the Article suggests that a rational intermediary will discount the expected effect of making a "low-quality" recommendation on its reputational capital to the extent that the party to whom it makes the recommendation lacks the means or incentive to determine the quality of the recommendation it received. A rational intermediary will further discount the expected effect to the extent that the party lacks the means or incentive to publicize that it received (and followed) a low-quality recommendation even if accurately identified. Particularly in settings where an intermediary can make a reasonably informed judgment about these probabilities, concerns about reputation cannot be presumed to result in high-quality recommendations. The Article further shows that the risk is exacerbated when a class of intermediaries is entrenched and new entry difficult, as the value of reputation in such settings tends to be determined on a relative basis. When a party has no choice but to rely upon a particular type of intermediary, the business will go to the intermediaries whose reputations are relatively untarnished, no matter how far from shiny that might be.[14] The collective effect of these dynamics can substantially inhibit the efficacy of reputation as an internal constraint on the underside of transaction fees.

To complete the analysis, the Article considers regulatory efforts to reduce fee effects. Fee effects do represent a social cost. Each time an intermediary uses its influence in a self-serving way, there are gains left on the table. The difference between the surplus that would have been

11. *See infra* Part II.C.
12. *See infra* Part II.C.
13. *See infra* Part II.C.
14. *See infra* Part II.C.

produced by the transaction that would have occurred had the intermediary not been biased and the gains created by the transaction actually consummated are foregone gains and a social cost. When the transactions at issue facilitate the flow of capital, fee effects can also give rise to externalities, further suggesting that intervention may be warranted. And, even in settings where there are no immediately identifiable externalities, regulation may be able to facilitate a better outcome than the market will reach on its own. The decision to rely upon a specialized intermediary is often a bundled decision, and, taking a dynamic perspective, intermediaries may use their influence to entrench or alter institutional arrangements in ways that artificially protect or increase intermediary influence, thus an arrangement cannot be presumed to be efficient just because it persists.[15]

At the same, there is reason for caution. Fee effects do not, in themselves, provide a sufficient basis for justifying regulatory intervention. The reliance that gives rise to fee effects also enables significant value creation, and the cost savings that arise from relying upon specialized intermediaries will frequently dwarf the costs identified here. Relatedly, the ability of intermediaries to earn additional fees in this fashion may help to sustain institutional arrangements that are more efficient than viable alternatives. And, efforts to combat fee effects are often imperfect and costly, even when warranted. Ultimately, whether and how regulators should respond to fee effects are questions that can only be answered in a context-sensitive way. The Article, accordingly, focuses on the types of responses that are most likely to be cost justified, while leaving application to future work.

The primary lesson is that policymakers and market participants should "follow the fees" in order to better understand how an intermediary's incentive scheme may alter its course of action in ways that do not serve the interests of the ultimate parties to a transaction. The Article also holds two lessons regarding how policymakers can reduce fee effects. First, policymakers should examine the ways that regulatory regimes may increase intermediary influence and, thereby, fee effects. Recognizing the costs associated with licensing and certification schemes does not mean such schemes are inappropriate, but it does suggest that policymakers should set a higher threshold before intervening in ways that foreseeably increase fee effects. Second, when further intervention is warranted, or already in place, regulators should consider ways to harness market forces to improve the robustness of internal and external constraints on intermediary influence before turning to solutions, like prohibitions, which bluntly alter intermediary incentives. This could entail promoting price transparency, promoting competition, and reducing frictions in reputational feedback loops.

15. Kathryn Judge, Intermediaries and Institutions 1 (2013) (unpublished manuscript) (on file with author).

The Article proceeds in four parts. Part I provides background. It introduces the notion of the underside of transaction fees and shows that this market force has long affected the mix of transactions consummated even if not formally named. It then illustrates why fee effects are socially costly, and it introduces a framework for assessing the probable magnitude of the fee effects that are likely to arise in particular contexts.

In Part II, the focus shifts to the financial markets. Part II addresses some of the reasons that the underside of transaction fees may be more influential in this domain than in other areas. It suggests, first, that the nature of the role played by financial intermediaries and the complexity of the markets in which they operate may make it particularly likely that financial intermediaries will be in a position to influence the nature or frequency of transactions consummated. Second, it uses theory and evidence to suggest that many financial intermediaries operate in markets that are far from perfectly competitive, reducing the efficacy of one of the primary external constraints on the underside of transaction fees. Similarly, it shows that one of the primary internal constraints—the desire to maintain a good reputation—may be less effective at aligning the interests of intermediaries with the parties they serve than simple models would suggest.

Part III provides two case studies of how fee effects may alter the allocation of capital in troubling ways. It considers how path dependency can link particular transaction types with sectors of the economy, and how even temporary conditions enabling an intermediary to earn excessive fees from a particular transaction type can contribute to bubbles. It uses the recent real estate bubble, funded in part by MBOs and CDOs, and the leveraged buyout boom of the 1980s, funded in part by high-yield debt, to demonstrate how this occurs and as evidence consistent with the claim.

Part IV considers the lessons this Article holds for policymakers and market participants. It begins by addressing the challenge of trying to limit the underside of transaction fees once intermediaries are entrenched, showing that attempts to reduce fee effects are often costly and imperfect, even when warranted. It then lays the groundwork for a path forward. As a first step, it calls on policymakers and market participants to follow the fees and better understand how the underside of transaction fees may alter an intermediary's actions in a given setting. It further suggests that policymakers consider interventions that increase the quality of the feedback mechanisms through which intermediaries' recommendations affect their reputation, and it considers other ways that policymakers may seek to harness market forces as a way of reducing fee effects.

I. THE FOUNDATION

The rise of intermediaries and intermediary influence can be traced to the critical role they often play in helping parties overcome barriers to transacting. As a society becomes more industrialized and specialized, an

increasing proportion of the barriers to transacting are bridged by intermediaries.[16] As a result, an increasing proportion of transaction costs take the form of fees paid to a specialized intermediary, rather than time or effort incurred by the parties to the transaction. Daniel Spulber has estimated that intermediation contributes approximately twenty-eight percent of the U.S. gross domestic product ("GDP").[17] More recent work by Thomas Philippon suggests that total compensation for just financial intermediaries recently reached an "all-time high" of nine percent of GDP.[18]

At least part of the explanation for the magnitude of the role that intermediaries play in the economy lies in the value they can contribute.[19] As Spulber describes, intermediaries can provide valuable services in facilitating price setting and clearing, providing liquidity in the financial markets, providing immediacy in product markets, facilitating matching and searching, providing guarantees to address concerns about lemons, and acting as delegated monitors.[20] Framed in terms of recognized transaction costs, intermediaries provide value by helping parties to overcome information asymmetries, facilitating their ability to find one another, creating a bridge between them, and helping to set the terms of the transaction.[21] Using specialized intermediaries can thus yield significant cost savings for the parties involved, enabling a wide range of transactions that transaction costs would otherwise inhibit. This, clearly, is a positive development on the whole and is but one of the ways our society has become increasingly specialized. But that does not mean that the effect is totally benign or without collateral consequence. One effect of this development is the rise to a class of persons whose interests are best served by maximizing, rather than minimizing, the transaction fees incurred in connection with a value-creating transaction.

There are at least two different ways that intermediaries may seek to maximize their returns in ways that have effects beyond merely altering how the gains from a trade are allocated. First, intermediaries may advocate or

---

16. *See generally* Spulber, *supra* note 6 (discussing the role of intermediaries in our economy).

17. *Id.* at 141.

18. Philippon, *supra* note 6, at 1.

19. *Cf.* Judge, *supra* note 15 (describing ways that intermediaries may alter institutional arrangements in ways that increase their fees at the expense of efficiency).

20. Spulber, *supra* note 6, at 135, 138–39.

21. Robert C. Ellickson, *The Case for Coase and Against "Coaseanism,"* 99 YALE L.J. 611, 615 (1989) ("[T]ransaction costs can be divided into three somewhat overlapping functional categories: (1) get-together costs, (2) decision and execution costs, and (3) information costs." (footnote omitted)). Coase never defined what constitutes a transaction cost, although he did endorse another scholar's articulation that transaction costs may be understood as consisting of "search and information costs, bargaining and decision costs, [and] policing and enforcement costs." R.H. COASE, THE FIRM, THE MARKET, AND THE LAW 6 (1988) (citing Carl J. Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 148 (1979)).

otherwise promote a transaction *because* of the fees they will receive in connection with it. In so doing, intermediaries have the capacity to alter the numerosity and type of transactions consummated. This is the underside of transaction fees, and the focus of this Article. Second, intermediaries may seek to use their influence to entrench or alter institutional arrangements in ways that maximize their influence and fees over time. I address this dynamic effect of intermediary influence in other work, showing that intermediaries may be expected to promote laws, norms, and market structures that maximize their influence and returns.[22] Moreover, because of collective action issues and the informational and positional advantages intermediaries acquire in the process of repeatedly helping parties overcome barriers to transacting, intermediaries often find some success in these endeavors. While each phenomenon contributes to intermediary influence and profitability (and the line separating the two is far from precise) the two phenomena are sufficiently distinct to merit separate attention. This Article, accordingly, takes institutional arrangements as a given, focusing solely on how intermediaries may promote their self-interest within a given arrangement.

This Part begins by using a simple example to illustrate the prevalence of the underside of transaction fees and fee effects, and it situates the Article's claim in relation to other conceptual lenses that have been used to evaluate intermediary influence. The second Subpart identifies the social costs of fee effects. The final Subpart completes the overview by providing a framework for identifying when and how intermediaries use their influence to affect transaction frequency.

A. THE UNDERSIDE OF TRANSACTION FEES

The notion that intermediaries may affect which transactions are consummated is well understood by market participants. One illustration is the practice of resale price maintenance ("RPM"). RPM occurs when the creator of a good requires that an intermediary sell the good at a specified price. The difference between the price at which the good is sold by the creator to the intermediary and the price at which the intermediary subsequently sells it to the consumer is a transaction fee—it is a cost from the perspective of the creator and the consumer, and a profit to the intermediary who facilitates the transaction. At first, RPM may seem puzzling. The profit a creator earns depends solely on the price that it receives from the intermediary, not the price paid by the consumer. And, if one assumes that lower prices increase sales, one would expect creators to be indifferent to, if not pleased by, an intermediary's decision to sell the good at a lower price. The traditional view of transaction fees operating as a friction provides an alternative way to frame the puzzle. Discounting by an

22. Judge, *supra* note 15, at 4.

intermediary results in lower total transaction fees and thus less friction, an effect that should seem purely positive from the perspective of the creator and the consumer.[23] Nonetheless, RPM is rampant. Creators of goods ranging from cheap chocolates to high-end handbags have regularly sought to implement RPM schemes, even in the face of significant legal hurdles.[24]

This mystery disappears if we recognize, as creators long have, that transaction fees also act as a grease. By ensuring that intermediaries earn exceptionally high fees in connection with one type of transaction (here, the sale of a particular good), the net effect is often an increase in sales of that good, as intermediaries now have an incentive to promote that particular type of transaction.[25] As Justice Kennedy explained in a recent Supreme Court decision holding that RPM schemes should be reviewed under a rule of reason, "[o]ffering the retailer a guaranteed margin . . . may be the most efficient way to expand the manufacturer's market share by inducing the retailer's performance and allowing it to use its own initiative and experience in providing valuable services."[26] In other words, when a consumer enters the intermediary's store interested in buying a particular type of product, the intermediary now has an incentive to steer the consumer toward the product on which it will earn the greatest fee, and away from possible substitutes. The intermediary could do this through a variety of mechanisms, including product placement and encouraging its salesmen to favor the product. The key is that the intermediary is now biased in favor of a particular good for reasons unrelated to its suitability for particular consumers. While the intermediary has to consider a number of other factors in determining how actively to steer customers toward the good protected by the RPM scheme, a fee effect is likely to result—the intermediary will likely sell more of that good and fewer close substitutes than it would in the absence of the scheme. And, while consumers may receive collateral benefits funded by this pricing scheme, another probable effect is that many consumers will end up acquiring a good that is less suited

23. Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 896 (2007) ("The difference between the price a manufacturer charges retailers and the price retailers charge consumers represents part of the manufacturer's cost of distribution, which, like any other cost, the manufacturer usually desires to minimize."); *id.* at 914 (Breyer, J., dissenting) ("[P]roducers should want to encourage price competition among their dealers . . . [as] doing so they will often increase profits by selling more of their product.").

24. *Id.* at 896 (majority opinion) (addressing the use of RPM by Leegin Creative Leather Products, Inc., the maker of Brighton handbags); Russell Stover Candies, Inc. v. FTC, 718 F.2d 256, 260 (8th Cir. 1983) (addressing the use of a form of RPM by the maker of chocolates sold at drugstores).

25. Benjamin Klein, *Competitive Resale Price Maintenance in the Absence of Free Riding*, 76 ANTITRUST L.J. 431, 464 (2009) (explaining how "[m]anufacturers compete with one another in the retail distribution marketplace for retailer point-of-sale promotion by offering retailers increased compensation for their dedicated promotional efforts").

26. *Leegin*, 551 U.S. at 892.

to their needs than the alternative good that the intermediary would have recommended, and the consumer would have bought, had the intermediary's incentives not been skewed by the promise of a higher fee. Thus, some portion of the surplus that would have been created in the absence of the scheme is left on the table.[27]

Most discussions about RPM schemes focus, understandably, on how such schemes may be used to both promote and impede competition. While emphasizing the pro-competitive ways that creators may use such schemes, Justice Kennedy also recognized, and Justice Breyer in dissent emphasized, that RPM can also be used in anti-competitive ways.[28] Academics have similarly weighed in on both sides of the debate.[29] That RPM may be used to both promote and impede competition, however, is largely tangential to this Article's claim.[30] Whether used by a new entrant to gain market share or a dominant creator to exclude new entrants and thereby preserve market share, a creator adopts a RPM scheme because it expects that paying higher fees to the intermediaries distributing its good will favorably alter the total mix of transactions consummated. Specifically, an intermediary expects that the frequency of one type of transaction (those involving the sale of the creator's good) will rise and the frequency of another type of transaction (those involving the sale of its competitors' goods) will decline accordingly. RPM thus illustrates the power of the underside of transaction fees to alter the total mix of transactions consummated.

Market participants, of course, are not the only ones to recognize that intermediaries are profit maximizing, and that their attempts to maximize their returns can influence the transactions consummated. In addition to engaging in a vigorous debate about the motivations behind and effects of RPM, economists, legal academics, and others have long studied the ways that intermediaries create value, in the financial markets and elsewhere, and some of the drawbacks of such arrangements.[31] Thus, it is not surprising that the notion of the underside of transaction fees overlaps with other

---

27. *See infra* Part I.B.

28. *Leegin*, 551 U.S. at 894; *id.* at 910–13 (Breyer, J., dissenting).

29. *See* 8 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION ¶ 1620 (3d ed. 2010 & Supp. 2012); *see also* B.S. YAMEY, THE ECONOMICS OF RESALE PRICE MAINTENANCE 5–6, 34 (1954) (describing the use of RPM by manufacturers to "dispos[e] some distributors more favourably towards their brands" and thereby "hinder[] the entry of new firms or growth of excluded firms"); John Asker & Heski Bar-Isaac, Exclusionary Minimum Resale Price Maintenance (May 12, 2011) (unpublished manuscript), *available at* http://pages.stern.nyu.edu/~jasker/WPs.html (showing that RPM may be used by "an incumbent manufacturer . . . to exclude a more efficient entrant[] by increas[ing] the profits of retailers in the event that they refuse to accommodate entry").

30. That RPM schemes may be used in both pro- and anti-competitive ways illustrates why the underside of transaction fees cannot be presumed to be problematic (or benign), but rather must be examined in context. *See infra* Part IV.

