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MORAL HAZARD AND THE INITIAL PUBLIC OFFERING

Christine Hurt*

INTRODUCTION

The United States securities market is at a crossroads. Almost every aspect of buying and trading listed securities has come under intense scrutiny recently,1 from the method that publicly held corporations use to calculate earnings and report those earnings in disclosure statements2 to timing strategies that allow some investors in mutual funds to accrue hidden profits created by stale prices.3 Even the inner workings of the New York Stock Exchange have come under fire.4 Rising skepticism among the public has created a backlash against corporations, underwriters, analysts, and mutual funds that has

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1 But see A Penny in Whose Pocket, ECONOMIST, May 26, 2001, at 71 (describing Wall Street as “everybody’s favourite scapegoat” at the end of the “dotcom party”) [hereinafter Pocket].


3 See generally David Million, Why is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?, 70 GEO. WASH. L. REV. 890 (2002) (describing recent scandals related to aggressive “earnings management”); see also John Cook, The Year of Corporate Crooks, SEATTLE POST-INTELLIGENCER, Dec. 23, 2003, at D1 (remarking that before the mutual fund timing scandals, the mutual fund industry was “highly regarded” by the public).

4 See Susanne Craig & Laurie P. Cohen, SEC Takes Another Look at Grasso, WALL ST. J., Nov. 3, 2003, at C11 (detailing the public outcry over Dick Grasso’s $187.5 million deferred compensation package, which led to the New York Stock Exchange CEO’s resignation and new allegations that Grasso pressured a specialist firm to increase its purchases of shares in American International Group Inc. (AIG)); Kate Kelly & Susanne Craig, NYSE Traders Will Pay Fines of $240 Million, WALL ST. J., Feb. 18, 2004, at C1 (reporting on settlement among the SEC and the five largest specialist firms of the NYSE regarding charges that firms profited by buying for their own accounts when a buyer was readily available, signaling a possible end to the 211-year-old practice of “open outcry”).
resulted in numerous investigations, civil and criminal, into various trading practices, some of which have been around in various forms for years. At the same time, the number of individual investors participating in the capital markets has grown substantially, highlighting the discrepancies in investing opportunities between Wall Street regulars and retail investors.

One of the first trading practices to come under regulatory and shareholder fire was the initial public offering (IPO) process, which has revealed itself to be undemocratic at best and manipulative at worst. During the late 1990s and early 2000s (the "1999-2000 Boom"), a growing number of companies "went public," making the transition from being privately owned to having shares traded and owned by public investors. During the 1999-2000 Boom, IPOs generated $65 billion each year, compared with $8 billion per year in the 1980s. Among those companies going public were an increasing number of companies without a significant history of positive earnings. However, the prices of shares of these companies were skyrocketing in value during the first hours or days of the offering. Although large first-day returns of IPO shares have been reported for decades, the first-day returns during this period were unprecedented. However, most individual investors were never buyers of original IPO shares. In the presence of very high demand for shares in almost any IPO, underwriters allocated the majority of original IPO shares to regular customers, mostly institutional investors, and few retail investors are

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5 See Laura S. Unger, Technology and Regulation: The Road Ahead, Address before the San Diego Securities Institute (Jan. 27, 2000), available at 2000 WL 132740, at *1 (S.E.C.) (noting that according to a 1999 survey, "almost half of all households own stock" and at least 18 percent of those investors had bought or sold stock on the Internet) [hereinafter 2000 Address].

6 See Brian J. Lane, Views into the Crystal Ball, Address before the Committee on Federal Regulation of Securities, American Bar Association (Nov. 13, 1999), available at 1999 WL 1399912 (S.E.C.) (stating the number of IPOs tripled from 1994 to 1998 and that 1999 would also be a record year for the aggregate value of IPOs); Jay Ritter & Ivo Welch, A Review of IPO Activity, Pricing, and Allocations, 57 J. Fin. 1795 (2002) (noting that between 1980 and 2001, an average of one business a day went public); see also Unger, 2000 Address, supra note 5, at *1 (stating that the amount of capital raised in IPOs in 1999 was $69.2 billion, or roughly the size of the 1998 U.S. budget surplus).

7 See Ritter & Welch, supra note 6, at 1796 (adding that the number declined at the end of the IPO boom to $34 billion in 2001).

8 See id. at 1801 (stating that by 1999-2001, 72 percent of companies going public were technology companies, few of these companies had even four quarters of positive earnings, much less four years of positive earnings, which was standard in the 1980s, and 79 percent of these companies had negative earnings).

9 See discussion infra Part II.A.

10 See discussion infra Part II.B.

able to buy these shares until they were resold by an original buyer. Because of the high demand for IPO shares, any investor who was offered the opportunity to buy original IPO shares at the offering price was buying an almost guaranteed first-day profit.

Unfortunately, the majority of the shares issued in IPOs in the last few years did not retain that initial profit, and the share price eventually plummeted, resulting in a loss for the retail investor who purchased in the aftermarket. For every person inside the IPO loop who sold high, a retail investor bought high. What at first seems to be a very respectable process, managed by the most elite investment banks, analysts, and venture capitalists substantially conforming to existing securities laws, turns out to be a Wall Street-sponsored "pump-and-dump" scheme.

Historically, taking a company public was the equivalent of receiving the Good Housekeeping Seal of Approval; not only was the company a success story, but Wall Street was vouching for its potential for all the investing public to see. However, after the end of the most recent IPO boom, investors are beginning to realize that Wall Street was very willing to sell its stamp of approval for the opportunity to use a company's IPO for personal gain. In the 1999-2000 Boom the investing public fell victim to the oldest trick in the IPO order book: The Pump-and-Dump. Together, existing securities laws and industry customs have worked together to create a system that not only routinely excludes the small investor from seizing the opportunity to be an original buyer of IPO shares but also cleverly attracts the same investor to purchase these same shares in the aftermarket, locking in a profit for the fortunate original buyers.

The legal academic literature has previously treated the basic IPO process with undeserved respect. Although academics have focused on specific aspects of the IPO process that could be improved to eliminate certain market inefficiencies or on certain relationships or pieces of information that could be disclosed more fully, this Article fills a specific vacuum by arguing that the entirety of the IPO process is much more in need of reform than any of its parts alone. From the date of the first road show to the date that the last industry player sells original IPO shares, participants use existing avenues in regulatory schemes to

("The traditional allocation of IPOs has been 80% institutional, 20% retail.").

12 See discussion infra Part II.B.

13 One judge in describing the recent technology bust and related putative plaintiff-investor claims not only blamed the starry-eyed investor but also condemned the IPO market as "a freewheeling casino that lured 1,000's obsessed with the fantasy of Olympian riches, but which delivered such riches to only a handful of lucky winners." In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 358 (S.D.N.Y. 2003). Unfortunately, in the case of the IPO market, the lucky winners are not randomly chosen, but are handpicked by the industry players.
extract wealth from retail investors wanting to invest in an initial public offering. Although certain reforms have been enacted or proposed, they address only the symptoms of an infirm process and not the inherent root cause of the infirmity. This Article argues that the root cause of the abuses in the IPO process is the bookbuilding method of distributing IPO shares. This discriminatory system of pre-allocating shares to industry players creates an inefficient market for IPO shares that negatively affects both issuers and secondary market investors.

Section II of this Article describes the predictable movements of the share price of a company engaged in an IPO from the first day of the offering through various time periods and compares these movements to the expected profile of the share price of a company involved in a pump-and-dump scheme. Section III details the various agency problems, conflicts of interest, and levels of participation in the IPO process that are characteristic of the various industry players and investors, and Section IV provides an overview of the common IPO practices, legal and illegal, that result from those agency problems and conflicts of interest. Section V argues that the IPO process should be drastically reformed to improve both the efficiency and the fairness of the offering system, and Section VI discusses in depth one drastic alternative to the current system, the IPO auction. Section VII details recent regulatory reforms that attempt to improve the existing system, and Section VIII reports on the outcomes of certain SEC investigations and the status of certain investor-driven lawsuits that call into question the IPO process. Section IX calls for the abolition of the bookbuilding method and a recreation of the issuer-underwriter relationship to create a more transparent IPO process free from inherent and profound agency problems.