31. *See generally* AREEDA & HOVENKAMP, *supra* note 29, ¶¶ 1620–1633.

conceptual frames for evaluating relationships among actors and the efficiency of those arrangements. Often, for example, the underside of transaction fees is an agency cost, and many of the circumstances in which the intermediary cannot be characterized as an agent for either party entail "two-sided markets." "Two-sided (or, more generally, multi-sided) markets are roughly defined as markets in which one or several platforms enable interactions between end-users . . . [; such] platforms court each side while attempting to make, or at least not lose, money overall."[32] These alternative frames can help shed light on the circumstances in which the underside of transaction fees may be particularly influential, how it may help to sustain efficient institutional arrangements, and how its effects can be lessened when intervention is warranted.[33] Nonetheless, the overlap in each case is imperfect, as each alternative frame is both under- and over-inclusive when mapped against the underside of transaction fees.[34] More importantly, even where the overlap is clear, the new lens presented here may shed light on adverse effects commonly overlooked and introduce new ways of reducing those effects.[35] Agency costs illustrate. Consider an investor seeking advice regarding how to invest for retirement or a company seeking help implementing a cash management system that provides both liquidity and a reasonable rate of return. In each instance, an adviser may be in a position to propose thousands of options of which twenty might fit the needs of the investor or company reasonably well and three or four would suit their

32. Jean-Charles Rochet & Jean Tirole, *Two-Sided Markets: A Progress Report*, 37 RAND J. ECON. 645, 645 (2006) (footnote omitted).

33. *See generally, e.g., id.*; Marc Rysman, *The Economics of Two-Sided Markets*, 23 J. ECON. PERSP. 125 (2009); E. Glen Weyl, *A Price Theory of Multi-Sided Platforms*, 100 AM. ECON. REV. 1642 (2010).

34. Agency costs illustrate the imperfect overlap. An intermediary's efforts to encourage a party to engage in Transaction *A*—because the intermediary will make more money on Transaction *A*—when Transaction *B* would be better for the party is a clear agency cost reflecting the overlap. Yet, the same scenario may also give rise to other agency costs, such as a tendency by the intermediary to do less due diligence than would be optimal from the perspective of the party, which fall outside the underside of transaction fees. Similarly, the intermediary will often be in a position that precludes it from being characterized as a pure agent for either party to the transaction. Finally, there may be circumstances where the transaction that yields the highest fee for the intermediary is also the transaction that best serves the other parties involved—perhaps because an innovation enables a much greater surplus from one transaction than alternatives. In such circumstances, the underside of transaction fees is still at work, pushing in favor of the transaction that serves the intermediary, but there is no agency cost. Moreover, in many settings, the nature of the intermediary's role precludes it from being easily characterized as an agent for either party. Thus, while there is a significant overlap and fee effects will often represent agency costs, the fit is imperfect.

35. *Compare infra* Part IV, *with* Andrew F. Tuch, *Conflicted Gatekeepers: The Volcker Rule and Goldman Sachs* 17 (Wash. Univ. in St. Louis Legal Studies Research Paper Series, Paper No. 12-12-1, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1809271 (stating that implicit in the economic study of agency costs is the desirability of the agents acting in "the best interests of the principal . . . [so] principal-agent theory focuses on those mechanisms . . . that reduce agency costs and thus promote an agent's loyalty to her principal").

needs exceptionally well. That an intermediary recommends one of those three or four options that yields the highest transaction fee is not the type of agency cost that is easy to identify or rectify, particularly considering this Article's assumption that transaction costs also remain a friction, so the parties must believe that the transaction creates value in excess of the associated fees.

A final point of clarification is that this Article uses the notion of "high-fee" transactions to refer to transactions that are in the best interests of the intermediary facilitating the transaction. Intermediaries seek to maximize profits, not fees, and the Article focuses on profitability when it is feasible to do so. Even profitability, however, may be too coarse a metric if too narrowly measured, as there will often be additional benefits and costs that arise from a course of dealing that cannot be easily linked to a particular transaction. A bank holding a portfolio of bonds, for example, may sell particular bonds to an unsophisticated client because the bank anticipates earning greater returns by keeping other comparable bonds on its balance sheet. Such an action would be motivated by the bank's desire to maximize its returns, but those returns would not be captured in the fees the bank earns on the transaction. A related challenge is that the difference between an intermediary's marginal cost and its revenue on a particular transaction may be great because the intermediary has invested significant fixed costs into developing expertise or technology that enable it to undertake that type of transaction with exceptional efficiency. When these fixed costs are taken into account, intermediaries may not earn excess profits from that line of business. Nonetheless, once those costs have been sunk and an intermediary is positioned to earn exceptionally high returns on that type of transaction, the intermediary will be biased toward that transaction type, potentially giving rise to fee effects.[36] The notion of high-fee transactions should thus be construed as shorthand for the transaction that yields the highest return for the intermediary.

B. EFFECTS

The underside of transaction fees may be socially costly in two ways. The most common way is by altering the mix or frequency of transactions consummated away from the socially optimal levels. In order to measure this cost, and to even see it as a cost, it is necessary to choose the appropriate reference point. Because the Article assumes that a transaction will only proceed if the parties believe it will create value in excess of the associated fees, the parties' perceived well-being immediately after a transaction should exceed their perceived well-being immediately prior to consummation, even if an intermediary made a highly tainted recommendation. The cost here

36. This is one of the reasons why the presence of fee effects does not provide a basis for assuming that an institutional arrangement is suboptimal. *See infra* Part IV.

thus takes the form of a foregone gain. More specifically, fee effects can be measured as the difference between the surplus created by the transaction and the greater welfare gains that would have been produced had the intermediary not been biased by the underside of transaction fees.[37]

To be sure, even without the underside of transaction fees, the transaction consummated will often deviate from the one that might yield the greatest surplus for the parties involved. Reasons other than self-interest may cause an intermediary to make a recommendation that deviates from the one that is best for a party. Information asymmetries, the challenge of identifying a party's type, and the limited number of options an intermediary typically can understand and readily access all limit an intermediary's ability to make a perfect recommendation. A consumer who walks into a wine store, for example, cannot completely and costlessly convey to the shopkeeper the types of wine she prefers. A short exchange may reveal that the consumer likes big, Italian reds, but it may not yield the additional information necessary to discern whether she is likely to prefer an Amarone to a Brunello, much less whether she is likely to prefer one Amarone over another. As a result, the shopkeeper will often make imperfect recommendations for reasons completely apart from the shopkeeper's economic self-interest.[38] There may seem to be a cost, if one takes the transaction that creates the maximum amount of surplus as the relevant reference point, but that cost should, on average, be less than the additional transaction costs required for the consumer to more effectively convey her type. More importantly, incomplete information transfers and other frictions that may affect recommendation quality should not result in any systematic deviation in the total mix of wines sold.[39]

The same is not true when the underside of transaction fees enters the picture. If a particular producer uses RPM or some comparable scheme to

37. In situations where parties have mistaken assessments regarding the value a transaction will create, fee effects may also take the form of welfare losses. *See, e.g.*, Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1118–39 (2009) (using insights from behavioral economics to suggest that at least some borrowers entered into subprime mortgages based on mistaken perceptions and those mortgages were welfare destroying); *infra* notes 52–56 and accompanying text (explaining how behavioral biases can cause consumers to buy insurance products that do not seem to be welfare enhancing).

38. The costs and imperfect tools for conveying type can help to explain the value of relationships between an intermediary and a consumer. If a consumer always buys her wine at the same store, and each time conveys to the shopkeeper her assessment of the last wine she bought, the shopkeeper will develop a much more nuanced understanding of the consumer's type. This enables greater surplus from each subsequent transaction, as the shopkeeper can make significantly more precise recommendations, and the marginal costs the parties incur conveying and receiving information will go down.

39. Notably, if the person regularly shops at the same wine store and reports back regarding how much she enjoyed various wines she purchased, the store may come to know more about her preferences and be able to make recommendations more suited to her type. This can help explain the stickiness of certain relationships.

make the sale of its wines more profitable for the wine shop, the shopkeeper may well recommend that wine more frequently than he otherwise would, and he is likely to sell more as a result.[40] As an initial matter, given the costs that a consumer would incur going elsewhere, the range of wines the shopkeeper has available, the consumer's inability to perfectly assess a bottle's contents by its label, and the shopkeeper's superior understanding of the wines he stocks, there is a reasonable possibility that once a consumer enters a wine store seeking a bottle of wine, the shopkeeper will have some influence over her decision about which one to buy, and the constraints on how the shopkeeper exercises his influence are likely to be incomplete. How often the shopkeeper actually makes a biased recommendation will depend upon a complex calculus which the shopkeeper may tailor based upon the shopkeeper's assessment of each consumer's preferences, sophistication, and other factors. Nonetheless, even if the shopkeeper recommends the high-fee wine only to the subset of consumers whom that wine would otherwise seem to suit, given their style and price preferences, and even if only a portion of those consumers buy the wine, the result will be a systematic shift in the mix of wines that shopkeeper sells relative to the mix he would sell in the absence of the RPM scheme. He will sell more of the high-fee wine and proportionately fewer bottles of other wines. Moreover, it is probable that many buyers of the high-fee wine would have been better off with the bottle of wine that the shopkeeper would have recommended in the absence of the RPM scheme. The difference between the surplus that consumers would have enjoyed had the shopkeeper not been biased by transaction fees and the surplus that the consumers ultimately enjoyed, taking into account the excessive sales of the high-fee wine, is the "cost" that results from the underside of transaction fees. It is the potential welfare gains left on the table—not the fact that the shopkeeper keeps proportionally more of the gains created—that make this fee effect socially costly.

Notably, the existence of fee effects does not itself imply that a party's decision to rely upon an intermediary is suboptimal. As Ronald Coase has recognized, "we are choosing between social arrangements which are all more or less failures."[41] The use of specialized intermediaries can result in dramatic cost savings relative to alternative institutional arrangements.[42]

---

40. This does not mean that a RPM scheme will always increase sales. For example, a shopkeeper may determine, because it serves primarily repeat clients, that it is very important for it to have a good reputation with those clients and the best way to do so is to make only unbiased recommendations. Another may determine that it wants to maximize volume and it can best do so by providing the lowest prices possible. Such calculations will be context-specific and affected by a range of factors outside the scope of this Article.

41. Ronald H. Coase, *The Regulated Industries: Discussion*, 54 AM. ECON. REV. 194, 195 (1964).

42. *See supra* notes 16–21 and accompanying text.

More generally, intermediaries often provide a variety of services, from providing advice to storing inventory, for which they cannot directly charge consumers, so a shopkeeper may need to earn something greater than its marginal cost on the sale of a bottle of wine, and it may even be reasonable and necessary for the size of the markup to follow something other than a linear pattern.[43] Thus, the presence of fee effects is not itself a sufficient basis for assuming that an arrangement is suboptimal. Identifying fee effects does, however, enable inquiry into whether there may be efficient ways to reduce this important and often overlooked cost associated with reliance upon specialized intermediaries.

Also noteworthy is that fee effects need not be net negative. A variety of factors, including incomplete information and behavioral biases, can cause parties to err in their judgment regarding the transaction that will create the greatest welfare gains over time.[44] Appropriately designed incentive schemes targeting intermediaries may thus prove to be an effective mechanism for "nudging" individuals toward better decisions.[45] Nonetheless, the focus here is on situations where intermediaries' bias arises entirely from their ability to earn higher fees, apart from any policy scheme to promote good decision-making. Thus, the fee effects here identified will tend to be socially costly.

A second way that the underside of transaction fees may affect social welfare is by giving rise to externalities. In most settings, the probability of externalities is low, if not non-existent. In the wine-store example, any welfare loss is likely to be borne entirely by the parties involved in the transaction, and perhaps the friends with whom a consumer shares the wine she acquires. The same is not true when the transactions at issue facilitate the flow of capital. The primary function of the capital markets is to allocate scarce resources among different projects, ideally based upon the expected returns of each. When financial intermediaries use their influence to distort the frequency of a particular transaction type, and that transaction is linked (often for historically contingent reasons) to a particular sector of the economy, greater capital will flow to that sector than is socially optimal. At the extreme, fee effects may thus contribute to bubbles. Similarly, when firms or sectors are funded in ways that are less profitable for intermediaries, those firms or sectors may receive less capital than is socially optimal. Such deficiencies are harder to identify, and potentially somewhat less costly, because they are less likely to lead to a financial crisis and recession.

43. *See infra* notes 53–55 and accompanying text (describing why monopoly type pricing may be consistent with competition in a variety of contexts).

44. *See, e.g.*, RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WELFARE, AND HAPPINESS 17–39 (2009).

45. *Id.* at 74–82.

Nonetheless, if pervasive, these effects could also give rise to real social costs as value-creating projects are forgone for a lack of capital.[46]

In the next Subpart, this Article provides the basic framework for how the underside of transaction fees arises and addresses constraints on its operation. Part II then considers why financial intermediaries may be particularly influential and the reasons that the constraints on this market force may be less robust in the financial markets than in other domains. Part III uses two case studies that are consistent with this Article's claims regarding the existence of the underside of transaction fees. In addition to providing support for the notion that the underside of transaction fees can have powerful effects on shaping the mix of transactions ultimately consummated, these case studies illustrate why its effects may be particularly problematic in the financial domain.

C. *FRAMEWORK*

This Subpart provides a framework for evaluating when transaction fees will have the tendency to distort the mix of transactions consummated. It suggests a two-part inquiry. The first step is to identify an intermediary that, directly or indirectly, has the capacity to influence a party's decision about whether to consummate a particular transaction. The second step is to identify and analyze the internal and external factors constraining how the intermediary uses that influence. This two-part inquiry may be used both to identify settings where fee effects are likely to arise and to assess the probable magnitude of those effects in a given area.

1. Influence

The first inquiry is whether an intermediary has the capacity to influence a party's decision to consummate a particular transaction. Some level of influence is probable in almost any setting, as the ability for an intermediary to add value usually depends upon the intermediary playing a role in helping the parties to find one another, reducing information asymmetries, or otherwise bridging a barrier to transacting. Nonetheless, the level of influence can vary dramatically. As a general matter, the greater the role the intermediary plays in helping parties to overcome these barriers, the more influence it will enjoy; and, the easier it is for a party to compare possible transactions or make an independent assessment of the value of one relative to others, the less influential an intermediary is likely to be. A person buying olive oil from a store where she can readily sample the store's offerings or read reviews from multiple sources describing the various olive

46. The possibility of negative externalities is not limited to finance. *See, e.g.*, Bar-Gill, *supra* note 37, at 1083 (explaining how excessive subprime mortgages led to "foreclosure[s], which impose significant costs not only on borrowers but also on surrounding communities, lenders, loan purchasers, and the economy at large").

oils, for example, is likely to be less influenced by the storekeeper's recommendation that she should buy a particular one than a consumer lacking this additional information.[47] Intermediaries may also derive influence from a law, norm, or other institutional arrangement that requires parties to use a particular type of intermediary in connection with a transaction. While such institutional arrangements often arise because of the role the intermediary plays in helping to overcome a barrier to transacting, once in place, such an arrangement can provide an independent basis for intermediary influence.[48]

2. Constraints

Once this threshold is satisfied, the inquiry shifts to factors that constrain how an intermediary uses its influence. Constraints take two forms. The first category is internal; that is, constraints that an intermediary internalizes into its own cost–benefit analysis. These constraints often take the form of benefits and costs that accrue to the intermediary outside the immediate context of the transaction. Two of the most significant internal constraints are potential liability and the effects of an action on an intermediary's reputational capital. To the extent an intermediary's action may be deemed unlawful—and the intermediary held liable—the intermediary will reduce the expected returns on that course of action accordingly. Ex post liability may arise because the intermediary owes a fiduciary obligation to one of the parties or because the law prohibits the intermediary from taking particular actions.[49] An action need not be actually unlawful for potential liability to alter the intermediary's assessment, as enforcement is inherently imperfect. All that is required is that there is a reasonable chance that it would be deemed unlawful by a court or relevant decision-maker.[50] The extent to which an intermediary will discount the expected returns on such a course of conduct will depend on a number of probabilistic assessments, including the likelihood that the party harmed will

47. Of course, many of the ways an intermediary exercises its influence will be less transparent. The choice of which olive oils to stock, for example, also meaningfully influences the consumer's decision about which one to buy.

48. *E.g.*, Jonathan Macey, *The Demise of the Reputational Model in Capital Markets: The Problem of the "Last Period Parasites,"* 60 SYRACUSE L. REV. 427, 434–35 (2010) (explaining that while rating agencies once thrived because they provided valuable information to investors, regulations mandating the use of ratings and limiting the agencies authorized to provide them "created an artificial regulatory demand for the services of a small number of favored ratings agencies," and that demand persisted even as the quality of the information conveyed declined).

49. *See infra* Part IV.A.

50. Louis Kaplow, *Burden of Proof*, 121 YALE L.J. 738, 754 (2012) ("[A]n individual with an opportunity to commit a benign act will be *chilled* from doing so when the private benefit of the act is less than the expected sanction . . . .").

seek recompense, the probability that the action will be deemed unlawful, and the expected payout upon such a finding.

Reputational considerations, by contrast, can either increase or reduce the expected return on a transaction depending upon the expected effect of the action on the intermediary's reputation. Whether positive or negative, the magnitude of the effect similarly depends upon a number of probabilistic assessments, including the probability that the party involved will be able to discern a high-quality recommendation from a low-quality one and the capacity of the party to broadcast its determination to other parties with whom the intermediary may work.

The second category of constraint is external. It encompasses everything else, including institutional and other structural constraints on the range of possible transactions. One of the most significant external constraints is competition, which can affect the underside of transaction fees in a number of ways. Most significantly, competition can reduce, and at the extreme eliminate, an intermediary's ability to earn anything more than a competitive rate of return on any possible transaction. Thus, in a perfectly competitive market, an intermediary has no incentive to favor one transaction over another. By contrast, if a market is competitive, but less than perfectly so, deviations become possible, thereby creating an environment in which intermediaries may prefer some transactions over others.

If the internal constraints, external constraints, or a combination thereof are complete—that is, they suffice to ensure that the intermediary will always act in an unbiased way—then the fee effects will be negligible. At the same time, the less effective those constraints are, the greater the probability that the intermediary will use its influence in a way that alters the transaction consummated. In sum, the combination of the intermediary's influence and the robustness of the constraints on how it uses that influence determine the expected fee effects in a given area.

In exploring the factors affecting intermediary influence in the capital markets and using case studies to illustrate how intermediaries may use their influence to distort the mix of transactions consummated, Parts II and III shed additional light on how this framework may be used to assess expected fee effects. Before moving into applications, however, a few additional threshold issues merit attention. First, the constraints on the underside of transaction fees interact, at times reinforcing and at other times undermining the efficacy of each other. Similarly, factors that constrain how an intermediary uses its influence may also affect how much influence it has, in both positive and negative ways. A more competitive environment, for example, may reduce an intermediary's influence by making it easier for a party to assess the quality of that intermediary's recommendation and facilitating the ability of the party to forego working with that particular intermediary if the party suspects she has received tainted advice. In

contrast, a fiduciary obligation may create the risk of future liability while also increasing influence, as the party may be more inclined to trust an intermediary when she knows that the intermediary has a legal obligation to act in the party's best interest.

Second and relatedly, the lines separating the inquiries into intermediary influence and the robustness of constraints on how they exercise that influence are far from clean. A law prohibiting an intermediary from making a particular type of recommendation, for example, could be characterized as an external constraint, limiting the range of options, or an internal constraint, affecting the intermediary's cost–benefit analysis. While such characterizations may alter the structure of the analysis, they should not alter its conclusion. The analysis is separated into a multi-step inquiry to ensure that all factors likely to influence fee effects are captured. But, so long as the factors are captured and accurately assessed, how a particular factor is categorized should have a negligible effect on the conclusion reached, so there is little value in spending excessive effort demarcating the bounds among the inquiries.

Third, the intermediary-influence and constraint analyses must be undertaken in a context-specific and nuanced fashion to yield meaningful results. Consider, for example, the way that situational monopolies can arise even in highly competitive settings.[51] If an analysis concluded that fee effects were likely to be low in a given domain based solely upon the competitiveness of the primary market, the analysis might miss very significant fee effects. This possibility is illustrated by a number of case studies from the insurance market provided by Tom Baker and Peter Siegelman.[52] One case study examines the sale of extended warranties on consumer electronics, such as those commonly sold by Best Buy and other big box stores in connection with the sale of a TV or stereo. The consumer electronic market is a very competitive field and these stores do not generally seem to earn supra-competitive rates of return.[53] Nonetheless, the stores earn monopoly type rents on the extended warranties they often sell

51. *E.g.*, STEVEN E. LANDSBURG, THE ARMCHAIR ECONOMIST: ECONOMICS & EVERYDAY LIFE 167–77 (1993) (explaining how high-priced popcorn enables movie theaters to charge less for tickets and may be completely consistent with a competitive market). This is just one of a number of ways that pricing schemes that may seem problematic may be revealed to be efficient when collateral benefits are taken into account. *See, e.g.*, George J. Stigler, United States v. Loew's Inc.: *A Note on Block-Booking*, 1963 SUP. CT. REV. 152 (explaining how tying can facilitate price discrimination and the reduction of transaction costs).

52. *See generally* Tom Baker & Peter Siegelman, *Protecting Consumers from Add-On Insurance Products: New Lessons for Insurance Regulation from Behavioral Economics* (Univ. of Pa. Law Sch. Inst. for Law & Econ., Research Paper No. 13-1, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2199569.

53. If anything, they earn, on net, less than they generally need to in order to remain viable. *E.g.*, Stephanie Rosenbloom, *Circuit City Seeks Bankruptcy Protection*, N.Y. TIMES (Nov. 10, 2008), http://www.nytimes.com/2008/11/11/technology/11circuit.html.

in connection with the underlying product.[54] In Baker and Siegelman's view, the "seller['s] ability to charge a situational monopoly price . . . provides ample incentive to push people into buying protection that they don't really need," and they show that such warranties are sold with a frequency that cannot be explained in a rational-actor framework and can be only partially explained once insights from behavioral economics are taken into account.[55] Framed in this Article's terms, the difference between the number of extended warranties that would be socially optimal and the number actually sold represents a fee effect, and one that would be overlooked without a close analysis of the dynamics surrounding the sale of such warranties.[56]

II. FINANCIAL INTERMEDIARIES

This Part addresses the reasons that fee effects may be particularly great in the financial markets. It begins by considering why financial intermediaries may be particularly influential. It then examines why two of the primary constraints on how financial intermediaries exercise their influence—competition and reputation—are likely to be highly incomplete.

A. THE INFLUENCE OF FINANCIAL INTERMEDIARIES

The degree of an intermediary's influence depends in significant part on the magnitude of the role that the intermediary plays in bridging the various hurdles to transacting. The more critical the intermediary's role in helping to overcome information asymmetries, bringing the two principals together, and negotiating the terms of the deal, the more influential the intermediary is likely to be. Financial intermediaries play important roles in each of these regards, and their influence is often further augmented by the existence of regulations and market norms mandating their involvement.

The magnitude of the informational asymmetry between an entity or person in need of capital and those with capital to invest is one of the greatest challenges impeding the flow of capital.[57] A company seeking public financing, for example, must have a certified public accountant audit and certify the accuracy of the company's financial statements.[58] By staking their

---

54. Robert Berner, *The Warranty Windfall*, BLOOMBERG BUSINESSWEEK (Dec. 19, 2004), http://www.businessweek.com/stories/2004-12-19/the-warranty-windfall (noting that in 2003, "profits from warranties accounted for all of Circuit City's operating income and almost half of Best Buy's," and yielded profit margins "nearly 18 times the margin on the goods themselves").

55. Baker & Siegelman, *supra* note 52, at 44, 45–46.

56. Baker and Siegelman's analysis also illustrates that the range of possible transactions is constrained by the parties' perception that a particular transaction creates value, not actual value creation. *See id.* at 44–47. Part IV returns to this example in assessing possible regulatory responses.

57. *E.g.*, Bernard S. Black, *Information Asymmetry, the Internet, and Securities Offerings*, 2 J. SMALL & EMERGING BUS. L. 91, 92 (1998) ("In [the author's] judgment, the single largest cost that stands between issuers and investors is the problem of asymmetric information.").

58. *See* 15 U.S.C. §§ 77f–77g (2006).

reputation (and more) on the accuracy of a company's financial statements, accountants play a critical role helping to convince investors that a company's financial statements are an accurate reflection of its financial health.[59] Investment banks underwriting a securities offering also play an important role in overcoming information asymmetries, particularly in connection with initial public offerings, by effectively pledging their reputation on behalf of the company issuing the securities.[60] Credit rating agencies, too, play a critical role in this regard. Rating agencies help bridge information asymmetries by collecting and analyzing an extensive body of information relevant to the expected performance of a company and translating that information into a rating that potential investors can readily comprehend in deciding whether to buy securities issued. In each of these instances, the intermediary is effective precisely because investors rely, at least to a degree, on the intermediary's assessment. In addition, each represents a situation where law or a market norm effectively requires the parties to use each type of intermediary. As a result, by adjusting the assessment it provides or its willingness to represent a particular party, an intermediary can affect the probability that a transaction will be consummated.

Intermediaries also play a critical role in bringing together investors with capital and companies in need of it. Many individuals, for example, work with a financial adviser, like a stockbroker, who makes recommendations about what types of investments they should hold and who often effectuates trades on their behalf. Many individuals and institutions also invest through intermediaries, such as mutual funds, private equity firms and hedge funds, pursuant to arrangements that give the intermediary some discretion in how to invest the funds. In each instance, the intermediary plays a critical role linking (and separating) the investor, on one hand, and the project in which his money is ultimately invested on the other.

Companies similarly rely upon intermediaries to help them find suitable investors. Even well-established public companies generally use an underwriter when they seek to raise additional funds.[61] One reason is that an underwriter's relationships with investors can reduce the discount that a company must offer investors to acquire the securities issued and can

59. COFFEE, *supra* note 6, at 108–91.

60. *E.g.*, Randolph P. Beatty & Jay R. Ritter, *Investment Banking, Reputation, and the Underpricing of Initial Public Offerings*, 15 J. FIN. ECON. 213 (1986); Richard Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 J. FIN. 1045 (1990).

61. *See* Nancy D. Ursel, *Rights Offerings and Corporate Financial Condition*, 35 FIN. MGMT. 31, 32 (2006) ("[N]on-underwritten rights offerings are used by firms in poor financial condition with low net worth, largely as a last resort method for raising equity capital.").

increase a company's access to a broad pool of potential investors.[62] Similarly, because of the extensive regulations and market norms applicable to securities offerings, companies seeking financing are effectively required to retain specialized lawyers to assist them in the offering process and the underwriter (or investor, in offerings not involving an underwriter) will virtually always do the same.[63] This makes attorneys critical intermediaries in virtually all securities offerings.[64]

Another reason attorneys can play important and influential roles in the movement of capital is that virtually all investments, from home loans to venture-capital financings, are done pursuant to agreements drafted by lawyers. In other words, lawyers can play a critical role in helping parties overcome the challenge of negotiating and executing a transaction. Similarly, when an investment bank underwrites a securities offering, it reduces these expenses by effectively negotiating on behalf of all of the investors who ultimately acquire the securities issued. And, when an investor gives his money to an intermediary like a private equity fund, the fund's sponsor subsequently negotiates on behalf of that investor and others who have invested in the same fund each time the fund puts money into (or takes out of) a portfolio company.

There are also many settings where market structures are so firmly entrenched, by law or otherwise, that a party seeking to consummate a particular type of transaction has little choice but to work with the intermediary controlling the relevant structure. For example, an investor who wants to buy 100 shares of common stock will almost assuredly not seek to locate a current shareholder and negotiate the terms on his own. Rather, he will make the acquisition through a centralized exchange, like the New York Stock Exchange, or through another established arrangement for matching buyers and sellers. In so doing, the investor will necessarily work with, and to an extent rely upon, the intermediaries who constitute or otherwise have access to the established regime. The influence exercised by intermediaries so positioned is reflected in the capacity of the New York

62. *E.g.*, Brian J. Henderson & Heather Tookes, Do Investment Banks' Relationships with Investors Impact Pricing? The Case of Convertible Bond Issues 3 (June 15, 2011) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1546671 ("Our main finding is that investment banks can add value through their relationships with investors.").

63. *E.g.*, Subcomm. on the Sec. Law Ops., ABA Section of Bus. Law, *Negative Assurance in Securities Offerings (2008 Revision)*, 64 BUS. LAW. 395, 396 (2009) (stating that "underwriters have long followed the practice of requiring" company counsel to provide the underwriter with a negative assurance letter, thereby helping the underwriter establish a due diligence defense for the purposes of avoiding liability under Section 11 of the Securities Act of 1933).

64. *See* COFFEE, *supra* note 6, at 192–244 (describing the gatekeeping role played by attorneys in the securities issuance process).

Stock Exchange, and others, to maintain fixed brokerage fees that far exceeded a competitive rate until policymakers intervened.[65]

Taking a step back from the intricacies of particular transaction structures allows us to see why intermediaries play such a critical role—and thus can exercise so much influence—in the movement of capital. Consider the challenges a company would face trying to convince potential investors that it can be trusted to return their capital, along with a competitive rate of return, without the aid of a third party to verify the accuracy of the company's representations. Consider further the challenges the company would face trying to locate persons interested in the type of investment it has to offer and negotiating the terms of that investment without assistance. Today, the movement of capital is a global and highly specialized enterprise. It may well be appropriate for a young man living in Indiana to invest some of his retirement savings in a China-based telecom company, but it is hard to fathom that the two could find each other, much less negotiate the terms of the investment, without the aid of numerous intermediaries and the existence of secondary markets maintained by intermediaries. This helps to explain the degree of influence financial intermediaries enjoy and suggests that reliance upon intermediaries is likely to persist in the years ahead.

Two final considerations merit particular attention. They are addressed separately because they bear on all three of the issues examined in this Part—an intermediary's influence, the efficacy of competition as an external constraint, and the efficacy of reputation as an internal constraint. The first issue that cuts across all three categories is the complexity of financial products and the markets in which they are traded.[66] First, complexity can increase an intermediary's influence by reducing a party's capacity to evaluate a product directly, and thus limiting his capacity to independently evaluate the quality of an intermediary's recommendation.[67] A closely related issue is that as the complexity of a financial product increases, so too does the cost of trying to evaluate the product directly.[68] Increased reliance upon an intermediary's assessment can thus provide greater cost savings and be rational in a greater swathe of circumstances, even if the party has the capacity to engage in direct evaluation.

---

65. *See, e.g.*, Hans R. Stoll, *Revolution in the Regulation of Securities Markets: An Examination of the Effects of Increased Competition*, *in* CASE STUDIES IN REGULATION: REVOLUTION AND REFORM 12, 19–29 (Leonard W. Weiss & Michael W. Klass eds., 1981) (describing the ways the fixed-pricing scheme and associated rules and regulations effectively enabled securities firms to maintain cartel pricing).

66. *See, e.g.*, Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 212–13 (2009) (identifying complexity "as the greatest financial-market challenge of the future" and one of the three core causes of the Crisis).

67. John C. Coffee, Jr., *What Went Wrong? A Tragedy in Three Acts*, 6 U. ST. THOMAS L.J. 403, 409 (2009) (describing MBSs and CDOs as "inherently opaque").

68. *See, e.g.*, Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk*, 64 STAN. L. REV. 657, 684–86 (2012).