II. BACKGROUND

A. The Life Cycle of an IPO

Generally, the IPO share price usually rises above the offering price during the first day of trading. This increase may be modest or almost incomprehensibly large. Assuming that the resulting price is the “market price,” many commentators then refer to the IPO offering

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14 See Francois Derrien & Kent L. Womack, Auctions vs. Bookbuilding and the Control of Underpricing in Hot IPO Markets, 16 R. FIN. STUDS. 31, 44 (2003) (retelling the story of Broadcast.com, whose shares began the first day of trading at a premium of 277 percent); Debra Baker, Who Wants to Be a Millionaire?, A.B.A. J., Feb. 2000, at 36 (reporting that VA Linux Systems, Inc. stock was priced at $30 per share, then closed on the first day of trading at more than $239 per share).
price as being “underpriced.”

During the period 1980-2001, the average IPO share was underpriced by 18.8 percent. However, underpricing is even more pronounced in “hot” IPO markets than in “cold” markets. Like the stock market as a whole, the market for IPOs can be described as a cyclical bear and bull market. For example, in the 1999-2000 Boom, one study shows that the average stock was underpriced by 65 percent, compared to 2001, the beginning of a cold market, in which underpricing averaged 14 percent. In addition, in the 1999-2000 Boom, the share price doubled in the first day in 182 IPOs out of a total of 803 offerings. However, one research firm shows that the average first-day share price increase, or “pop” in 1999 was even higher: 77 percent. Among IPOs of technology companies, underpricing was even more dramatic, with one-third of these IPOs experiencing an increase in share price of 100 percent or more. Not coincidentally, in bull markets, such as the 1999-2000 Boom, more companies decide to access the capital markets, and more IPOs take place. In bear markets, fewer companies make the same decision.

In the first day of an IPO, shares generally flow from institutional investors, who were allocated original IPO shares from the underwriter, to retail investors in the aftermarket. Although some new issues will see price increases for weeks or even months, the average IPO share price will decrease over the first three years. This dynamic results in

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15 Alexander P. Ljungqvist et al., Hot Markets, Investor Sentiment, and IPO Pricing (Nov. 6, 2003), available at http://ssrn.com/abstract=282293 (last accessed Oct. 3, 2004) (concluding the discounted offer price is lower than the price available in an exuberant market but still higher than the “fundamental value” of the shares) [hereinafter Ljungqvist et al., Hot Markets]; see also Ritter & Welch, supra note 6, at 1820 (stating that between 1980-1997, IPO shares had offering prices 50 percent higher than the share prices of comparable publicly-held companies with similar fundamentals). As used in this Article, “underpriced” reflects the fact that shares are priced less than the price the market would sustain, but does not suggest that the price is less than the fundamental value of the company that each share represents.

16 See Ritter & Welch, supra note 6, at 1795.

17 See Derrien & Womack, supra note 14, at 31 (concluding that in hot markets, underpricing of IPO shares can be “double-digit” or “triple-digit”).


19 Id.


21 See id.

22 See Ritter & Welch, supra note 6, at 1799 (describing the “window of opportunity” created by high investment sentiment that lures businesses to conduct an IPO and concluding that businesses will enter the market at a six-month lag behind high investor sentiment).

23 See Ljungqvist et al., Hot Markets, supra note 15, at 33 (stating 92 percent of shares sold by institutional investors on the first day of trading are bought by retail investors).

24 See Cameron Stracher, Beyond Billable Hours, WALL ST. J., Feb. 12, 2001, at A26 (reporting the share price of Cisco Systems, Inc. rose to 15,191 percent in its first year of public trading). But see Ljungqvist et al., Hot Markets, supra note 15, at 30 (showing companies that have first-day returns over 60 percent will have the worst one-year returns of all issuers in the same year).

25 See Ritter & Welch, supra note 6, at 1817 (concluding that IPO shares have negative three
the original IPO share recipients realizing the most profits, accompanied by some investors who were lucky enough to buy quickly and sell quickly. However, the retail investors who acquired IPO shares from these investors and who did not sell quickly found themselves to be at the bottom of the IPO pyramid once the price eventually declined.26 In addition, underwriters engage in activities that may penalize retail investors but not institutional investors from selling early and realizing a profit, further ensuring that retail investors will not exit as quickly as the institutional investor.27 Unfortunately, these activities are widely known and supported by the agencies charged with regulating these activities.

B. The Pump-and-Dump

Securities laws universally condemn "pump-and-dump" schemes whereby insiders and underwriters hype a company's stock and create an illusion of high demand, then sell their shares once the public has accepted the hype and bought the stock.28 Wall Street generally derides these activities, assigning them to "microcap companies," internet scams and telemarketing ventures. Disturbingly, the movie "Boiler Room" juxtaposes a fly-by-night investment banking firm staffed with loud, aggressive men of varying ethnic backgrounds without ivy league educations against Wall Street investment banking firms staffed with sophisticated, WASP-ish MBAs.29 Of course, the former firm engages almost exclusively in illegal pump-and-dump schemes. Divorcing these stereotypes from the actual behavior, imagine a scenario in which any group of underwriters and company insiders tout the value of a stock,30

year returns and perform 23.4 percent worse than the average market portfolio over the same time period); Janet Cooper Alexander, The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced, 41 UCLA L. REV. 17, 23 (1993) (showing that for the time period 1968-1987, IPO shares grew only two percent in the first five years).

26 See John C. Coffee, Jr., IPO Underpricing and Dutch Auctions, N.Y.L.J., Sept. 16, 1999, at 5 (conceptualizing the eventual decline of IPO prices as the result of issuers "borrowing" earnings from future periods to keep up with the analysts' rosy projections of the IPO share value) [hereinafter Coffee, Dutch Auctions].

27 Boehmer et al., supra note 11, at 14 (showing that in one sample group, institutional investors sold twice as much of their allocated shares in the first two days of an offering than did retail investors).


29 BOILER ROOM (New Line Cinema 2000).

30 See Mark Bonham & Craig Norris, Recent Legal and Accounting Issues in Initial Public Offerings, 10/31/01 REV. SEC. & COMMODITIES REG. 233, 2001 WL 100035512 (2001) (describing how some Internet companies "used the initial public offering as a marketing event, creating legitimacy where the lack of profits and revenues often could not").
create arrangements whereby other industry insiders create demand in the stock in return for cheap stock, and then sell their shares shortly after a successful IPO. This scenario, which describes the U.S. IPO process, is a pump-and-dump scheme.

Each step in the IPO process, when performed by industry players acting in their self-interest, creates an ingenious method to extract wealth from the retail investor. Because industry custom and legal practices combine together to restrict supply and generate demand, IPO share prices may increase substantially, allowing both issuer and industry insiders to sell early and realize profit. However, the average IPO stock will then see a dramatic decrease, leaving the retail investors with built-in losses. In keeping with the theory that pump-and-dump schemes are easier to conduct with smaller issues, dramatic increases in IPO prices in the first day occur in reverse correlation with the size of the issue; the efforts to artificially limit supply are more effective if the supply is thin at the outset. Accordingly, underwriters are able to more effectively manipulate IPO share prices by pre-allocating most of the original shares and controlling the resale of those shares, making the "public float" very small. In addition, this theory of underwriter self-interest is supported by the fact that in boom periods, more underwriters bring more issuers to market. In cold periods, underwriters bring fewer issuers to market. Issuers generally would have the same motivations to raise capital, diversify holdings of the founders, and provide a liquid market for its shares regardless of the temperature of the market; however, underwriters and founders may be more motivated to engage in an IPO when there is a greater opportunity to extract wealth from the market through the IPO process.