Second, the incredible complexity of many financial products also has the potential to reduce, at times significantly, the capacity of competition to eliminate opportunities to earn higher fees from particular transaction types. When trading a complex product or trading in a complex market, a party may not be able to readily identify and seek to address inefficiencies leading to higher fees. Complexity may further reduce competition's efficacy, as relevant here, by limiting the capacity of parties to compare products or services offered by different intermediaries. Third, complexity may also reduce the tendency of concerns about reputation to result in high-quality recommendations. In order for a recommendation to affect an intermediary's reputation, the party must be able to distinguish a high-quality recommendation from a low-quality one, and the more complex the product, the more difficult it will be for a party to discern accurately the nature of the advice he received.

The second issue that influences all three analyses is relationships. Relationships often play a significant role in the financial markets, and for good reason. When a party engages in repeated transactions with the same intermediary, the intermediary develops a body of information about the party's preferences, enabling the intermediary to make recommendations that are better suited to the party while also reducing the costs the intermediary might otherwise incur trying to discern the party's type. Switching costs, including the costs that a party would incur trying to find and learn about alterative intermediaries, can further motivate a party to continue to work with the same intermediary with whom he has worked previously.[69] Once established, a relationship may increase a party's tendency to rely upon an intermediary, increasing the degree of influence an intermediary enjoys in all future interactions with that party. Additionally, a sticky relationship can increase an intermediary's capacity to increase prices without losing business, thus facilitating the persistence of price differentials not correlated to costs. Sticky relationships may also facilitate intermediaries' ability to engage in interdependent action to increase prices by reducing the probability that a deviant who lowers prices can quickly increase its business as a result, again making it more likely that different types of transactions will vary in their profitability. The importance of relationships with respect to the area of focus—the efficacy of reputation as a constraint—cuts in multiple directions. On one hand, each party, costlessly and inevitably, knows the recommendations that he has received previously from an intermediary, thereby eliminating the frictions that arise from the need for communication.[70] Recognizing this and taking into account the

69. *See generally* Joseph Farrell & Paul Klemperer, *Coordination and Lock-In: Competition with Switching Costs and Network Effects*, *in* 3 HANDBOOK OF INDUSTRIAL ORGANIZATION 1967 (M. Armstrong & R. Porter eds., 2007).

70. *See infra* Part II.C.

profits that could be earned over the course of a long-term relationship may reduce an intermediary's tendency to make a recommendation that is not fully in the party's interest.[71] At the same time, once a relationship is established, a party may critically analyze the quality of the recommendations an intermediary provides and how that intermediary's reputation compares to others as frequently. Hence, powerful relationships may reduce the efficacy of reputation as an internal constraint.

B. COMPETITION

Competition is one of the most significant external constraints on the underside of transaction fees. The primary reason is that an intermediary operating in a highly competitive market is unlikely to earn much above a competitive rate of return on any transaction, substantially reducing its incentive to favor one transaction over another. While not susceptible to any hard and fast generalizations, many financial intermediaries operate in markets that are far from perfectly competitive.

As an initial matter, industry structures dominated by a small number of players and protected by significant barriers to entry are common in the financial domain. As a result of a series of mergers and a scandal, for example, there are now only four leading accounting firms. While corporations can choose to have another accounting firm audit its financial statements, the strong reputation of the "Big Four," combined at times with explicit contractual obligations requiring their use, results in the four leading firms enjoying substantial market share and market power.[72] The situation is even more dire with respect to credit rating agencies. Regulatory and privately imposed restraints effectively require issuers to seek a credit rating from at least one, and sometimes more than one, of three designated rating agencies.[73]

Commercial and investment banking have also become quite concentrated. As one source noted, "the global financial market has been increasingly dominated by a few global, universal banks," and "[t]hese banks

---

71. *See infra* Part II.C.

72. *E.g.*, Lawrence A. Cunningham, *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels*, 106 COLUM. L. REV. 1698 (2006) (suggesting that large audit firms often believe that they can act with impunity, and recommending alternatives to allow any auditing firm to fail without disrupting the financial system); Mario Christodoulou, *Big-Four-Only Clauses Are Rare: BBA*, ACCOUNTANCYAGE (June 18, 2010), http://www.accountancyage.com/aa/news/1809491/big-four-clauses-rare-bba (describing, while questioning, the ubiquity of provisions requiring British banks to use one of the Big Four accounting firms). The "Big Four" are KPMG, Ernst & Young, Deloitte & Touche, and PricewaterhouseCoopers. Cunningham, *supra*, at 1700 & n.3.

73. Partnoy, *supra* note 6, at 60 ("[C]redit rating agencies have benefited from an oligopoly market structure that is reinforced by regulations that depend exclusively on credit ratings issued by Nationally Recognized Statistical Rating Organizations . . . ."); *see also* COFFEE, *supra* note 6, at 284–86 (same).

also command a substantial market share in virtually all financial markets, including debt and equity issues."[74] There is also evidence that the leading banks are capturing a growing proportion of the underwriting business, with the top five banks underwriting 64% of common stock offerings in 2003, and the top ten banks capturing a full 87%.[75] "At the same time, the number of commercial banks has fallen" dramatically,[76] and "[t]he proportion of bank assets held by the three biggest American banks has tripled since 1994."[77] This trend toward consolidation became even more pronounced following the wave of bankruptcies and mergers that occurred over the course of the Crisis. In its quarterly report on derivatives, for example, the Comptroller of the Currency found that at the end of 2010, of the $216.5 trillion in derivatives contracts outstanding with commercial banks, $209.1 trillion, or 96.6%, were with the top five banks (JPMorgan Chase Bank, Bank of America, Citibank, Goldman Sachs Bank, and HSBC).[78] Similar concentration patterns can be seen in more specialized financial intermediaries. As described by the *Financial Times*, "[t]he dominance of the big four providers [of custodian services] is unquestioned. So far ahead of the field are they . . . that it is apparently the height of futility to aspire to join their ranks by any means other than by being consolidated into one of them."[79]

The "futility," or at least the challenge, of gaining entry into these markets can be attributed to a number of factors. One reason is that many financial intermediaries operate in industries where a firm must be licensed by a regulator before it can engage in a particular activity.[80] The need for substantial capital—both in monetary and reputational terms—can further limit entry.

To be clear, the claim here regarding competition is descriptive, not normative. Less than perfect competition may be critical to the operation of

---

74. Sergei Guriev & Dmitriy Kvasov, *Imperfect Competition in Financial Markets and Capital Structure*, 72 J. ECON. BEHAV. & ORG. 131, 132 (2009) (internal quotation marks omitted) (citing Charles W. Calomiris, *Banking Approaches the Modern Era*, REGULATION, Summer 2002, at 14, 14).

75. *Id.* (citing data from the Securities Data Corporation).

76. Loretta J. Mester, Commentary, *Some Thoughts on the Evolution of the Banking System and the Process of Financial Intermediation*, 92 ECON. REV. (FED. RES. BANK OF ATLANTA) 67, 67 (2007).

77. Buttonwood, *Time for a Rent Cut*, ECONOMIST (June 3, 2010), http://www.economist.com/node/16274625.

78. COMPTROLLER OF THE CURRENCY, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES: FOURTH QUARTER 2010, at 16 graph 4 (2011).

79. Brian Bollen, *Winners & Losers: Bigger Providers Increase Domination*, FIN. TIMES (Sept. 19, 2011, 12:41 AM), http://www.ft.com/intl/cms/s/0/4baf0474-d7b4-11e0-a06b-00144feabdco.html.

80. *E.g.*, 15 U.S.C. § 7211(c)(1) (2006) (describing as among the duties of the newly created Public Company Accounting Oversight Board, "register[ing] public accounting firms that prepare audit reports"); *id.* § 78f (regulating national exchanges and requiring that membership be limited to registered broker dealers and persons associated with them).

some of these markets, and increased competition may not always bring about salutary effects. John Coffee, for example, has drawn attention to the potential for increased competition among certain financial intermediaries, like rating agencies, to have adverse consequences, and there is support for his assessment in other areas.[81] Similarly, one way to discourage financial intermediaries whose failure may have systemic repercussions from assuming excessive risks is by allowing them to operate in imperfectly competitive markets, thus giving them an incentive to be more risk averse in order to protect their ability to reap monopoly profits in the future.[82] The point here is merely that financial intermediaries often operate in industries where there are a limited number of market participants and high barriers to entry, increasing the likelihood that they will be able to earn supra-competitive fees on some types of transactions. When they do, they will be incented to promote that transaction type.

In addition to looking to the competitiveness of the industries in which intermediaries operate to discern the probability that intermediaries will be able to charge a price well above cost in connection with certain types of transactions, we can also look directly at the prices they charge for their services. There is evidence that at least some financial intermediaries use pricing structures that might enable them to earn higher fees on particular transaction types. One example is for the market to underwrite initial public offerings ("IPOs"). One study found that "from 1995 to 1998, for the 1,111 IPOs raising between $20 and $80 million in the United States, more than 90 percent of issuers paid gross spreads of exactly seven percent."[83] The "spread" is the difference between the price at which the underwriter acquires the securities from the issuer and the price at which it sells the securities into the market, and hence is the fee the underwriter earns on the transaction. While there are different theories as to the mechanisms that enable this pricing scheme, most commentators believe that it enables underwriters to earn a higher than competitive rate of return, particularly on the larger transactions.[84] Moreover, more recent studies show that this

81. Coffee, *supra* note 67, at 415–16 (identifying ways that competition among intermediaries may have contributed to the Crisis); *see also* Anil Shivdasani & Wei-Ling Song, *Breaking Down the Barriers: Competition, Syndicate Structure, and Underwriting Incentives*, 99 J. FIN. ECON. 581 (2011) (demonstrating that increased competition in the market to underwrite bonds as a result of the entry of commercial banks led to reduced screening incentives).

82. *E.g.*, GARY B. GORTON, SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007, at 156 (2010) (describing this as one benefit of issuing a limited number of bank charters).

83. Hsuan-Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J. FIN. 1105, 1105 (2000).

84. *Id.* at 1106.

pricing pattern persists despite the fact that more cost-effective solutions seem like they should be viable.[85]

Other studies provide further evidence of financial intermediaries' tendency to compete on non-price terms. In a study of innovative financial products, for example, Peter Tufano found that the initial "[o]fferings of 'successful' products [that is, products imitated by others,] underwritten before rival entry have spreads 29 basis points lower than those underwritten after rival entry."[86] This means that the fees typically charged for a particular type of transaction tended to go up as competitors entered the market. Tufano also found "that as more rivals offer imitative products . . . the level of underwriting spreads does not change."[87] Yet other evidence shows that the fees for underwriting high-yield debt during the 1980s exceeded a competitive rate.[88] There is also evidence of persistent price differentials in the mutual fund context, despite there being far less concentration and thousands of potential competitors.[89] While non-price competition does not alone suffice to establish that intermediaries are earning exceptionally high profits,[90] it does support that conclusion.

Specific features of the environments in which financial intermediaries operate provide further support for the suggestions that they often operate in less than perfectly competitive markets and often charge prices that are not directly linked to their costs. For example, intermediaries whose services are highly regulated may earn fees slightly in excess of a competitive rate on some transactions. In addition to imposing a barrier to entry, regulation may provide a mechanism through which intermediaries can coordinate their activities, discipline deviants, and work collectively to promote their interests.[91] A closely related issue is that many financial intermediaries operate in environments where industry participants can observe each other's behavior and pricing patterns. For example, a public company seeking to raise funds generally must disclose the fees that it pays to the

85. *See* Mark Abrahamson, Tim Jenkinson & Howard Jones, *Why Don't U.S. Issuers Demand European Fees for IPOs?*, 66 J. FIN. 2055, 2056–57 (2011) (providing a summary of the authors' findings and indicating that no favored reason explained the fee differences).

86. Peter Tufano, *Financial Innovation and First-Mover Advantages*, 25 J. FIN. ECON. 213, 227 (1989).

87. *Id.* at 228.

88. *See infra* notes 122–28 and accompanying text.

89. *See, e.g.*, Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1988–91 (2010); *see also* Jones v. Harris Assocs. L.P., 130 S. Ct. 1418, 1429 (2010) (explaining why the fees charged by mutual fund advisors "may not be the product of negotiations conducted at arm's length").

90. *See generally* George J. Stigler, *Price and Non-Price Competition*, 76 J. POL. ECON. 149 (1968).

91. *See generally* George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964).

intermediaries involved in the offering process.[92] Transparency can also be key to making a system work. The capacity for dispersed NASDAQ market makers to create a cohesive market, for example, depends upon each market maker publicly posting, and constantly updating, the prices at which it is willing to buy and sell a particular stock.[93] Even though transparency may be critical and serve other salutary aims, pricing transparency also facilitates interdependent action, making it easier for competitors to collude and thus maintain artificially inflated pricing schemes.[94]

To be clear, the concern here is not with competition for the sake of competition; nor is it with the general risk of rent-seeking by intermediaries. The aim in drawing attention to concentrated industry structures and pricing patterns is to illustrate why competition cannot be presumed to eliminate an intermediary's incentive to prefer one transaction over another. That many intermediaries operate in less than perfectly competitive environments and compete on non-price terms suggest that financial intermediaries will often be able to earn a higher fee in connection with a particular transaction type. That is the only condition required for fee effects to arise.[95]

C. *REPUTATION*

Reputation is a powerful internal constraint on the underside of transaction fees. The long-term success of most intermediaries depends on their ability to attract future business, and their capacity to do so will be significantly influenced by their reputation.[96] Reputational capital can be particularly critical in financial markets, where a common explanation for

---

92. *See* 17 C.F.R. § 228.508(f) (2008) (requiring disclosure of all consideration "to be received by any dealer in connection with the sale of the securities" offered pursuant to that registration statement); SEC. & EXCH. COMM'N, SEC 870, FORM S-1, REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933, at 4 (2008), *available at* http://www.sec.gov/about/forms/forms-1.pdf.

93. William G. Christie & Paul H. Schultz, *Did NASDAQ Market Makers Implicitly Collude?*, 9 J. ECON. PERSP. 199, 199 (1995) (describing the results of their study published at William G. Christie & Paul H. Schultz, *Why Do NASDAQ Market Makers Avoid Odd-Eighth Quotes*, 49 J. FIN. 1813 (1994)).

94. Louis Kaplow, *An Economic Approach to Price Fixing*, 77 ANTITRUST L.J. 343, 398 (2011) ("Another important factor [in how conducive an industry is to collusion] is the transparency of prices . . . .").

95. These pricing patterns are also relevant to a related factor that influences the probable magnitude of fee effects in a particular setting, that is, the elasticity of the demand curve an intermediary faces. RICHARD A. POSNER, ANTITRUST LAW 11–12, 61–62 (2d ed. 2001); *see also* Kaplow, *supra* note 94, at 400. While elasticity cannot be easily measured, the evidence that firms often do not compete on price is consistent with the conjecture that financial intermediaries often face relatively inelastic demand curves.