This IPO price curve is the expected result of a concerted effort of the investment banks and other industry insiders to extract wealth from the investing public by acquiring stock, hyping that stock, and then selling that stock. Moreover, some facets of the process are legal; other practices are arguably illegal, but common, especially in bullish markets. However, the combined practices create an unfair regime.

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31 The trick, of course, is to sell while there are more buyers than sellers, before the price starts to decline. Some economists believe that the discounted IPO share price reflects the risk that regular customers accept that "sentiment demand" will suddenly cease. Ljungqvist et al., Hot Markets, supra note 15, at 2.


33 See Ritter & Welch, supra note 6, at 1802 (noting that when the market cools, IPOs in preparation generally withdraw from the market altogether, rather than adjust price).

34 See In re Initial Pub. Offering Antitrust Litig., 287 F. Supp. 2d 497 (S.D.N.Y. 2003) (dismissing on preemption grounds plaintiffs' assertions that the entire syndicated underwriting process, including bookbuilding, road shows, impositions of penalty bids, and tie-in arrangements, created an anti-competitive market for IPO shares and artificially inflated the price.
Legal academics and economists have extensively examined the many aspects of the IPO process in the United States and arrived at varying hypotheses about how each aspect may or may not lead to a more efficient IPO market or maximize the issuer’s goals. However, one primary regulatory concern in addressing these practices should be whether the practices working together have an unfair negative impact on the public investor.

C. The Scenario

Envision the stereotypical IPO scenario in the 1999-2000 Boom: A group of entrepreneurs (the “Guys”) own and manage Start.com, a web-based company. The Guys have traditional reasons to engage in an IPO: they want to raise capital; they want to diversify their own portfolios and reduce the risk of tying most of their capital into one asset; they want to obtain liquidity for their shares and the shares that they offer to entice employees, vendors, and service providers; and they want to attain the industry validation that a public offering can bring.

At some point, the Guys begin a relationship with a venture capital firm (VC) that gives them access to capital for growth and for the transaction costs necessary to effectuate the IPO. In return, the Guys give the VC stock and possibly one or more positions on the Board of Directors of Start.com. With this capital and upon the advice of the VC, the Guys hire an independent accounting firm, a law firm, and an investment banking firm (IBank).

The Guys begin discussing with the investment banker (ModelGuy) the logistics of the offering: timing, size, and price. During these discussions, ModelGuy alerts the research department of the investment bank that a new issue is in the pipeline. AnalystGal, the bank’s leading research analyst in the technology industry, starts meeting with the Guys and learning about Start.com. AnalystGal usually offers recommendations on new issuers like Start.com and will in fact be issuing public comments on the value of Start.com’s IPO.

35 Alexander P. Ljungqvist & William J. Wilhelm, Jr., IPO Allocations: Discriminatory or Discretionary?, 65 J. FIN. ECON. 167, 168 (2002) (“The bulk of academic theory treats maximization of proceeds received by the issuer as the appropriate objective.... Some might even argue for non-discriminatory allocations on egalitarian grounds regardless of the consequences for issuing firms.”) [hereinafter Ljungqvist & Wilhelm, Jr., IPO Allocations].

The Guys hope that a positive recommendation from AnalystGal will cause investors to want to buy stock during the IPO.

But first, the Guys and ModelGuy need to determine a price. Common sense suggests that everyone would be proposing the highest price that the market will bear for a given number of shares in the issue. Start.com will only receive the capital raised in the first sale of each share, so the higher the offering price, the more capital that Start.com will receive. IBank receives a percentage of the capital raised, so the higher the offering price, the larger the underwriting fee it will receive and, presumably, the greater ModelGuy's compensation from IBank. However, neither the Guys nor ModelGuy argue for setting the price at the highest price the market will bear. Why not?

The Guys of course already own some shares of Start.com. However, they will also be able to give employees, family members, and friends the opportunity to buy original IPO shares at the offering price. The Guys may even get requests for IPO shares from executives at large, flashy companies that may be future customers, vendors, or strategic partners. The Guys may calculate that underpricing somewhat and giving these business colleagues a chance at guaranteed profit will be good for business. If they can secure a good strategic partnership before the IPO, that news could even help the stock price in the secondary market, sealing everyone's potential profit. The Guys also know a lot of founders who made so much on their IPO shares that they were even able to retire. Therefore, they consciously or subconsciously are aware that they need to "buy low."

ModelGuy has competing considerations himself. ModelGuy knows that in this hot IPO market, investor demand will exceed supply and the price of the stock will increase dramatically in just the first day of trading. ModelGuy also will be calling his favorite clients and offering them the opportunity to buy the shares. These clients may be repeat brokerage customers, such as institutional investors that frequently buy shares traded by IBank, or these clients may be current or potential investment banking clients. ModelGuy knows that an additional investment banking deal and repeat institutional brokerage business will bring in more revenue than the marginal difference in the stock price, so he may be motivated to set the price low in order to guarantee certain valued customers a profit when those customers resell.

Of course, if all these customers sell the first day or two, then the price could plummet and some of ModelGuy's customers might not realize huge gains and may even face a loss. Therefore, the ModelGuy will tell his customers not to sell the shares for a certain period of time. He may also encourage them to buy more shares in the secondary market as a "thank you" for the special allocation. He will restrict the Guys and the VC from selling any shares for six months or so. If
anyone gets nervous that market conditions may cause the price to drop before they can sell, ModelGuy will ask AnalystGal to be sure and issue favorable reports on Start.com as soon as legally possible and again simultaneously with the end of this lock-up period. If AnalystGal can maintain positive recommendations on the stock, then ModelGuy's customers are virtually assured of realizing a profit from the shares that they will be allocated if they sell early.

The IPO team determines a price, and the IPO goes forward. The Guys take the opportunity to allocate some IPO shares to friends, family, and employees. ModelGuy allocates IPO shares to repeat institutional investors, regular customers, and executives at companies that he either has taken public before or would like to take public at a later date. AnalystGal issues favorable reports about this great new company. The IPO price skyrockets the first day. Some of the initial investors sell during the first days and realize huge profits. At the end of the lock-up period, the Guys, their friends, family members, and employees, and ModelGuy's executive clients sell. Because of AnalystGal's continuing support, the price remains high enough for this group to also realize huge gains. Everyone wins.

III. THE PLAYERS

To understand how a process that should benefit the issuer and the investing public has evolved to benefit primarily agents and intermediaries, we need to analyze the specific agency problems, conflicts of interest, and moral hazard inherent in the relationships at issue in the IPO process. The term "moral hazard" is sometimes used narrowly to describe the incentive created by a contract, usually an insurance contract, for one party to do nothing and create losses that the party will not eventually bear. However, the more general use of the term, and the one that is employed here, is to describe the incentive created by any agreement between parties for one party to actively engage in dubious behavior that will either reward the party or at least not create loss for the party.37 Each of the players in the process has the

37 See, e.g., HOWELL E. JACKSON ET AL., ANALYTICAL METHODS FOR LAWYERS 50 (2003) ("After a contract is made, a party to it may have incentives to act in a way that's detrimental to the other party to the contract."); ROBERT H. MNONOKIN, ET AL., BEYOND WINNING: NEGOTIATING TO CREATE VALUE IN DEALS AND DISPUTES 13 (2000) ("In almost ever deal in which the parties have a continuing relationship there will be the potential for moral hazard. The moral hazard problem concerns post-contractual opportunism."). In its more general economic use, the term "moral hazard" is almost interchangeable with the concept of opportunism. Opportunistic behavior is defined as "when a performing party behaves contrary to the other party's understanding of their contract, but not necessarily contrary to the agreement's explicit terms." Timothy J. Muris, Opportunistic Behavior and the Law of Contracts, 65 MINN. L. REV.
motivation and opportunity to act in their self-interest to the detriment of both the issuer and the retail investor. Section IV will describe the IPO process and the actions of these players in that process that are motivated by self-interest and opportunism.