96. For example, there is a significant body of literature on the important role that reputation can play in promoting private ordering. *See, e.g.*, Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328, 2333 n.10 (2004).

the use of many intermediaries, including investment banks, accountants, and rating agencies, is that the intermediary "pledges" its reputation on behalf of a party issuing securities.[97] For a long time, many economists and legal academics believed that the value of reputation was sufficiently important to the intermediaries that they would have little incentive to recommend low-quality transactions or take other actions that might jeopardize that reputation. A 1998 review by Jonathan Macey of Frank Partnoy's 1997 book, *F.I.A.S.C.O.: Blood in the Water on Wall Street*, illustrates this view, while the book itself embodies the type of first-hand account that has surfaced with some regularity and that cannot easily be reconciled with strong assumptions regarding the efficacy of reputation as an internal constraint.[98]

In *F.I.A.S.C.O.*, Partnoy describes his experiences working for investment banks, primarily as a salesperson for Morgan Stanley. The book is replete with tales suggesting a fairly unconstrained variant of the underside of transaction fees. Partnoy tells numerous stories involving a client relying upon Partnoy or one of his colleagues for advice regarding an investment, their providing advice that serves the short-term economic interests of Morgan Stanley more than the long-term interests of the client, and the client taking the advice, often with poor consequences for the client. As Macey sees it, both *F.I.A.S.C.O.* and Michael Lewis's *Liar's Poker* "characteriz[e] the investment banks as willing and able to take advantage of their clients' naïvete."[99] Similar themes were echoed in a recent Op-Ed by former Goldman Sachs employee Greg Smith, who accused the firm of sending the following messages to its employees: "persuad[e] your clients to

97. *See, e.g.*, Akerlof, *supra* note 6, at 496 (demonstrating that one way to deal with the lemons problem is for an intermediary to distinguish between high- and low-quality versions of a product and provide a guarantee of quality to a buyer); Randolph P. Beatty, Howard Bunsis & John R.M. Hand, *The Indirect Economic Penalties in SEC Investigations of Underwriters*, 50 J. FIN. ECON. 151, 152 (1998) (finding "that SEC investigations of underwriters impose a variety of measurable and significant *indirect* penalties on both underwriters and their clients," which the authors "attribute . . . to a sudden deterioration in the value of the underwriter's assurance-based reputation capital"); Black, *supra* note 4, at 786–89 (describing how financial intermediaries function as "reputational intermediaries" in the securities market); Jonathan Macey, *The Value of Reputation in Corporate Finance and Investment Banking (and the Related Roles of Regulation and Market Efficiency)*, J. APPLIED CORP. FIN., Fall 2010 at 18, 18 (2010) ("The centrality of the economic theory of reputation to the functioning and success of global financial markets . . . cannot be overstated. The very existence of many of the key institutional components of the financial world, including credit rating agencies and audit firms, can be explained only by the theory of reputation."); Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 366 ("The critical importance of reputation can be seen in the advertising campaigns launched by major dealers in [over-the-counter] derivatives.").

98. Jonathan R. Macey, *Wall Street Versus Main Street: How Ignorance, Hyperbole, and Fear Lead to Regulation*, 65 U. CHI. L. REV. 1487, 1488 (1998) (review of FRANK PARTNOY, F.I.A.S.C.O.: BLOOD IN THE WATER ON WALL STREET (W.W. Norton & Co. 1997)).

99. *Id.* at 1487–88.

invest in the stocks or other products that we are trying to get rid of because they are not seen as having a lot of potential profit"; "get your clients—some of whom are sophisticated, and some of whom aren't—to trade whatever will bring the biggest profit to Goldman"; and seek out positions "where your job is to trade any illiquid, opaque product with a three-letter acronym."[100]

Macey, at the time he wrote the review, found such accounts implausible. While recognizing that "[t]he time-inconsistency issue" and agency costs within intermediaries might result in the occasional "unscrupulous salesman" taking actions contrary to the client's best interest, he claimed that "[f]rom an economic perspective, Morgan Stanley simply has too much invested in its reputation to risk it all on short-term profits."[101] Thus, Morgan Stanley and other investment banks "have strong incentives to police against this kind of conduct."[102] In so writing, Macey was conveying a position that was common in economic theory and remains influential.

The pervasiveness of such counterexamples; other scandals, such as the roles played by accountants, lawyers, and other gatekeepers in the fraud perpetuated by Enron, WorldCom, and others; the repeated failures by rating agencies; and many dimensions of the recent Crisis have motivated Macey and others to explore why theory and reality so often seem to diverge. In subsequent work, Macey has provided a variety of explanations for why the reputational model has not performed as expected, including the mistaken perception that regulation could act as a substitute for reputation, the tendency of individuals within firms to promote their own reputation rather than that of the firm for whom they work, and mistaken beliefs by some intermediaries that they could engage in segmentation, favoring those clients who did the most business with the intermediary.[103]

Other academics have provided additional insight into the reasons that reputation may not suffice to cause a financial intermediary to act with integrity and in a client's best interest. Coffee, for example, has explained how conflicts of interest and flawed incentives contributed to the failure of accounting firms, law firms, credit rating agencies, and securities analysts—all intermediaries of a particular kind, known as gatekeepers—to expose

100. Greg Smith, Op-Ed., *Why I Am Leaving Goldman Sachs*, N.Y. TIMES (Mar. 14, 2012), http://www.nytimes.com/2012/03/14/opinion/why-i-am-leaving-goldman-sachs.html. This laundry list nicely illustrates the range of ways that an intermediary may economically benefit from a particular transaction. Selling an investment that is expected to provide relatively low returns, for example, helps the intermediary economically not because of the fees that the intermediary earns in connection with the sale but because a failure to sell the investment would require the intermediary to continue to hold the investment, thus requiring it to endure directly any subsequent losses or, even if the investment does not lose money, to forego the greater returns the intermediary may have earned by using the capital to hold a different, higher returning investment.

101. Macey, *supra* note 98, at 1502.

102. *Id.*

103. Macey, *supra* note 48, at 429–30; Macey, *supra* note 97, at 19–21.

problems at Enron and WorldCom in a timely fashion.[104] These failures occurred even though investors and others relied upon these intermediaries, and their reputations, in their decisions to provide capital to these firms. Coffee further identifies an array of factors, including insufficient intrafirm monitoring of agents, the desire to develop different reputations in the eyes of different constituencies, and collusive behavior, to help explain why these important intermediaries act in ways that seem counter to their long-term interest in maintaining a good reputation.[105] These critiques and contributions are sufficient to provide a strong basis for questioning the extent to which reputation, even if important, may be relied upon to fully constrain the underside of transaction fees.

At the same time, existing accounts do not fully resolve the tension between the apparent pervasiveness of intermediaries acting in ways that further their short-term best interests, even when doing so is counter to the best interests of the parties they rely on for future business. Given the importance of reputation as an internal constraint that can help to align an intermediary's actions with the interests of the parties it serves, exploring these tensions can shed helpful light on the expected magnitude of fee effects in a given domain. Complementing the work done by others, the remainder of this Subpart suggests that much of the apparent tension disappears if one looks carefully at the mechanisms through which an intermediary's actions affect its reputation and the way that reputation translates into future business (the basis upon which reputational capital has value).

At least two things must occur for an intermediary's action, such as making a recommendation, to have any effect on its reputation: (1) the party to whom the recommendation is made must be able to discern the quality of that recommendation, and (2) the party must broadcast its finding through a channel that reaches other parties who might rely on that intermediary's services in the future. To the extent there are frictions impeding either process, the relationship between the quality of a recommendation that an intermediary makes and its reputation is weakened.

A simple hypothetical of an intermediary recommending that a client invest in a particular financial product illustrates how these frictions may arise. Consider a situation where an intermediary has the option of recommending two different investments, a high-quality one that is in the client's best interest and a low-quality one that yields higher fees yet is also within the range of options acceptable to the client. Under traditional assumptions regarding the value of reputation, we should expect the intermediary to recommend the low-fee, high-quality investment in virtually

104. COFFEE, *supra* note 6, at 15–47, 55–56.

105. *Id.* at 325–30.

every instance. The short-term gains from making the low-quality recommendation are rarely sufficiently great to outweigh the long-term future revenue stream that the intermediary would place at risk in making such a recommendation. Now, however, consider the information that the party possesses and compare it to the information the party requires to determine whether he received a high-quality recommendation. The primary information that a party will possess is the subsequent performance of the investment he acquired. This is an inherently noisy signal. Investments inevitably entail some risk and uncertainty. High-quality recommendations will not always perform well and many low-quality recommendations will end up performing quite well. Even sophisticated investors can find it challenging to determine the degree to which subsequent performance is indicative of the quality of the recommendation.[106] The greater the uncertainty in this regard, the less likely it is that the investor will modify its willingness to work with the intermediary as a result of the recommendation or publicize its perception in a way that affects the intermediary's reputation.

Complicating the scenario so that it more closely resembles reality accentuates the challenge. First, the choice an intermediary makes is often not between a high-quality and low-quality recommendation, but between a subset of reasonably good options, making differences relatively small. Second, in order to completely assess the quality of a recommendation, a party must not only have information regarding the investment he pursued but also the other options available to the intermediary at the time he made the recommendation, information that the party generally lacks. Third, the complexity of the product and the various indirect mechanisms through which a recommendation may be in the pecuniary interest of the intermediary can make it difficult, and at times impossible, for a party to determine how the underside of transaction fees may bias the recommendation it receives, a factor that might otherwise serve as a helpful flag for parties seeking to discern the quality of a recommendation. Finally, the value created by relying upon an intermediary dissipates the greater the resources a party invests in when analyzing the recommendation quality.

A second challenge is that it is costly, for both the party to whom the recommendation is made and other parties with whom the intermediary may work in the future, to convey and obtain information about the quality of service an intermediary has provided in the past. The costs of communication can take a variety of forms. First, an investor that is itself a participant in the financial markets may have its own reputation to preserve,

106. Macey recognizes this as a challenge, but he uses it as a basis for arguing that there is a place for regulators to police fraud that market participants cannot easily detect, rather than considering how it may systematically alter the efficacy of reputation as a constraint. *Cf.* Macey, *supra* note 97, at 26.

and thus may not want to harm its reputation by broadcasting that it was duped by an intermediary. As an example, consider the sale of synthetic CDO investments in ABACUS 2007-AC, which formed the basis of a suit by the SEC against Goldman Sachs, the intermediary that helped to create and sell them. According to the SEC, Goldman Sachs failed to make adequate disclosures regarding the role played by Pauslon & Co., a hedge fund that had effectively taken a short position in the transaction, in choosing the reference securities that would determine the value of the CDO investments.[107] At the time the suit was filed, the investors in the securities had "lost more than $1 billion" on their investment.[108] Nonetheless, they had never come out publicly to decry Goldman Sachs' role in selling them the securities. One reason may be that the two main investors were large, European banks that had held themselves out as CDO experts and thus had their own reputations to protect.[109]

Second, the challenge of communicating information about the quality of recommendations an intermediary has made can further impede successful transmission. Conveying and receiving information are inherently costly undertakings. A variety of factors, including the medium of communication and the nature of the distance separating parties from one another, can affect the magnitude of these costs. In situations where former and future parties are all members of a community that has a norm of disclosure and open communication, these costs may introduce very little friction. By contrast, in a setting where parties are diffuse and each party has relatively little reason to be worried about the well-being of others, the friction may be far greater. Ready access to a mode of communicating one's experience, and the reliability of information communicated through that mode, can further affect the amount of friction arising from the need for communication to occur for an intermediary's action to have any general effect on its reputation. In general, the greater the costs of conveying one's experience to other potential investors, the less likely it is that an investor will choose to or succeed in doing so. The intermediary may still lose future business from that particular client, but such a loss would be less costly than an adverse effect on its general reputation.

To be clear, these dynamics do not undermine the important role that reputation can play in reducing fee effects, but they do suggest that a

---

107. Press Release, Sec. & Exch. Comm'n, SEC Charges Goldman Sachs with Fraud in Structuring and Marketing of CDO Tied to Subprime Mortgages (Apr. 16, 2010), *available at* http://www.sec.gov/news/press/2010/2010-59.htm.

108. *Id.*

109. James Wilson & Patrick Jenkins, *IKB's Experience Is Thin End of the Wedge*, FIN. TIMES (Apr. 19, 2010, 11:55 PM), http://www.ft.com/cms/s/0/94dfc17c-4bf8-11df-a217-00144feab49a.html (explaining that at the same time it created the entity that acquired the Abacus CDOs, "[IKB] stated its intention to offer more securitisation services to outsiders and set up IKB Credit Asset Management, an asset management arm").

different calculation is required. In assessing whether immediate fees justify a possible adverse effect on reputation, an intermediary will rationally discount the adverse effect based upon (1) its probabilistic assessment of the likelihood that the investor will be able to detect the low-quality nature of the recommendation, and (2) its probabilistic assessment of the likelihood that the investor will seek to and will succeed in conveying the fact that it received a low-quality recommendation to other parties who might otherwise work with the intermediary in the future. Given the importance of a good reputation to many intermediaries, the degree of discounting will play a significant role in determining when, if ever, it is in an intermediary's interest to take such a risk.

Focusing on these feedback mechanisms also suggests bases upon which intermediaries may "segment" clients that are different from those proposed by Macey.[110] More specifically, to the extent an intermediary believes it can make relatively accurate probabilistic assessments regarding the likelihood that a particular client will be able to discern the quality of a recommendation and the likelihood that the client would have the incentive and means to communicate its finding, the intermediary may vary the quality of the recommendation depending upon the client with which it is dealing. Clients that the intermediary perceives as genuinely sophisticated, and thus best positioned to discern the actual quality of an investment, and those viewed as likely to communicate their experience to others, are rewarded with the high-quality recommendation. Meanwhile, other investors are effectively penalized, as the intermediary will discount the expected adverse effect on its reputation of a low-quality recommendation by the probability of detection and successful publication.

Recognizing these frictions can help to explain many of the situations where intermediaries make low-quality recommendations. In *Boomerang*, Michael Lewis seeks to understand (among other things) why IKB and other German banks ended up holding such large portfolios of low-quality MBSs and CDOs, particularly considering that the incentive schemes used to compensate the individual traders did not seem to encourage risky acquisitions.[111] According to Lewis, a common refrain from Wall Street bankers who worked with the Germans buying the bonds was that the explanation lies in the "German mentality" or genetic disposition: "It was form over substance. You work with Germans, and—I can't emphasize this

110. A more significant difference is that while Macey concludes that "two-tiered treatment of customers has proven to be a clear and costly failure," it is less clear that segmentation according the criteria suggested can be so easily dismissed. Macey, *supra* note 97, at 21.

111. MICHAEL LEWIS, BOOMERANG 160–62 (2011) (noting that while "American bond traders may have sunk their firms by turning a blind eye to the risks in the subprime bond market," those traders reaped small "fortune[s] for themselves in the bargain" and "were paid to put their firms in jeopardy," whereas "German bankers were paid peanuts . . . strongly suggest[ing] that they really didn't know what they were doing").

enough—they are not natural risk takers. . . . So long as a bond looked clean on the outside, the Germans allowed it to become as dirty on the inside as Wall Street could make it."[112] Even if we assume that Lewis's account is stylized, these types of characterizations—by the Wall Street bankers who were selling them—strongly suggest that the financial intermediaries creating and selling MBSs and CDOs distinguished among their clients in categorical ways and made different recommendations to them accordingly. Maintaining the stylized account, the bankers perceived their German clients to be unsophisticated in a particular way—overly focused on formal characteristics and disinclined to investigate the underlying substance. These perceptions were formed through the intermediaries' repeated interactions with German and other clients, discussions with other similarly situated intermediaries, and other mechanisms. Once formed, these perceptions shaped the recommendations intermediaries made—and the types of transactions consummated—in at least two ways. First, the perceptions altered the range of possible transactions the intermediaries chose to propose to their German clients. Perceiving Germans to care more about form than substance, intermediaries were incented to try to sell them a greater range of assets that met their formal requirements, primarily, a AAA-rating, and they were incented to avoid trying to sell them financial products with similar (or even superior) substantive risk/return profiles but lacking that demarcation. Second, and more relevant here, the intermediaries likely discounted the expected effect of recommending a low-quality product to a German bank on its reputation, believing that the German bank would likely lack the means or inclination to undertake an independent assessment of the quality of the bond recommended. Moreover, accounts of this type are common, suggesting that investment banks and other financial intermediaries are regularly assessing client sophistication and varying their recommendations accordingly.[113]

Another consideration often underplayed in standard accounts of the power of reputation is that the economic value associated with a good reputation is not solely a product of the quality of one's reputation. The value of reputational capital lies in the expectation that a good reputation will affect future deal flow. In settings where parties consistently rely upon a particular type of intermediary, the economic value of a good reputation depends primarily upon the quality of an intermediary's reputation *relative to*

112. *Id.* at 164 (internal quotation marks omitted). Other sources corroborate Lewis's analysis. *E.g.*, Wilson & Jenkins, *supra* note 109 ("Look at any transaction that turned sour during the financial crisis and there is a good chance there will be a German bank close to the wrong end of the agreement. . . . [M]any US and UK bankers like to joke . . . that the German bankers doing the deals were naïve . . . .").