A. The Founders

Although much of the economic and legal literature addresses the concerns of the issuer in the IPO process, traditional IPO theory has not separated the founders from the issuer as an entity; however, the founders and the issuer may have different short-term interests in the IPO scenario. Under the theory of the firm, the issuer is a separate legal entity from the managers, directors, and the shareholders, and at times the long-term interest of the firm may deviate from the short-term goals of the shareholders, directors, and managers. In the beginning of the corporate life cycle, before outside investors and before any public offering, the shareholders, directors, and managers may be the same group of people. These founders operate the company in such a way as to increase profits to enlarge the pool of excess cash available to pay salaries, make capital improvements, and generally enhance the quality of corporate life. Until now, not much concern is paid to the "share price" because the founders' shares do not have a market for resale. The founders generally think of the value of their shares as the value of their proportionate ownership in the enterprise, i.e., the present value of their share of future profits and the liquidation value of land and equipment. At this stage, the interests of the issuer as an entity and the founders may be functionally consistent: to make appropriate investments in capital to increase revenues and lower costs.

Once the founders decide to attract outside investment, whether through a private or public offering, the interests of the founders, future shareholders, and the issuer begin to diverge and moral hazard is created. Founders may want to generate capital for the purpose of providing the company with funds it needs to grow and prosper, but founders may also be interested in an "exit strategy." Although most founders will continue to be shareholders, directors, or managers of the


39 See id. at 155 (noting that undiversified managers have interests that are aligned with the company's long-term goals more than diversified stockholders, at least until the managers liquidate their undiversified holdings).

40 Jensen & Meckling, supra note 36, at 312-13 (describing how agency problems arise when owner-managers sell equity shares to outside shareholders, reflecting the conflicts of interest between the parties).
issuer, the sheer amount of personal wealth that could be manipulated from an IPO is very tempting and may take priority over raising the most capital for the long-term goals of the company.\textsuperscript{41} Founders begin to have short-term interests instead of long-term interests.

This opportunism of the founders may be reflected in their willingness to allow the underwriter to underprice their IPO offerings. The founders will not sell their shares at the IPO price in the offering and may be required by the underwriter to hold their shares for six months or more. However, founders will offer IPO shares at the offering price to relatives, friends, employees, business colleagues, and other industry acquaintances.\textsuperscript{42} To the extent that founders can deliver cheap stock to these individuals, the instant wealth created the first day of the IPO will inure to their benefit.\textsuperscript{43} The founders then sell their own shares after any lock-up period, designated by the underwriter, ends, generally ninety to 180 days after the IPO.\textsuperscript{44} Accordingly, in IPO issues, the amount of manager-owned shares is positively related to the amount of underpricing.\textsuperscript{45} Founders may also be encouraged to underprice the shares by underwriters who promise them allocations in future IPOs.\textsuperscript{46}

\textsuperscript{41} The willingness of the founders to underprice the shares for a quick profit may be relative to the founder's pre-IPO net worth, with wealthy founders less susceptible to the temptation. See Shawn Tully, Betrayal on Wall Street, FORTUNE, May 14, 2001, at 84 (describing billionaire Ross Perot as being "outraged" when institutional investors flipped shares of Perot Systems after its 1999 offering for a $180 million profit). Cf. RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 6 (2d ed. 1995) (quoting a Kurt Vonnegut character who advises a law student to pay attention to transactions in which large amounts of money will change hands: "If the man who is to receive the treasure is unused to wealth, has an inferiority complex and shapeless feelings of guilt, as most people do, the lawyer can often take as much as half the bundle, and still receive the recipient's blubbering thanks.").

\textsuperscript{42} This Article does not address the efficiency or fairness of practices whereby issuers may issue stock to these same individuals in a private offering prior to an IPO.

\textsuperscript{43} See Booth, supra note 32, at 158-59 (describing the seemingly irrational desire of existing shareholders to have issuers underprice the stock so that they may benefit from the "big pop in price" rather than to set the share price at market level and allow for both the existing shareholders and issuer to benefit from the higher price); see also In re Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281, 366 (S.D.N.Y. 2003) (alleging as proof of motive in § 10(b) claim against individual officers and directors the gains that the individuals made from underpricing, which ranged from $220,000 to $40 million in 309 issues).

\textsuperscript{44} Rajesh K. Aggarwal et al., Strategic IPO Underpricing, Information Momentum, and Lockup Expiration Selling, 66 J. FIN. ECON. 105, 106 (2002) (explaining why founders are unconcerned with IPO share price and instead focus on price at the expiration of the lock-up period) [hereinafter Aggarwal et al., Lockup].

\textsuperscript{45} Id.

\textsuperscript{46} John C. Coffee, Jr., "Spinning" for Dollars: IPOs and Allocation of Hot Issues, N.Y.L.J., Mar. 26, 1998, at 5 (describing a hypothetical scenario in which founders are inclined to protest because the share price jumped the first day but are placated both by their newly created personal wealth and by receiving IPO shares of another client of the investment banker) [hereinafter Coffee, Spinning].
Although the venture capital firm is not technically in an agency relationship with the issuer during the IPO,\textsuperscript{47} the VC has some conflicts of interest with the issuer and may be in a position to influence the issuer's decisions in choosing the underwriter and in setting the IPO offering price. In most circumstances, a venture capital firm will have provided the issuer with capital that helps the company to become established and grow and then to get organized and proceed with the IPO, which can be expensive.\textsuperscript{48} As part of the bargain, the VC receives shares of the company, and the issuer agrees to work toward a successful IPO that will enable the VC then to sell its shares and "cash out."\textsuperscript{49} The VC may also negotiate for a position on the Board of the Directors pre-IPO so that the VC can somewhat control the issuer's short-term strategies.\textsuperscript{50}

To the extent that the VC has any contribution to the pricing of the IPO shares, the VC may want to create the largest short-term premium so that the VC can also realize gain in the IPO. The VC may also be motivated to underprice to ensure that the offering is completed and that the firm's position in the issuer is closed. If the VC's shares will be restricted by the underwriter after the IPO, the VC will be susceptible to underwriter persuasion to underprice, to create investor interest and enthusiasm, and then to exit in a successful secondary offering within six to nine months.\textsuperscript{51} Notably, principals in the VC will have had much input in the selection of the underwriter,\textsuperscript{52} who may even reward them by granting additional IPO shares at the IPO offering price or by allocating original shares in an unrelated IPO.\textsuperscript{53}

\textsuperscript{47} However, if a principal of the VC is a director, the principal will have fiduciary duties to the issuer.
\textsuperscript{48} See Robert D. Kraus, *Inevitable Conflicts?: When a Venture Capitalist is a Director*, 13 BUS. L. TODAY 49, 49 (Jan./Feb. 2004) (describing the process by which a small company partners with a VC firm for capital in return for preferred stock).
\textsuperscript{49} The VC's shares may be common stock or preferred shares convertible to common. If an IPO does not seem feasible, then the issuer may court potential acquirers instead, and the acquisition then becomes the VC's exit strategy. See Timothy J. Harris, *Modeling the Conversion Decisions of Preferred Stock*, 58 BUS. LAW. 587 (2003) (noting that acquisition events are much more common exit events for VCs, especially in "cold" markets such as the post-2000 market).
\textsuperscript{50} Kraus, *supra* note 48, at 49-50.
\textsuperscript{51} See Tully, *supra* note 41, at 88 (describing the underwriter's "pitch" to VCs "ripe for the plucking" who might otherwise not agree to the investment banker's underpricing strategy or refusal to negotiate fees).
\textsuperscript{52} Some venture capital firms are even divisions of investment banking firms. See Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1050 (2003) (remarking that this relationship is problematic, giving investment banks yet another incentive to support the IPO share price in the secondary market).
C. The Underwriter

Although the founders may have a conflict of interest with the issuer, a more profound agency problem in the IPO process arises between the investment bank and the issuer.\textsuperscript{54} Although the investment banker's role is to advise the issuer on raising capital with the least cost, the investment banker may be using the issuer to extract wealth for its regular customers and future clients.\textsuperscript{55} The underwriter has a conflict of interest not only when it courts potential clients with IPO shares of a current client, but also for simply representing both the buyer and the seller in the same transaction.\textsuperscript{56} In most public offerings, a lead underwriter, an investment banker at an investment banking firm, manages a syndicate of other broker-dealers who will be responsible for selling blocks of the IPO shares. The lead underwriter will also be responsible for distributing some portion of the IPO shares.