113. *See generally, e.g.*, MICHAEL LEWIS, LIAR'S POKER (2010); FRANK PARTNOY, F.I.A.S.C.O.: THE INSIDE STORY OF A WALL STREET TRADER 59 (Penguin Books 1999) (1997); GREG SMITH, WHY I LEFT GOLDMAN SACHS: A WALL STREET STORY (2012).

other intermediaries of the same type. To use a simple example, if the expected value of future deal flow to a class of intermediaries is $100, the value of any one intermediary's reputation is capped at $100. And the degree to which its reputation will influence how much of that deal flow it attracts depends on how it is perceived relative to other intermediaries in the same class. Thus, if there are only four intermediaries offering a service, and barriers to entry are high, then the proportion of the $100 that one intermediary captures will depend not only on its reputation, but also on the reputation of the other three intermediaries in the class.

The comparative nature of the process through which an economic value is placed upon an intermediary's reputation can both accentuate and diminish the efficacy of reputation as an internal constraint. For example, if relationships are rare, there is high-quality information about different intermediaries' reputations, and other intermediaries in the class engage in high-quality actions and have correspondingly strong reputations, this may lead to a race to the top. Other factors, like the ease of entry and the availability of close substitutes for the services that the class of intermediaries provides, may tend to further accentuate the power of reputation to serve as an internal constraint, leading an intermediary to make high-quality recommendations. The same considerations can also pull in the opposite direction, weakening the capacity of reputation to incent good behavior. Thus, when parties tend to use the same intermediary without evaluating alternatives—because there is limited accurate information about the quality of other intermediaries or an intermediary's competitors have relatively poor reputations—an intermediary may have less to gain from foregoing high fees for the sake of building a good reputation. And, again, the more insulated that class of intermediaries is from outside competition—in the form of new entrants or close substitutes—the less effective reputation is likely to be at incenting good behavior.[114] In all cases, reputation may provide some outer check on how bad the behavior can become, as it is possible for an entire class of intermediaries to be discredited if their actions are sufficiently egregious.[115] But, given the scandals that have plagued numerous classes of intermediaries without seeming to undermine their influence, this outer bound is far from a robust check on behavior.

---

114. This may help to explain how financial intermediaries can remain profitable even though, as Jonathan Macey has highlighted, they generally do not enjoy strong reputations when compared to other types of firms. Macey, *supra* note 48, at 447 ("[T]here are no financial institutions among the top twenty companies in the world when ranked by reputation. . . . The list of major U.S. financial institutions that did not even make the list of global companies ranked by reputation [includes] . . . Bank of America, Citigroup, Goldman Sachs, JP Morgan Chase, [and] Morgan Stanley.").

115. *See id.* at 432–45 (suggesting that certain classes of intermediaries have lost their influence).

Again, the comparative nature of the analysis is consistent with observation. Many of the greatest intermediary failures—like the failure of Arthur Andersen to expose Enron's accounting shenanigans—arise in settings that have many of the characteristics suggesting that reputational damage may not be as harmful to future business as models ignoring this comparative dimension would suggest.[116] The behavior of rating agencies provides a striking example. Reputation clearly matters to rating agencies, whose ability to add value is contingent upon investors trusting the ratings they provide to convey useful information about how a security is likely to perform. Yet, all of the rating agencies have made egregious mistakes—including missing the problems at Enron and other companies that went bust around the same time and providing clearly erroneous ratings to MBSs, CDOs, and other securitized products issued before the Crisis—and those mistakes have been far from fatal for any of them. Looking at the context in which they operate in light of the relativistic analysis proposed can help to explain why this is.[117] Because of the importance of reputation, market norms, and legal hurdles to becoming a nationally recognized statistical rating organization, the field is perceived to have relatively high barriers to entry and has long been dominated by a small number of participants (Standard & Poor's and Moody's Investor Service, with a third, Fitch Ratings, recently joining their ranks).[118] Additionally, until recently, many investors were under regulatory and other constraints that effectively required (or strongly incented) them to buy only instruments rated by one of the three leading agencies, and other benefits of value to investors (like liquidity) tended to attach only upon ratings given by one of the leading agencies. As a result, issuers often feel compelled to work with at least one of the three, and there are no close substitutes. Finally, because all three rating agencies have made numerous mistakes, none has been penalized as much as one might expect in the abstract for those mistakes. If they can only lose business to one another, then their ability to maintain business depends only upon their reputation relative to each other. Recognizing that the economic value of reputation to each of the three is relativistic, rather than absolute, may thus help to explain why each continues to be a highly profitable, ongoing

116. COFFEE, *supra* note 6, at 26–29.

117. Again, this explanation complements existing explanations. Partnoy, *supra* note 6, at 81 (arguing that "the differences between credit rating agencies and other gatekeepers" include their reliance on outside ratings and their limited liability); *see also* COFFEE, *supra* note 6, at 283–316.

118. Partnoy, *supra* note 6, at 60 ("[T]he most successful credit rating agencies have benefited from an oligopoly market structure that is reinforced by regulations that depend exclusively on credit ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs). These regulatory benefits . . . generate economic rents for NRSROs that persist even when they perform poorly and otherwise would lose reputational capital. Until recently, there were only three NRSROs: Moody's, Standard & Poor's, and Fitch." (footnote omitted)); *see also* COFFEE, *supra* note 6, at 284–85.

business despite having made grievous errors. It may also help to explain their willingness to give high credit ratings to debt instruments subsequently revealed to default far more frequently than their initial ratings would imply.[119] This example also illustrates that the capacity of industry reputation to promote good behavior (to avoid the risk that the entire class of intermediaries might lose its influence) is likely to be weaker in settings where reliance is entrenched in a law or market norm.

In drawing attention to the significant frictions that can impede the processes through which an intermediary's actions are reflected in its reputation, and highlighting the relativistic nature of the value of that reputation, the aim is not to downplay the importance of reputation to financial intermediaries. For many types of financial intermediaries, reputation is critical to enabling the intermediary to play the role that it does. Making low-quality recommendations based upon probabilistic assessments of the likelihood of detection or transmission is a risky strategy, and could lead to an intermediary's demise. Business, however, often entails such risks. Moreover, that an intermediary takes actions which subsequently harm its reputation does not provide a basis for assuming that the intermediary engaged in what Macey deems a "failed" experiment in segmentation or otherwise erred in its decision-making.[120] To focus on situations where we can determine ex post that an intermediary's course of action proved unprofitable without recognizing that there may be many situations where intermediaries gained far more than they lost by making low-quality recommendations ignores selection bias. When making relatively low-quality recommendations appears likely to yield greater economic benefits to an intermediary than making high-quality recommendations, taking into account the probabilistic effect of such recommendations on the intermediary's reputation and the relativistic process through which that reputation translates into future revenue, there is no basis for assuming that a rational intermediary will forego the opportunity to enrich itself at the expense of the parties it serves even if its reputation is quite valuable.

These dynamics are particularly important to recognize when assessing the actions of financial intermediaries, as financial intermediaries often operate in environments where both of the frictions between action and reputation will be high, and the relativistic process through which reputation translates into revenue can facilitate herd behavior toward low-quality recommendations. The examples scattered throughout this Part, the earlier descriptions of the industry structures in which many financial intermediaries operate, and the incredible complexity of many financial products and the markets in which they trade all provide reasons to question

119. For further discussion of how the influence of credit rating agencies may have contributed to the Crisis, see *infra* Part III.B.

120. *See* Macey, *supra* note 97, at 29.

the efficacy of reputation as a mechanism for ensuring that financial intermediaries make high-quality recommendations. Oftentimes, reputational constraints will be sufficiently great to align an intermediary's incentives with those of the parties with whom it is working. But often is not always. The analysis here reveals why that gap might be particularly large in capital markets, and it provides a guide to assessing how effective reputation is likely to be as an internal constraint on an intermediary's course of conduct.

III. CASE STUDIES

This Part presents two case studies. Each illustrates how the underside of transaction fees can alter the mix of transactions consummated and how this can, in turn, affect the allocation of capital in socially costly ways. The underside of transaction fees suggests that when financial intermediaries can earn higher than competitive rates of return for producing a particular type of financial product, and other conditions are satisfied, the result should be an overproduction of that type of financial product. One challenge inherent in trying to determine whether this is in fact happening is finding an appropriate baseline from which to measure the socially optimal level of production of a particular financial product. High production alone does not suffice, as a financial product may be in high demand for entirely legitimate reasons. This Part attempts to mitigate this challenge by focusing on situations where, with the benefit of hindsight, it is clear that the prices investors paid for the financial product and the volume created were not rational in light of fundamentals, i.e., bubbles. More specifically, the focus is on two recent bubbles—the leveraged buyout ("LBO") boom of the 1980s and the real estate boom of the 2000s—which were funded in part by particular types of products—high-yield bonds and securitized products, like MBSs and CDOs—for which investors overpaid. This does not entirely overcome the challenge of confounding factors, as there are other explanations for the existence of bubbles.[121] The aim here is not to displace other explanations, but to draw attention to an additional factor that also helps to explain the phenomenon and to examine situations that might provide support for the workings of the underside of transaction fees.

121. *E.g.*, José A. Scheinkman & Wei Xiong, *Overconfidence and Speculative Bubbles*, 111 J. POL. ECON. 1183, 1184 (2003) ("In this paper, we propose a model of asset trading, based on heterogeneous beliefs generated by agents' overconfidence, with equilibria that broadly fit these observations. We also provide explicit links between parameter values in the model, such as trading cost and information, and the behavior of equilibrium prices and trading volume. More generally, our model provides a flexible framework to study speculative trading that can be used to analyze links between asset prices, trading volume, and price volatility.").

A. HIGH-YIELD DEBT

It is widely recognized that there was a LBO boom in the 1980s. The total value of LBO deals went "from less than $1 billion in 1980 to a peak of more than $60 billion in 1988."[122] Over this same period, the quality of LBO deals declined significantly: the average valuation placed on a company relative to its fundamental value rose while coverage ratios (a measure indicative of the likelihood that a company will be able to make payments on debt outstanding as they come due) declined.[123] Not surprisingly, LBOs consummated in the latter half of the decade were substantially more likely to encounter financial distress than earlier deals.[124] Still, the portion of these deals funded by publicly issued high-yield debt increased over the course of the decade.[125] And, LBO transactions funded by such high-yield debt were more likely than LBO transactions funded in other ways to face subsequent financial distress.[126] Moreover, comparing the terms of LBO transactions during that period with the terms of LBO deals in the more recent LBO wave, which lasted from 2005 through mid-2007, reveals "that debt investors offered overly favorable terms, particularly too much leverage, in the buyout wave of the 1980s."[127] Deals in the 1980s generally had equity of ten to fifteen percent of the deal value, while the equity was around thirty percent in the more recent boom, providing debt investors significantly greater protection against default.[128]

A common explanation for the 1980s LBO boom, for which Steven Kaplan and Jeremy Stein have provided empirical support, is that the market for high-yield debt "overheated." According to Kaplan and Stein, "[t]he success of early deals attracted a large inflow of new money."[129] As "too much financing . . . chas[ed] too few good deals," the result was that "many transactions were overpriced, recklessly structured, or both."[130] The claim here does not undermine the overheating hypothesis but it does add an additional dimension to it. To see the relevance of the underside of transaction fees, it is necessary to look at the fees paid to the financial institutions underwriting the high-yield debt that was used to fund these transactions. Examining the underwriting fees for corporate bonds in the 1980s and 1990s, Miles Livingston and Glenn Williams found that the

122. Steven N. Kaplan & Jeremy C. Stein, *The Evolution of Buyout Pricing and Financial Structure in the 1980s*, 108 Q.J. ECON. 313, 313 (1993).

123. *Id.* at 318–29.

124. *Id.* at 351 tbl.IX.

125. *Id.* at 337 tbl.VI.

126. *Id.* at 349–55.

127. Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121, 139 (2009).

128. *Id.* at 138–40.

129. Kaplan & Stein, *supra* note 122, at 313.

130. *Id.*

average fee for a high-yield debt offering in the 1980s was 3.5%, a figure that fell to 2.5% in the 1990s.[131] Livingston and Williams suggest that the dramatic decline is most likely attributable to the 1990 bankruptcy of Drexel Burnham Lambert.[132] They explain that Drexel first created one of the only active secondary markets for high-yield debt in the 1980s and then used its prominence in that domain to attract underwriting business.[133] Because of the expectation that its offerings would enjoy greater liquidity in the secondary market, Drexel was able to charge a higher than competitive rate of return for its underwriting services.[134] With Drexel controlling a full half of the market, other underwriters sought to compete by offering advantages other than a lower price.[135] The demise of Drexel in 1990 led to a more truly competitive marketplace, which in turn resulted in fees declining from the excessively high 3.5% to the more competitive rate of return of 2.4%.[136] That there was no comparable drop in the underwriting fees for higher grade bond offerings during this period, as well as other checks, corroborate this account.[137]

This Article's claim regarding fee effects suggests that in the face of the opportunity to earn supra-competitive fees, underwriters can be expected to use their influence to increase the number and volume of high-yield debt offerings they underwrote. The rise in the frequency and size of LBOs during the 1980s, as well as the rise in the proportion of a typical LBO deal that was funded with high-yield debt, are thus predictable consequences of the underside of transaction fees. To be sure, the mechanisms through which underwriters affected the size and frequency of high-yield debt offerings cannot be observed directly, but there were a number of viable channels for them to exercise such influence. For example, investment banks underwriting high-yield debt may have contributed to the demand for such debt by encouraging investors with whom they had ongoing relationships to acquire it and encouraging analysts they employed to extol its virtues.[138] Investment banks also may have used their relationships with

131. Miles Livingston & Glenn Williams, *Drexel Burnham Lambert's Bankruptcy and the Subsequent Decline in Underwriter Fees*, 84 J. FIN. ECON. 472, 472 (2007).

132. *Id.* at 473.

133. *Id.* at 474–76.

134. *Id.* at 475.

135. *Id.* at 475–76.

136. *Id.* at 484.

137. *Id.* at 484–86.

138. There is empirical support for the tendency of investment banks to use their influence in these ways, and the success of such efforts can be found in studies looking at the way the probability a transaction will be consummated is affected by the fee structure used to compensate an investment bank providing a fairness opinion in connection with the transaction. *See, e.g.*, P. Raghavendra Rau, *Investment Bank Market Share, Contingent Fee Payments, and the Performance of Acquiring Firms*, 56 J. FIN. ECON. 293, 319 (2000) ("[A] strong negative relation exists between the average contingent fee paid to the advisor and the abnormal return

buyout specialists to encourage and facilitate the use of high-yield debt to fund transactions. This account does not deny that the parties on both ends sought to issue and acquire high-yield debt; but, it does suggest that the intermediaries who profited so handsomely from these deals may have played a significant role in contributing to that demand.

The net result is well known—a high number of excessively leveraged LBO deals, which in turn led to a wave of defaults, followed by bankruptcies and the challenges and costs of shutting down or reorganizing.[139] As this account highlights, the form that fee effects take is in part a product of the path-dependent history behind the fees charged on particular financial instruments and the types of transactions or companies typically funded by those instruments. It was by no means inevitable that high-yield debt would produce greater fees for intermediaries than other transaction types. That the fees charged in connection with the creation of a financial product may be affected by the history of the product in addition to the costs an intermediary incurs in creating it is not, however, unique to this instance.[140] It similarly was not inevitable, nor unique to this instance, for high-yield debt to be used predominantly in connection with a particular type of transaction—the LBO. Nonetheless, once these conditions were in place, the foundation was laid for the underside of transaction fees to lead to the overproduction of high-yield debt and an excessive amount of capital flowing into LBOs. Moreover, as this example also illustrates, such conditions need not persist for capital to be misallocated. While the market may eventually eliminate most such instances, significant distortions can arise in the period before the market self-corrects.