Most importantly for our analysis, the underwriter has primary responsibility for pricing the IPO shares and for distributing them. In the United States, almost all IPOs are conducted using the bookbuilding method, which gives the underwriter extraordinary discretion in the pricing and allocation of the IPO shares. Section IV.A. discusses the bookbuilding process in more detail.

Some commentators have argued that because underwriters have ultimate responsibility for sale of the IPO shares in a firm commitment offering that they intentionally underprice IPO shares for an easy distribution.\textsuperscript{57} Still others have argued that underwriters intentionally underprice IPO shares to avoid shareholder fraud litigation based on overpricing or to mitigate damages based on share price declines in those lawsuits.\textsuperscript{58} The third major reason for underpricing, and the one most often cited by economists, is as consideration to investors who give the underwriter price information by indicating during the bookbuilding process at what prices they would be willing to buy the

\textsuperscript{54} Ljungqvist & Wilhelm, Jr., IPO Allocations, supra note 35, at 169 (hypothesizing moral hazard problem in which investment bankers collude with regular customers to extract rents from the issuing companies).

Although this Article focuses on the conflicts arising in the context of pricing and allocating IPO shares, recent media attention has also exposed areas in which underwriters may entice potential investment banking customers with promises to be business clients. See Randall Smith, Companies Put a New Squeeze on their Investment Banks, WALL ST. J., Aug. 26, 2003, at A1 (describing how Morgan Stanley told Accenture Ltd. during preliminary investment banking meetings that Morgan Stanley would purchase $20 million in consulting services from the firm).

\textsuperscript{55} See Tully, supra note 41, at 84 (describing the IPO process as an "IPO con game").

\textsuperscript{56} See id. (charging that underwriters award regular customers with "artificially cheap shares" and get "high-commission stock trades" in return).

\textsuperscript{57} But see Ritter & Welch, supra note 6, at 1807 (counter-arguing that this theory is weak because underpricing is more severe in hot IPO markets when shares are easiest to sell).

\textsuperscript{58} See Alexander, supra note 25, at 24 (discussing three models of lawsuit avoidance theory).
IPO shares. Although some of those rationales may have some truth to them, the underpricing of IPO shares is often an intentional act designed to extract wealth for the few that receive original IPO allocations.

The underwriter begins the offering with an artificially low price, allowing key beneficiaries access to this bargain. The low price attracts investors to the initial offering, which stimulates demand for the shares in the secondary market. The most underpriced offerings take place in the hottest markets, where retail investors are prone to be overly optimistic and to buy shares as part of a “bandwagon effect.” The high demand creates a high initial return, which stimulates even more demand. The underwriter is then able to constrict supply further by using stabilizing techniques, requiring original IPO shareholders to buy additional shares, and requiring original IPO shareholders to hold on to those shares for some period of time. Once the price increases to a satisfactory level, the original IPO investors are able to sell their shares and recognize large gains.

Critical to the underwriter’s incentive to underprice is the fact that the underwriter has the power to determine which institutions and individuals will be able to share in this wealth extraction. The underwriter can use this power to reward current investment banking clients, reward current brokerage clients, reward venture capital firms that send underwriting business, and entice future investment banking clients. Although the underwriter and the investment bank may not directly profit from selling profit-laden original IPO shares, they benefit from being able to parcel out that privilege and expect something in return. If the IPO share prices were not underpriced and therefore did not have a virtual built-in, guaranteed profit, then the underwriter

59 See Ritter & Welch, supra note 6, at 1805.
60 See discussion infra Part IV.A (discussing overpricing of IPO shares).
61 See Hersh Shefrin, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 248 (2000) (hypothesizing that investment banks underprice issues to create demand for the purpose of motivating investors to form a “bandwagon”).
62 See Ritter & Welch, supra note 6, at 1808 (concluding the greater the initial underpricing, the greater the trading volume in the aftermarket).
63 See discussion infra Part IV.E (flipping) and Part IV.F (laddering and stabilizing techniques).
64 Derrien & Womack, supra note 14, at 60 (describing the agency conflict of interest between the issuer, who may want to mitigate underpricing of shares, and the underwriter who may choose to reward repeat customers such as brokerage customers, over issuers).
65 See Tully, supra note 41, at 86 (hypothesizing that one reason underpricing and IPO allocations grew markedly in the 1999-2000 Boom was that underwriters desperately wanted to offer brokerage clients something that the new, cheap on-line brokerages could not).

Now anytime you take a company public at an artificially low price, there is
would forego a lucrative opportunity to maintain and attract valuable business. Therefore, an underwriter motivated by opportunism will underprice IPO shares at the expense of the issuer.67

Although the founders select the underwriter and presumably could switch underwriters if they were unhappy with the relationship, some have suggested that the market for investment banks is not truly competitive given the small number of investment banks and the uniform fee structures.68 In fact, litigation is ongoing by both investor-plaintiffs and issuer-plaintiffs alleging antitrust violations against investment banks in setting underwriting fees.69 Additionally, as more issuers both have suffered economic losses from the bursting of the technology bubble and been named as defendants in securities litigation brought by IPO investors, some issuers have brought lawsuits against the underwriters for breach of contract and breach of fiduciary duties relating to such practices as underpricing and allocating the majority of original IPO shares to underwriter customers.70

guaranteed profit. Anytime there is guaranteed profit to be assigned by somebody, there are kickbacks. It doesn't matter if you are talking about some Paraguay customs official or if you are talking about some white shoe banker on Wall Street. So what they were doing is giving guaranteed profits to their friends and pension funds and other things and getting kickbacks.

Id.

67 See id. (quoting a former investment banker as saying that historically, a "major pop" was a "black mark" that reflected that the underwriter was not balancing the interest of both issuers and investors).

68 See Coffee, Dutch Auctions, supra note 26, at 5 (describing underwriters as having a monopsony in which three underwriters constitute 50 percent of the market for IPOs and in which all underwriters charge a 7 percent fee for IPOs). A "monopsony" is a monopoly comprised of buyers, as opposed to sellers. See also Andres Rueda, The Hot IPO Phenomenon and the Great Internet Bust, 7 FORDHAM J. CORP. & FIN. L. 21, 31 (2001) (comparing the non-negotiable 7 percent fee in the U.S. to underwriting fees of 3.4 percent in Japan and 5 percent in Europe).

69 See In re Pub. Offering Fee Antitrust Litig., Nos. 98 Civ. 7890, 00 Civ. 7804, 2003 WL 21496795 (S.D.N.Y. June 27, 2003) (consolidating both issuer and investor actions to deny motions to dismiss on the basis that SEC regulation and NASD regulation of underwriting fees did not preclude cause of action for antitrust violations); In re Pub. Offering Fee Antitrust Litig., Nos. 01-7585(L), 01-9072, 52 Fed. App. 548 (2d Cir. 2002) (denying motion to dismiss in investor class action based on reasoning that investors' claimed damages in paying higher IPO prices was sufficient to plead cause of action); In re Issuer Plaintiff Initial Pub. Offering Antitrust Litig., No. 00 Civ. 7804, 2004 WL 487222 (S.D.N.Y. Mar. 12, 2004) (denying motions to dismiss on statute of limitations grounds in issuers' class action claim that twenty-eight major investment banks violated the Sherman Act by colluding to charge uniformly higher fees in IPOs).

70 See, e.g., MDCM Holdings, Inc. v. Credit Suisse First Boston Corp., 216 F. Supp. 2d 251 (2002) (denying underwriter's motion to dismiss in class action that alleges, among other things, that the underwriter breached the underwriting agreement by purposefully underpricing the shares in order to enrich itself and incur kickbacks from regular customers that received allocations); Xpedior Creditor Trust v. Credit Suisse First Boston (USA), Inc., 309 F. Supp. 2d 459 (S.D.N.Y. 2003) (granting in part a motion to compel discovery in class action by issuers against Donaldson Lufkin & Jenrette Securities Corp. for breach of contract in underpricing eighteen IPOs in return for receiving kickbacks from customers receiving allocations).
D. Research Analysts

The "independent" research analyst is generally not considered to be in an agency relationship with either the issuer or the investing public. Therefore, the moral hazard of the research analyst arises not from a contract or an agreement between the research analyst and the issuer or even the public, but in the pressures on the research analyst to produce biased research reports. Here, the analyst acts as an accessory to the underwriter in engineering the pump-and-dump scheme, and in fact, the scheme can only work on a large scale through the efforts of the analyst.

Although research analysts have traditionally been viewed as independent gatekeepers to the capital markets and as mere conduits of information from the issuers to the shareholders, the latest scandals have exposed analysts as opportunists acting under severe personal and career conflicts of interest. Although some analysts may be independent of financial or career restrictions, many "sell-side" analysts are cost-center employees at investment banking firms that rely on brokerage commissions and investment banking business for revenue. These conflicts of interest also create pressure on the research analyst to collude with the investment bank to issue overly optimistic reports and recommendations to maintain artificially high IPO share prices for a sufficient period of time.

In the IPO context, Professors Fisch and Sale have identified three conflicts of interest that may lead an analyst to zealously hype an IPO stock and have argued that the analyst be seen as in a quasi-agency relationship with the investor. In the most obvious conflict situation, an analyst may personally own stock in the issuer. In addition, the

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71 See In re Merrill Lynch & Co., Research Reports Sec. Litig., 273 F. Supp. 2d 351, 357 (S.D.N.Y. 2003) (noting that investors did not claim a fiduciary relationship with professional analysts that issued research reports "free of charge").
72 See generally Fisch & Sale, supra note 52, at 1038 (positing that analysts "have been relatively free from regulation" due to the SEC's view that analysts were "unbiased market gatekeepers").
73 See William R. Hambrecht, Comments on the NASD/NYSE IPO Advisory Committee Report, 7 No. 1 Wallstreetlawyer.com: Sec. Elec. Age 11 (2003) ("Historically, underwriting, distribution, research and lending were provided by separate firms, helping to create systemic checks and balances. This is no longer the case.").
75 See Fisch & Sale, supra note 52, at 1043-56 (concluding that because of these conflicts, analysts should be seen as salespeople or at best conduits of issuer management to present selected information to the public).
76 See id; Firm Fined Over "Hot" IPOs; Broker Charged for Tainted Reports, 8 No. 17 ANDREWS SEC. LITIG. & REG. REP. 9 (Jan. 15, 2003) (reporting that Paul Johnson, former
analyst may enjoy a relationship with the issuer's officers that provides him with information about this company and the industry, or may work at a firm that either has or wants to have the issuer as an underwriting customer. Recently, litigation has exposed the fact that research analysts' compensation and bonuses are related to effects on increased brokerage activity and obtaining or maintaining investment banking business, not on accuracy of the analysts' reports themselves. Each of these three conflicts create an incentive for the analyst to praise the issuer and contribute to the price inflation of the IPO shares. Studies have shown that the market reacts markedly to analysts' reports and recommendations; therefore, the analyst has substantial power to influence the price of an individual stock through published reports.

In addition, during the 1999-2000 Boom the analyst played an

managing director and senior research analyst at Robertson Stephens, settled SEC charges that he issued favorable coverage of a merger without disclosing that upon completion of the merger, he would recognize a multimillion dollar windfall and that he issued a "buy" recommendation for another stock that he was then simultaneously selling and telling associates to sell) [hereinafter Firm Fined]; see also Testimony Concerning Global Research Analyst Settlement: Hearing Before Sen. Comm. on Banking, Housing & Urban Affairs 2 (2003) (statement of William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm'n) (testifying that the SEC first began investigating research analysts in 1999 with the suspicion that certain media star analysts were not disclosing personal conflicts of interest) [hereinafter Donaldson Testimony].

See Mohammed Hadi, NASD Reaches Settlement Pact with Banc of America Ex-Analyst, WALL ST. J., Dec. 10, 2003, at C5 (reporting that ex-analyst Andrew Hamerling issued positive research regarding SBC Communications Inc., even though he privately contradicted that opinion because he was fearful that SBC would deny him access to future information); Deborah Solomon & Robert Frank, Stock Analysis: "You Don't Like Our Stock? You Are Off the List" WALL ST. J., June 19, 2003, at C1 (describing sentiment on Wall Street that analyst reforms will not reduce pressure analysts receive from companies to produce positive research reports in return for continued access to information).

See Fisch & Sale, supra note 52, at 1056; Donaldson Testimony, supra note 76, at 2 (testifying that research analysts at investment banking firms commonly provided reports on companies whose offerings were underwritten by the same investment bank).

See Donaldson Testimony, supra note 76, at 2-3 (charging that analyst compensation at investment banks was in large part based on the success of the investment banking departments and that investment bankers evaluated research analysts for purposes of determining compensation).

See Shayne & Soderquist, supra note 74, at 981-82 (presenting empirical evidence that during the period between 1988 to 1991, analysts were more likely to issue a "buy" recommendations if the analysts' firm had an investment banking relationship with the company (71.5 percent versus 56 percent) and much less likely to issue a "sell" recommendation (0.7 percent versus 7.1 percent)).

Determining whether the investment bank or the issuer is the more powerful party in this symbiotic relationship can be difficult. The NASD recently fined an investment bank for threatening to discontinue analyst coverage unless the issuer agreed to future investment banking fees of a minimum of $1 million. See Press Release, NASD Fines Robertson Stephens and Former Vice President $350k for Attempting to Coerce Investment Banking Fees (Apr. 7, 2004) available at http://www.nasdr.com/news/pr2004/release_04024.html).

See Fisch & Sale, supra note 52, at 1042 ("The securities markets have become highly sensitive to revisions of analyst estimates and to discrepancies between analyst predictions and issuer announcements of actual operating results, often responding to either with substantial price fluctuations.").
MORAL HAZARD AND THE IPO

integral and high-profile role in the hyping of IPOs. Because the analyst is not prohibited from issuing future projections or other nonpublic information during the waiting period, the analyst often made a cameo appearance at the road show.\(^8\) During the road show, the analyst would endorse the company and the upcoming offering and would present predictions along with data, giving institutional investors exclusive information and creating relationships between the analyst and the issuer and the analyst and the institutional investors. Although the market has treated the analyst as independent and trustworthy, these relationships create a great opportunity for moral hazard and self-interest, especially in the IPO context in which the only information regarding an unseasoned company may come from the issuer and the analysts.\(^8\)

E. The Institutional Investor

Although institutional investors are part of the investing public, in the IPO process, the institutional investor is given the opportunity to profit at the expense of the issuer and other investors. As a repeat customer of the underwriter, the institutional investor is in a position to insist on access to a scheme that will extract wealth from the investing public. Institutional investors are anything but passive investors; these industry players exert influence not only over management in the companies in which they invest, but also over brokerage firms and investment banking firms, and therefore receive preferential treatment.\(^8\)

In addition to receiving advantageous IPO allocations, the institutional investor may also be able to exert some influence over the research analysts at a brokerage firm.\(^8\) Like the investment bank, the institutional investor has an incentive for the share price to increase in the secondary market and so may pressure the investment bank and the analyst to maintain demand for the shares until the institutional investor has sold its shares.\(^8\) This incentive to maintain the share price may

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\(^8\) See id. at 1041.