B. MBSs AND CDOs

A more recent example of an excessive flow of capital to a particular market sector is the proliferation of MBSs and CDOs in the years leading up to the Crisis. MBSs and CDOs are securitization transactions in which a pool of assets (mortgages and debt instruments, respectively) are bundled together and placed into a newly created entity. The entity simultaneously issues multiple classes of securities with different rights to the cash flows from the underlying assets. The securities are rated by a credit rating agency based upon their expected performance. Because of the complexity of the

---

earned by the acquiror over a 6–18 month period after the completion of the tender offer."); David A. Becher, Jonathan B. Cohn & Jennifer L. Juergens, Do Stock Analysts Influence Merger Completion? An Examination of Post-Merger Announcement Recommendations 27, 39 tbl.VIII (June 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=1566991 ("[T]he evidence presented supports the argument that [stock] analyst recommendations . . . influence the likelihood of merger completion . . . .").

139. *E.g.*, Ursel, *supra* note 61, at 32 ("[I]n the 1990s . . . corporate financial bankruptcies soared.").

140. *See supra* Part II.A.

transaction structures, the process of putting these deals together required numerous intermediaries, each of whom received significant fees for their services. The analysis here focuses on just one, which played a particularly critical role: credit rating agencies.

By way of background, securities rated AAA tend to be valued at a slight premium relative to their expected rate of default. This has been credited to a variety of factors, including regulatory constraints that encourage (and sometimes mandate) regulated entities to hold securities with a AAA rating and the tendency for AAA-rated securities to be more liquid than lower rated ones.[141] Additionally, a AAA rating signifies that the credit rating agency believes that there is an exceptionally low probability that the security will default, making them informationally insensitive and reducing the need for an investor to engage in due diligence to understand the risk of what he is acquiring.[142] As a result, as the proportion of AAA-rated securities issued in a transaction increases, so too does the aggregate amount investors are willing to pay for the securities issued. That, in turn, increases the probability that the securities issued will be worth more than the assets underlying the transaction and the costs of putting it together, the condition that must be met to consummate a transaction. In other words, by consistently giving a AAA rating to a sizeable portion of the securities issued in a particular type of transaction, credit rating agencies can effectively encourage the consummation of that type of transaction. As a result, even though credit rating agencies do not have any direct control in determining the types of transactions consummated, they have significant capacity to affect such decisions indirectly through their relative willingness to bestow AAA ratings on the securities issued.

There is evidence that the credit rating agencies did precisely this with respect to complex securitization transactions leading up to the Crisis. John Griffin and Dragon Yongjun Tang examined the ratings given to CDOs issued between 1997 and 2007.[143] Griffin and Tang found that the actual ratings the credit rating agencies gave to securities issued in these transactions frequently deviated from the ratings dictated by the rating agency's model.[144] These deviations are attributable to discretionary

141. *E.g.*, FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 118–20 (2011) [hereinafter INQUIRY REPORT].

142. *E.g.*, MOODY'S INVESTORS SERV., MOODY'S RATING SYMBOLS & DEFINITIONS 8, 12 (2009), *available at* http://www.moodys.com/sites/products/AboutMoodysRatingsAttachments/MoodysRatingsSymbolsand%20Definitions.pdf ("Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk."); *see also* GORTON, *supra* note 82, at 5 (explaining the difference between securities that are "information sensitive" and securities that are "information insensitive").

143. *See generally* John M. Griffin & Dragon Yongjun Tang, *Did Subjectivity Play a Role in CDO Credit Ratings?*, 67 J. FIN. 1293, 1293–94 (2012).

144. *Id.* at 1295.

"adjustments" made by the rating agency. They found "that 84.6% of adjustments are positive and that, on average, adjustments amount[ed] to an additional . . . 18.2% by 2009."[145] More specifically, their findings show that "[i]f CDOs had been structured to meet smaller AAA thresholds according to the [rating agency]'s model, each CDO would have been $14.7 million more costly to structure," and that re-characterizing the securities issued to have ratings more in accord with those dictated by the model would have cost investors $38.7 billion for the 916 CDOs in their sample.[146] They further found that these adjustments cannot be explained by other factors, like "manager experience [or] credit enhancements," and "that adjustments to the rating agency model appear to have been harmful for future CDO performance."[147] In short, there is strong evidence that credit rating agencies regularly used their discretion in a way that overstated the value of the securities issued in CDO transactions. In so doing, they facilitated the consummation of an excessive volume of CDO transactions, because a precondition for any CDO transaction to proceed is that the amount that investors are willing to pay for the securities issued exceeds the costs of the underlying assets plus the fees associated with the transaction. Thus, by increasing the amount investors would pay for the securities issued, the rating agencies effectively increased the number of viable transactions.

Turning to consider why the rating agencies might have done this, there is evidence that the agencies earned substantially more for rating these complex securitization transactions than for other services they provided. The portion of Moody's revenue that it received from rating structured finance products like MBSs and CDOs, for example, increased fourfold between 2000 and 2007 and constituted approximately half of its total rating revenue from 2005 through 2007.[148] Standard & Poor's revenue from rating structured finance transactions similarly increased from less than $200 million in 2002 to over $600 million in 2006.[149] Additionally, there is evidence that Moody's and other credit rating agencies enjoyed extraordinarily high profit margins as a result.[150] Coffee has suggested that this profit incentive, and the rating agencies' desire to cultivate a favorable reputation with investment banks structuring MBS and CDO transactions,

145. *Id.*

146. *Id.* at 1296.

147. *Id.* at 1295–96.

148. INQUIRY REPORT, *supra* note 141, at 117; Coffee, *supra* note 67, at 410.

149. Jeannette Neumann & Thomas Catan, *U.S. Steps Up S&P Inquiry: Former Analysts Questioned Again on Mortgage-Bond Ratings*, WALL ST. J. (Jan. 17, 2012), http://online.wsj.com/article/SB10001424052970203721704577156963813900028.html (see "Rating the Rater" graphic).

150. According to one source, Moody's had the highest profit margin of any company in the S&P 500 for five years in a row prior to the Crisis. *Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 2 (2008) (statement of Hon. Henry A. Waxman, Chairman, H. Comm. on Oversight and Gov't Reform).

may well have outweighed the agencies' concerns about their long-term reputation with investors.[151] Partnoy similarly argued that "[c]redit rating agencies increasingly focus[ed] on structured finance and new complex debt products" in part because those instruments "generate a substantial share of credit rating agencies' revenues and profits" and that "[w]ith respect to these new instruments, the agencies have become more like 'gate openers' than gatekeepers."[152]

Putting these patterns together, this is yet another illustration of fee effects. The fees paid to the intermediaries—the credit rating agencies—were sufficiently excessive that it may have been rational for them to seek to do as many transactions as possible, even to the point of using their discretion to overstate the value of the securities issued. One result was the proliferation of MBS and CDO transactions. That effect gave rise to others.

To understand the broader economic consequences, a little additional background is needed. It just happens to be the case that the U.S. government, through Fannie Mae and Freddie Mac, was at the forefront of developing securitization structures; and, home loans were the sole type of assets originally placed into these structures.[153] Not surprisingly, when private market participants started to create securitization structures, they too started with home loans. As a result, the securitization of home loans continued to outpace the securitization of other debt instruments, even as securitization structures became more accepted and more widely used.[154] So, when too many structured finance transactions were consummated, one result was an influx of excess capital into the residential real estate market.[155] As a result, the dynamics here described likely contributed to the parallel bubbles in MBSs and CDOs, on one hand, and in the residential real estate market, on the other.[156] Thus, along with an array of other factors, these dynamics may well have played a role in the greatest financial crisis and recession since the Great Depression.

It is also worth noting some of the similarities between the Crisis and the LBO boom. In both settings, an influential class of intermediaries had the ability to earn excessively high fees in connection with a particular type of transaction. For historically contingent reasons, that transaction type tended to be used to funnel capital to a particular firm type or sector of the economy. And, while the market eventually corrected itself, a notable (and

---

151. Coffee, *supra* note 67, at 408–11.

152. Partnoy, *supra* note 6, at 60.

153. Judge, *supra* note 68, at 670.

154. *E.g.*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO THE CONGRESS ON RISK RETENTION 27 & n.20, 28 & fig.2, 69 & fig.15 (2010), *available at* http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.

155. *See* Judge, *supra* note 68, at 670–77, 693.

156. *See id.* at 693–94 (describing the relationship between the bubble in MBSs and CDOs and the bubble in residential real estate).

costly) bubble arose in the meantime. These examples suggest that when a transaction type is linked to a particular type of firm or industry, and influential financial intermediaries can earn excessive fees for producing a particular financial product, the firm types and industries so funded may well receive more capital than is optimal.

IV. RESPONSES

This Part explores the policy implications of fee effects. This analysis takes two forms. It begins by recognizing that there are already many laws and regulations in place aimed at reducing fee effects and showing how the framework introduced here can help us to evaluate the efficacy of such policies. It then considers some of the reasons that intervention may be warranted, and proposes some approaches to reducing fee effects that may be warranted in a number of domains.

While evaluating and advocating intervention in some settings, this analysis also recognizes the need for regulators to proceed with caution in their efforts to reduce fee effects. As Coase recognized, when choosing among various alternative arrangements, we are inevitably making a choice between options that are flawed in one way or another.[157] That there are costs associated with reliance upon intermediaries is thus, in itself, not a sufficient basis for assuming that such arrangements are suboptimal. This is particularly true in light of the significant cost savings and other advantages that arise from reliance upon specialized intermediaries. Further, fee effects may give rise to collateral benefits, like promoting particular types of innovation, or enabling efficient institutional arrangements that would not be sustainable otherwise. Economists have recognized, for example, that pricing certain goods well above the marginal cost of production, such as last-minute plane fares and popcorn in movie theaters, may be explained based on a need to cover fixed costs, time costs, the costs of holding inventories, and the like.[158] Similarly, higher fees may enable intermediaries to provide auxiliary services of real value to parties, and for which they cannot easily charge directly.[159] As such, there may be situations where there are fee effects, yet because of technological and other constraints, a more efficient equilibrium is not viable. Viewed in light of the challenge inherent in trying to ensure that intermediaries are appropriately compensated for their services, fee effects are better understood as descriptive facts arising from reliance upon specialized intermediaries, than a problem to be solved.

---

157. *See supra* note 41 and accompanying text.

158. *See* John R. Lott, Jr. & Russell D. Roberts, *A Guide to the Pitfalls of Identifying Price Discrimination*, 29 ECON. INQUIRY 14, 19–22 (1991).

159. *See* Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 896–97 (2007); *see also* Rochet & Tirole, *supra* note 32, at 649–50 (demonstrating the limitations of the Coase Theorem in the context of two-sided markets).

A related and additional reason for regulatory caution is that the operation of the underside of transaction fees, and the costs and benefits that result, are inherently context-specific. Had structured financing not been tied to a particular sector of the economy for historically contingent reasons, for example, there would be no reason that the exceptional fees intermediaries earned on creating such structures would have contributed to the bubble in residential real estate. The types of tools available to policymakers or market participants to address the adverse effects of the underside of transaction fees will also vary dramatically across settings. These considerations make it impossible to draw any broad normative conclusions about what should be done in light of the underside of transaction fees. A third reason for caution is that attempts to reduce the adverse effects of the underside of transaction fees will almost inevitably be both under- and over-inclusive, and will also be costly to implement.[160] For intervention to be justified, it should not only reduce fee effects, but should do so by an amount that exceeds the costs of intervention.

A. PROHIBITION

Consumer protection is a common rationale for many policies currently in place aimed at reducing fee effects. The class of financial intermediaries that may well have the greatest amount of interaction with retail investors is stockbrokers. Given the wide array of financial products available, many individual investors choose to work with a stockbroker or financial adviser in determining how to invest whatever wealth they have accumulated. Stockbrokers traditionally have not been compensated directly for many of the services that they provide to clients, such as providing advice about how to structure a portfolio likely to achieve a client's financial objectives and the risks associated with different investment options. Rather, stockbrokers typically were compensated based upon a client's investment activity. While a greater array of pricing schemes exist today, most stockbrokers (who often now identify themselves as financial advisers) continue to be compensated by collecting fees based upon the client's investment activity rather than being paid directly for the services they provide.[161] Putting to the side issues of whether and how this is an efficient arrangement, it is clear that the potential fee effects it creates are quite significant. Retail investors tend to use stockbrokers precisely because they are uncertain about how to translate their long-term financial goals into an investment plan, and the range of options available today can easily seem overwhelming. Stockbrokers tend to operate in a very competitive market, and reputation can play an important role in a stockbroker's ability to retain clients and attract new ones, but

160. *See infra* Part IV.A.

161. Daisy Maxey, *How to Pay Your Financial Adviser*, WALL ST. J. (Dec. 12, 2011), http://online.wsj.com/article/SB10001424052970204554204577024152103830414.html.

regulators long ago determined that these constraints were insufficient, in themselves, to ensure stockbrokers consistently took actions that were in their clients' best interests. This Subpart considers one of the most identifiable ways that the underside of transaction fees may bias broker recommendations, and it then evaluates efforts by regulators and market participants to counter its effects.

A common scheme for compensating brokers, which had been dominant and continues to persist, is for the broker to earn a commission each time a client buys or sells shares of stock or other securities. As a result, the broker's compensation increases with the frequency and size of his or her client's trades. Seeking to protect investors, reasoning that at least some were not capable of adequately protecting themselves, regulators responded by prohibiting a particular type of activity—churning. Churning is "the practice by a broker of advancing his own interest (his commissions based on trading volume) without regard to his customer's objectives by a course of trading which is excessive in light of the size and character of the customer's account."[162] Churning requires that (1) the broker had direct or de facto control over the level of trading in the account, (2) the amount of trading in the account was excessive, and (3) the broker acted with the requisite state of mind (a finding which may be inferred from establishing the first two elements).[163] In the framework proposed here, a prohibition on churning, enforced by imposing ex post liability on brokers found guilty of churning (and at times limiting their ability to remain stockbrokers), alters the internal constraints facing a stockbroker, deterring him from taking actions that might be deemed churning by a court.

Altering a stockbroker's internal constraints in this manner has two effects on social welfare. On one hand, it is likely to deter many socially wasteful trades. A broker contemplating whether to engage in a trade that would yield fees for the broker but which would not create actual value for his client will be less inclined to do so to the extent he expects the trade (in conjunction with others) might result in him being found liable for churning. On the other hand, the prohibition on churning likely also chills some socially valuable behavior. We can see how this might happen by looking at the basis for a finding that the trading in an account is excessive. "[E]xcessiveness is a subjective determination" that depends upon the client's wealth, trading objectives, and other context-specific considerations.[164] In making such a finding, a court may consider, among other factors, the turnover rate, holding periods, the presence of particular

162. Fey v. Walston & Co., 493 F.2d 1036, 1040 n.1 (7th Cir. 1974).

163. *E.g.*, Donald Arthur Winslow & Seth C. Anderson, *A Model for Determining the Excessive Trading Element in Churning Claims*, 68 N.C. L. REV. 327, 327–28 & n.2 (1990).

164. Patricia A. O'Hara, *The Elusive Concept of Control in Churning Claims Under Federal Securities and Commodities Law*, 75 GEO. L.J. 1875, 1890–91 (1987); *see also* Winslow & Anderson, *supra* note 163, at 328.

trading patterns, and the rate of return that would be required to cover the costs (including commissions), in light of the size of the account.[165] Because of the inherently imperfect nature of the inquiry, a broker exercising the requisite level of control over a client's account may well decide, at times, to engage in less trading than would be optimal for the client or to otherwise alter the types of trades in which he engages in order to avoid activity that too closely resembles the type that courts might find excessive.[166] As a result, some trades that should occur will not. Similarly, there may be circumstances in which an investor would prefer to have his stockbroker have complete discretion over his account, and such an arrangement would be socially optimal, but the broker might nonetheless decline such control based upon concerns that the client's investment goals would require trading activity that might easily be mistaken as excessive. In each instance, socially beneficial behavior is deterred. Another type of cost associated with the ban on churning is the cost of enforcement. Enforcement costs include the legal and other costs incurred by the parties and the tribunal each time a case is brought irrespective of how it is resolved.