\(^8\) See id. at 1079 (concluding that the conflicts of interest inherent in the analyst-investment bank relationship unfairly prejudice the retail investor by artificially raising IPO share prices “for companies that have no realistic prospects of success and which subsequently become insolvent”).

\(^8\) Institutional investors also receive preferences in how their trades are sold on public exchanges. See generally Eric C. Otness, Balancing the Interests of Retail and Institutional Investors: The Continuing Quest for Transparency in Today’s Fragmented Equity Markets, 96 Nw. U. L. Rev. 1607 (2002).

\(^8\) See Fisch & Sale, supra note 52, at 1050 (explaining that institutional investors are crucial to a successful underwriting business and that these investors “are unwilling to tolerate an analyst who downgrades a stock in which they hold a substantial position, leaving them to take the loss”).

\(^8\) See id. (noting that analysts feel pressure to support the IPO share price until the
even cause the institutional investor to agree to buy a smaller number of shares in the aftermarket to guarantee a profit for all of its shares. In addition, because institutional investors are repeat customers, they may agree to participate in “cold” offerings to ensure opportunities to participate in “hot” offerings.

These investors are also given preferential treatment by the SEC and are exempt from paternalistic regulation. This exemption creates opportunities for participation and acquisition of information not available to retail investors. One of the perquisites of being an institutional investor is being invited to participate in IPOs through both attending road shows and being allocated IPO shares. Therefore, most recipients of original IPO shares are institutional investors. Moreover, institutional investors are allocated more shares in “hot” IPOs. In addition, although brokers may request that original investors not “flip” their allocated shares before a certain date, most brokers give preferential treatment to institutional investors in this regard.

The market has seen dramatic growth in the activity of institutional investors in recent years. The major sources of capital in the U.S. are pension funds, insurance companies, and mutual funds. Although the institutional investors have exited the stock).

87 In Liar’s Poker, Michael Lewis gives a good example of how a large participant in the market can move the market by buying and selling until the price is conducive to him doing the exact opposite. In Lewis’ example, a money trader at Salomon Brothers in the 1970s needed to buy (borrow) $50 million, but every time he posted a bid, the price (interest rate) increased due to his large bid. Realizing the power that he had, the trader then sold (loaned) $100 million until the market collapsed and he was able to buy $150 million at the lower price. MICHAEL LEWIS, LIAR’S POKER 88 (1989).

88 Although the prevalence, effect, and legality of this practice is beyond the scope of this Article, economists have noted that in non-U.S. IPO auctions that distribute shares pro rata according to price and size of bids, institutional investors do not feel pressure to bid on “cold” issues. Matti Kiloharju & Sani Torstila, The Distribution of Information Among Institutional & Retail Investors in IPOs, 8 EUR. FIN. MGMT. 357, 358 (2002).

89 One far-reaching example is the ability of companies to privately sell securities to “accredited investors” under Regulation D without triggering disclosure requirements. Most institutional investors are by definition considered accredited investors. See 17 C.F.R. § 230.501(a) (2004) (defining “accredited investor”).

90 See Jeffrey W. Markham, Protecting the Institutional Investor—Jungle Predator or Shorn Lamb?, 12 YALE J. ON REG. 345, 346-47 (1995) (describing the securities regulation scheme as having two tracks, one for institutions and one for retail customers).

91 See Reena Aggarwal et al., Institutional Allocation in Initial Public Offerings: Empirical Evidence, at 2 (forthcoming 2002) (stating that institutional investors receive approximately 75 percent of all original IPO shares) [hereinafter Aggarwal et al., Institutional Allocation].

92 See id. at 8 (questioning whether institutions are given IPO shares in offerings in which investment banks have private information or in offerings where the demand is high). Note that this phenomenon triggers a chicken-or-egg scenario: Do institutional investors receive larger allocations in IPOs that the investment bank knows will have a high initial return or does the size of the institutional allocation restrict demand and therefore create the high initial return?

93 See discussion infra Part IV.E (flipping).

94 See Markham, supra note 90, at 347 (stating that in 1995, institutional investors held more than half of all corporate stock).
rise of the institutional investor can be tied to progressive improvements in some corporate governance issues, the fact that the institutional investor is a major beneficiary of the IPO allocation process has prevented that investor from reforming this problematic practice.  

F. The Retail Investor

Although the participation of individuals in the stock market grew substantially in the 1990s, the retail investor did not and does not participate fully in the IPO process. In the 1990s, individual investors were given unprecedented access via the internet and cable television to financial news reports and information; however, these investors were generally excluded from attending IPO road shows and from buying original IPO shares. Retail investors generally have less information concerning IPOs than institutional buyers and have the opportunity to purchase IPO shares only in the secondary market, when they are trading at a premium. The term “retail” investor even implies that someone else is purchasing the same good at a lower, “wholesale” price.

In addition, although retail investors have access to massive amounts of information, some studies show that these investors may make investment decisions not based on accurate processing of information but on trends or hype. Investors who make arguably “irrational” investment decisions have been called “sentiment investors” to distinguish them from professional arbitrageurs. Some argue that retail investors are more susceptible to “noise trading,” which may lead to buying at inefficient prices, which will be corrected by arbitrageurs’ trading returning prices to fundamental value.

95 See Coffee, Victim, supra note 34, at 5 (concluding that underpricing is a cost of capital that accrues to the underwriter and the institutional investor).
96 See 2000 Address, supra note 5.
97 See Charles Schwab & Co., Inc., SEC No-Action Letter, 1999 WL 1038050 at *3 (Nov. 15, 1999) (“[O]nly retail investors are discriminated against by being precluded from getting the benefits available from receiving road show information.”)
99 See id. at 20 (defining arbitrageurs as “smart money” and “rational speculators”).
100 See discussion infra Part IV.I (noise trading).
101 See Shleifer & Summers, supra note 98, at 28 (describing how some retail traders follow positive feedback strategies that ensure that they will “buy high”).

However, many retail investors do not make sympathetic victims and some behavior of retail investors in the 1999-2000 Boom has led commentators to argue that part of the blame for investor losses lies with the individual investors themselves. See Daniel Kadlec, Investigate the Investors, TIME, Aug. 13, 2001, at 68 (revealing that greedy investors used home equity loans and credit cards to finance stock purchases, curried favor with others to get on friends-and-family lists, let stock earnings ride to escape paying taxes, and manipulated calculations of net wealth to brokers to be eligible for risky IPO investments); Andy Kessler, Let’s Be Frank, WALL ST. J., May 6, 2004, at A18 (admitting that as a fund manager, the author had dumped original $9 IPO
Initial public offerings and the persons involved in them are governed by an interconnected group of public and private regulators. Of course, IPOs are primarily regulated by the SEC, through the Securities Act of 1933. In addition, underwriters that distribute IPO shares are members of the National Association of Securities Dealers and as such are regulated by that organization’s rules. The issuer will also be required to conform to the listing requirements of the exchange upon which the issuer’s shares will be traded, such as the New York Stock Exchange. The NASD and the NYSE are the two most important self-regulatory organizations (SRO’s), and each organization’s rules must be approved by the SEC before taking effect. The SROs propose rules, which are published in the Federal Regulations, and receive comments from the public before the rules are finalized. These comments from industry participants can substantially affect the resulting final rules.