Banning churning, on net, may well be appropriate. Recent evidence suggests that the more wealthy and sophisticated a client, the less likely he is to give an intermediary complete discretion over his account.[167] If stockbrokers are particularly inclined to engage in excessive trading in the accounts of their least sophisticated clients, because detection is less likely, there is good reason to expect that the benefits of the ban far exceed the costs. Nonetheless, because of the inevitably imperfect nature of enforcement coupled with the probability that the line drawn will be both over- and under-inclusive, such bans also tend to deter some socially valuable activity. Similar dynamics are likely inevitable in most domains where intermediaries are influential.

B. OTHER RESPONSES

Despite the many reasons for caution, intervention by regulators and market participants to reduce fee effects will at times be warranted. A primary function of the capital markets is to allocate scarce resources among different projects, ideally based upon the expected returns of each. When capital is allocated for reasons other than the expected return on a project, the distortions that result can be socially costly. Fee effects can lead to such distortions. When certain firm types or sectors of the economy receive capital through pathways that are particularly profitable for financial

165. O'Hara, *supra* note 164, at 1890–94.

166. Kaplow, *supra* note 50, at 754 ("[A]n individual with an opportunity to commit a benign act will be *chilled* from doing so when the private benefit of the act is less than the expected sanction.").

167. Julie Steinberg, *Do the Wealthy Trust Their Advisers?*, TOTAL RETURN (Jan. 10, 2013, 8:00 AM), http://blogs.wsj.com/totalreturn/2013/01/10/do-the-wealthy-trust-their-advisers.

intermediaries to build, the underside of transaction fees can result in excessive capital being allocated to those firms and sectors. At the extreme, the underside of transaction fees may thus contribute to bubbles. A closely related risk is that when firms or sectors are funded in ways that are less profitable for intermediaries, those firms or sectors may receive less capital than is socially optimal. Such deficiencies are harder to identify, and potentially somewhat less costly. Nonetheless, if pervasive, the effect could also give rise to real social costs, as value-creating projects are forgone for a lack of capital. Thus, intervention may be warranted to counteract the distortive effects of intermediary influence on the allocation of capital.

There are also other reasons to suspect that invention may at times be cost justified. As illustrated above, concerns about consumer protection may well merit intervention. In addition, the bundled nature of the decision to work with an intermediary may limit the capacity of market forces to achieve an optimal equilibrium without some regulatory assistance. Moreover, as I show in other work, intermediaries often succeed in shaping institutional arrangements in ways that increase and entrench their influence, thus increasing the expected fee effects.[168] Finally, interventions to reduce fee effects will at times take the form of reducing—rather than increasing—regulation, as regulations currently protect intermediaries and accentuate fee effects in a number of domains.[169]

1. Follow the Fees

One key lesson this Article holds is to follow the fees. Both policymakers and market participants would be well served to better understand the mechanisms through which intermediaries may seek to promote their interest in higher fees and the environments in which they are likely to succeed. For example, the follow-the-fees response may be an important tool guiding regulators in how they choose to allocate finite resources. In both case studies, the intermediaries involved were earning exceptionally high fees in connection with certain types of transactions.[170] Had regulators viewed these high fees as a flag indicating the need for greater scrutiny, it is possible that they would have been able to intervene in a timely fashion to reduce, if not eliminate, the distortions that resulted. Similarly, the exceptionally high fees that Arthur Andersen and other accounting firms were earning by providing consulting services has been identified as a significant factor contributing to their failures in their auditing roles; thus,

168. Judge, *supra* note 15, at 25.

169. *See infra* Part IV.B.2.

170. Sometimes, regulators will be in a position to readily determine the fees an intermediary is earning in connection with particular transaction types relative to others. In situations where this is not the case, indirect evidence—such as indications that an intermediary is rapidly expanding a new division or re-allocating resources to it—may also be used as flags signaling the need for further scrutiny.

again, attention to fees may have alerted regulators to pay close heed to their activities.[171] Particularly in areas where regulation or other institutional arrangements give a class of intermediaries significant influence, there may be significant value in using fees as an indicator suggesting that an intermediary's practices in a particular area merit scrutiny.

Following the fees may also be a helpful guide for policymakers beyond those with direct jurisdiction over the intermediary or transaction type at issue. The Federal Reserve and the Financial Stability Oversight Council, for example, have been charged with leading roles in the effort to maintain systemic stability.[172] Given the role that bubbles can play in contributing to financial crises, it may well be appropriate for these regulatory bodies to invest resources identifying critical intermediaries and understanding how those intermediaries may use their influence in ways that alter how capital is allocated. At a more granular level, examining the fees intermediaries earn on various transaction types and how this affects the ways intermediaries use their influence may help regulators to better understand the operation of critical markets and forces that might disrupt their operation.

Similar benefits may accrue to market participants who become more attuned to the underside of transaction fees. The more investors and others understand about how the intermediaries on whom they rely are compensated, the more adept they will be at seeking ways to reduce the problematic aspects of the underside of transaction fees. Regulation may have a role to play in helping to ensure that parties, ranging from consumers to large institutional investors, have access to the information they need to understand how an intermediary's recommendations may be biased by transaction fees. For example, it may be appropriate for the Office of Financial Education, a division of the Consumer Financial Protection Bureau, to devote additional resources to educating individuals about the ways intermediaries' interests may deviate, in systematic ways, from the parties they serve.[173] The Office might also devote even more resources to its efforts to improve disclosure requirements, focusing additional attention on the degree to which the mandatory disclosure facilitates consumers' ability

171. COFFEE, *supra* note 6, at 26–29.

172. Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, 12 U.S.C. §§ 5321–5322 (Supp. IV 2010) (forming the Financial Stability Oversight Counsel and noting that its purposes are to (1) "identify risks to the financial stability of the United States," (2) "promote market discipline," and (3) "respond to emerging threats to . . . stability"); *id.* § 5365 (stating that the Federal Reserve must "establish prudential standards for nonbank financial companies" with assets greater than fifty billion dollars "[i]n order to prevent or mitigate risks to the financial stability of the United States").

173. *See id.* § 5493(d) (establishing the Office and charging it with the responsibility of "develop[ing] and implement[ing] a strategy to improve the financial literacy of consumers"); Delayed Implementation of Certain New Mortgage Disclosures, 77 Fed. Reg. 70,105, 70,105 (Nov. 23, 2012) (to be codified at 12 C.F.R. pt. 1026) (delaying certain new requirements in order to avoid consumer confusion).

to discern the ways that the underside of transaction fees may be biasing an intermediary's advice. One approach could be to require intermediaries to provide greater information about how they are compensated, directly and indirectly, and how the fees they will earn from the proposed transaction differ from those they would earn on others that might be close substitutes from the consumer's perspective, the latter element being critical and less often required. Many reforms in this vein are already underway, but it is likely that more could be undertaken and those already underway might be improved if revised with the express aim of empowering consumers to identify and combat fee effects.[174]

2. Improve Constraints to Better Align Incentives

The framework offered here reveals that the magnitude of fee effects is determined by three related factors—the magnitude of the intermediary's influence, and the robustness of the external and internal constraints on how it exercises that influence. In so doing, the framework simultaneously provides a roadmap for potential ways to reduce fee effects while minimizing the new distortions regulations often introduce—reduce the intermediary's influence or improve the strength of the internal or external constraints on how it exercises that influence. This Subpart explores all three approaches.

a. Regulatory Restraint

One way to reduce intermediary influence is to reconsider regulatory regimes that give rise to such influence. The credit rating agencies, for example, achieved their influential role at least in part as a result of regulatory and market-based rules that mandated or encouraged particular types of firms to hold assets that had received a AAA or other designated credit rating.[175] Regulators further protected their influence by requiring the rating to come from a Nationally Recognized Statistical Rating Organization ("NRSRO") and allowing the market to be dominated by just three firms—Moody's, Standard & Poor's, and Fitch.[176] The influence of other gatekeepers has been similarly entrenched into regulatory and other institutional arrangements.[177] In revealing that such regimes tend to increase fee effects, a cost not previously examined, this Article suggests that regulators should set a higher threshold for the anticipated benefits before implementing a requirement that entrenches a class of intermediaries in this

174. *See, e.g.*, *Ask CFPB*, CONSUMER FIN. PROT. BUREAU, http://www.consumerfinance.gov/askcfpb (last visited Feb. 20, 2013) (describing some of the resources currently available).

175. Aline Darbellay & Frank Partnoy, *Credit Rating Agencies Under the Dodd-Frank Act*, BANKING & FIN. SERVICES POL'Y REP., Dec. 2011, at 1, 9 (explaining that in the years before the Crisis, credit rating agencies "benefited from regulations that required the use of ratings").

176. *Id.* at 2 ("[T]hree leading rating agencies are responsible for 98 percent of all outstanding ratings and collect 90 percent of the total rating revenue.").

177. *See supra* Part II.A.

fashion. Relatedly, lawmakers and regulators should reevaluate laws and regulations already in place that require market participants to work with a particular class of intermediaries or anoint a new gatekeeper. Some reforms in this vein are already underway. The Dodd-Frank Act, for example, requires all federal agencies to review and modify regulations that rely upon credit ratings.[178] It can be far more difficult to unwind such regulatory protections than to forego their adoption, so the focus should likely be on reducing implementation, but attempts to remove such protections merit consideration.

b. Improve External Constraints

A second strategy is to improve the robustness of external constraints on how intermediaries use their influence. As competition is often the most powerful such constraint, improving competition may go a long way to reducing fee effects.[179] One approach entails devoting greater regulatory resources to enforcing antitrust laws and other regimes designed to promote competition, including closely scrutinizing mergers, when the parties involved are intermediaries, particularly if they are in a position to influence the movement of capital.[180] There may also be times when regulators should seek to promote competition in ways that go beyond antitrust. Baker and Siegelman, for example, draw attention to the possibility that busting up situational monopolies, like those that seem to facilitate the sale of excessive and overpriced extended warranties, may help to address some of the problems they identify.[181] Their analysis acknowledges the challenges of implementation, and they suggest that more invasive forms of regulation may continue to be warranted.[182] Nonetheless, such interventions could at

178. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939A, 124 Stat. 1376, 1887 (2010) (codified as amended at 15 U.S.C. 78*o*–7 (Supp. V 2011)).

179. Sensitivity to context is particularly important in such efforts given the questions about the benefits and costs of heighted competition among certain classes of financial intermediaries. *See supra* Part II.B.

180. *E.g.*, 12 U.S.C. § 1828(c) (2006) (requiring the prior written approval of the FDIC for mergers involving insured depository institutions); 15 U.S.C. § 18a (2006) (requiring parties seeking to merge to provide notice and endure a waiting period, allowing regulators to review the proposed merger, subject to certain exceptions). These pricing patterns are also relevant to a related factor that influences the probable magnitude of the flipside of transaction fees in a particular setting, that is, the elasticity of the demand curve an intermediary faces. POSNER, *supra* note 95, at 11–12, 61–62 (2d ed. 2001); *see also* Kaplow, *supra* note 94, at 400.

181. Baker & Siegelman, *supra* note 52, at 56–60.

182. *Id.* at 34–42; *see also* Daniel Schwarcz, *Differential Compensation and the "Race to the Bottom" in Consumer Insurance Markets*, 15 CONN. INS. L.J. 723, 726 (2009) ("[D]ifferential . . . compensation contributes to this insurer-side adverse selection . . . . As such . . . . insurers who rely on independent agents to sell consumer lines of insurance should be prohibited from paying different rates of compensation to different agents for the sale of the same line of insurance."); Daniel Schwarcz, *Beyond Disclosure: The Case for Banning Contingent Commissions*, 25

times be viable.[183] By reducing the ability of intermediaries to earn monopoly profits, such interventions would increase the robustness of the external constraints on an intermediary's exercise of its influence, and thereby increase the probability that the intermediary will make recommendations and take other actions in line with the party's best interest. Moreover, such interventions are less likely to introduce chilling effects and other distortions.

c. Improve Internal Constraints

Yet another alternative is to strengthen the internal constraints on an intermediary's exercise of its influence. Rather than seeking to bluntly alter such constraints, as rules banning certain types of behavior tend to do, regulators could seek to improve the feedback mechanisms through which an intermediary internalizes the positive and negative effects of its recommendation. One way to do so would be to reduce the frictions that impede the feedback mechanisms through which an intermediary's actions affect its reputation. This might entail providing investors and other parties with information that could help them to discern whether they received a high-quality or low-quality recommendation. It could further entail the promotion, creation, and viability of forums through which similarly situated parties could learn from the experience of others. Specifics, again, have to be worked out in a context-specific way. For intermediaries that serve retail consumers, sites like Yelp or TripAdvisor might serve as a model. Such sites might have the additional benefit of allowing parties to sort themselves by "type," enabling users to give different weights to different reviews depending upon the extent to which the qualitative basis for a reviewer's assessment accurately reflects the party's own criteria. By contrast, in settings where the parties' desire to protect their own reputations inhibits robust information exchange, it may be appropriate for regulators to facilitate the creation of forums that enable confidentiality, recognizing the verification, and other issues that arise when identities are withheld.

While many review sites have arisen even in the absence of regulatory intervention, that does not mean we have reached a socially optimal level. Given the significant positive externalities that can flow from such sites, the failure of market forces to create effective equivalents in the financial realm by no means proves that the benefits would not far exceed the costs. In light of the collective action challenges facing parties, and the preference by

---

YALE L. & POL'Y REV. 289, 293–94 (2007) ("[A] disclosure requirement in consumer insurance markets is unlikely to address meaningfully the core risk of contingent commissions—the potential for inefficient steering.").

183. Baker & Siegelman, *supra* note 52, at 34–36, 57–60 (explaining the approach and identifying a proposal in this vein provided in Marieke Huysentruyt & Daniel Read, *How Do People Value Extended Warranties? Evidence from Two Field Surveys*, 40 J. RISK & UNCERTAINTY 197 (2010), and discussing why that proposal is unlikely to work).

many classes of intermediaries to limit transparency, intervention may be important to spur the creation and maintenance of effective review sites.[184] Additionally, certain structures, particularly ones that would hinge upon a mandatory reporting requirement or which would seek to maintain confidentiality, would likely require government coordination, at least initially. Nonetheless, like the other policies proposed here, such intervention would be of the "light-touch" variety, seeking more to facilitate than impede market forces. They may thus be a valuable additional tool in combating fee effects, and one that the government has under-utilized to date.

Many of the responses here proposed are relatively modest. This is in part because even modest responses, appropriately implemented, could meaningfully reduce fee effects in a number of domains or alter regulatory regimes already in place to the same effect. The proposed reforms, however, are far from exhaustive. Taking the dynamism of institutional arrangements into account, and the ways that intermediaries may use their informational, positional, and other advantages to alter those arrangements in ways that artificially augment their influence, may well justify more radical steps to reduce that influence or the fee effects that flow from it.[185]

CONCLUSION

This Article shows that an under-examined market force—the underside of transaction fees—plays a first-order role in shaping the mix of transactions that occur in the capital markets. This gives rise to a cost, in the form of a foregone gain, whenever intermediaries have influence and the constraints on how they exercise that influence are imperfect. While the optimal level of fee effects is probably not zero, the magnitude of these effects today are far greater than is socially optimal. By drawing attention to fee effects and providing a framework for understanding when they are likely to arise, this Article lays the ground for further investigation of how fee effects manifest in different industries. The Article thus suggests that regulators, market participants, and academics should "follow the fees," so we can better understand and reduce these effects.

184. MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 63 n.18 (1971) (explaining why mass media social pressure is "probably not ordinarily sufficient by itself" to spur the creation of review sites).

185. Judge, *supra* note 15.