Until recently, the NASD had long relied on Rule 2110 and its Free-Riding and Withholding Interpretation, IM-2110-1, to regulate underwriting practices in IPOs. The Free-Riding and Withholding Interpretation requires that IPOs be “bona fide public distributions” at the “public offering price” and prohibits certain practices in “hot” IPOs, which are defined as IPOs in which the shares trade at a premium on the first day. Some of the practices described below violate the Free-Riding and Withholding Interpretation or other NASD or SEC rules; however, many of the practices specifically do not.

shares of mp3.com, “the dumbest idea in history,” in the first “45 seconds” of the IPO for $60 per share to foolish small investors who were essentially gambling by placing no limit orders in an IPO.

102 See In re Initial Pub. Offering Antitrust Litig., 287 F. Supp. 2d 497, 507 (S.D.N.Y. 2003) (“As a registered national securities association under the 15 U.S.C. § 78o-3, the NASD comprehensively and actively regulates syndicates—including their formation, communications among syndicate members, commission structure, allocation of securities and fee arrangements—pursuant to rules that are formally reviewed by the SEC and subject to its approval.”).

103 15 U.S.C. § 78s(b) (2000). Because the NASD and NYSE rules often mirror each other and because the NASD rules specifically govern broker-dealers, this Article will focus on NASD rules and not their NYSE counterparts.

104 See discussion infra note 317 (describing how one proposed subsection of proposed NASD Rule 2712 was deleted due to negative comments from the financial industry).

105 See NASD Rule 2110 (Standards of Commercial Honor and Principles of Trade) (“A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.”).

106 See NASD IM-2110-1(b) (describing certain sales to restricted persons as violations of Rule 2110) [hereinafter Free-Riding and Withholding Interpretation].
iv. the practices

A. Bookbuilding and Underpricing

The central practice in the IPO process that creates moral hazard for the underwriter is the bookbuilding method and the opportunity to underprice shares using this method. In the United States, the dominant method of distributing IPO shares is the bookbuilding method. In this method, the underwriter seeks indications of interest from large institutional investors and other wealthy investors concerning the shares and the price of the shares. This information collecting happens during the registration waiting period, often at road shows or at face-to-face meetings. This process continues until a few days before the shares are priced and the registration becomes effective. At that time, the underwriter allocates IPO shares to investors who have indicated an interest in the shares, such as institutional investors, regular customers, persons on the friends and family list, and other individuals at the discretion of the underwriter. Other than the Free-Riding and Withholding Interpretation restricting the underwriter, its affiliates, and other industry affiliates from buying the shares and certain restricted persons from purchasing shares under certain circumstances, the underwriter has control of the allocation process. Through the bookbuilding process, the vast majority of the original IPO shares will be distributed to known investors through the underwriter.

The moral hazard of the bookbuilding process is created not only by discriminatory allocations, but also by the underpricing that almost always occurs in the bookbuilding process. Because bookbuilding has traditionally been the only method of distributing IPO shares in the United States, ascribing the underpricing of those shares solely to the bookbuilding method has been difficult. However, in other countries where issuers may choose from a variety of distribution methods, bookbuilding has been shown to create more underpricing than other

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108 See Ljungqvist et al., Hot Markets, supra note 15, at 32 (noting that having a small number of original investors facilitates the underwriter’s task of tracking those investors).
109 See IM-2110-1(b)(5) (providing an exception to the general rule in (b)(3) and (4) that the underwriter cannot sell “hot” IPO shares to fiduciaries, finders, and officers of certain institutional investors that such sale is permitted if “the securities were sold to such persons in accordance with their normal investment practices” and “the amount sold to any one of such persons is insubstantial in amount”).
110 See Therese H. Maynard, Spinning in a Hot IPO—Breach of Fiduciary Duty or Business as Usual?, 43 WM. & MARY L. REV. 2023, 2031 (2002) (“In general, the lead underwriter’s decision as to how to allocate the shares of an IPO is not subject to substantive regulation under the terms of either the 1933 or 1934 Acts.”).
Many economists and legal academics have attempted to explain why IPO shares are consistently underpriced in the United States using the bookbuilding method. The most common explanation is that underwriters discount IPO shares to compensate the institutional investors for providing price information during the bookbuilding process. Of course, not all of the originally priced IPO shares go to the investors that provided pricing information, so others also share in this discount. Other commentators have argued that underwriters and issuers underprice shares to avoid litigation, to create goodwill among investors that would support a secondary or follow-on issue, or to create "buzz" about the new company. In addition, an underwriter reasonably could underprice an issue somewhat to ensure that the offering closes successfully, avoiding the risk of a failed offering.

All of these studies assume that the underwriter is acting in the best interest of the issuer and that there is no agency problem between the issuer and the underwriter. However, if this assumption is abandoned, a moral hazard theory that the underwriter is acting opportunistically seems more plausible. If the underwriter is acting in its own self-interest, then the underwriter may be motivated to underprice the issue in order to extract wealth from the market to reward colleagues and friends. Adding to the equation, underpricing itself may create more of a premium in the secondary market by attracting demand, therefore manipulating the share price to rise to a level that an original IPO share price could not have sustained.

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111 See Derrien & Womack, supra note 14, at 33 (noting that the auction process worked better than the bookbuilding process and other hybrid models at controlling underpricing in both hot and cold markets).

112 See Ritter & Welch, supra note 6, at 1809 (compiling Table 4, which lists twenty-eight economics articles on IPO allocations).


114 See id. at 6 (noting that underpricing is essentially a discount to informed investors for supplying price information, but uninformed, "free-rid[ing]" investors that do not provide price information may also get shares at the same discount).

115 See generally Alexander, supra note 25.

116 Interview by Martin Smith with Bill Hambrecht, CEO of W.R. Hambrecht + Co., (2001), at http://www.pbs.org/wggh/pages/frontline/shows/dotcon/interviews/hambrecht.html (last visited Oct. 3, 2004) (speaking during the making of PBS' Dot Con about the IPO process and admitting that as an underwriter he would often advise clients to underprice somewhat so that companies could "start out as a winner," which would make regular investors more willing to buy more in the aftermarket).

117 But see Ritter & Welch, supra note 6, at 1807 (hypothesizing that although agency problems exist, the issuer may not be motivated to incur high monitoring costs and so acquiesces to underpricing).

118 See id. at 1810 (noting that underwriter discretion is not automatically used in the best interest of the issuing firm).

119 See id. (concluding that underpricing, even substantial underpricing, can maximize the aftermarket price for founders).
However, because the underwriter’s compensation is based on the IPO share price, the indirect benefits to the underwriter as a result of underpricing must be worth more than the difference in compensation. Logically, the difference between seven percent of the underpriced shares and seven percent of the “market priced” shares could easily be outweighed by even one additional investment banking client, a relationship that would generate another seven percent of an issue and by brokerage commissions from original IPO recipients. In numerous cases in which the underwriter was charging outrageously excessive commissions from customers in return for the privilege of being allocated original IPO shares, the underwriter was definitely profiting more from sharing IPO profits with brokerage customers than it was losing in its percentage underwriting fee. Recently, the NASD announced that it had fined Bear, Stearns & Co. Inc, DBSecurities, Inc., and Morgan Stanley & Co. for repeatedly receiving commissions within one day of hot IPO allocations during 1999-2000 that were obviously excessive; for example, $100,000 fee instead of the usual $3,000 fee, $800,000 fee instead of $63,000 fee, and $3 per share instead of $.06 per share.

The company, however, only receives the proceeds from the original distribution of the IPO shares: the number of shares issued multiplied by the IPO offering price. Therefore, the company does not directly benefit from underpricing or the increase in share price in the secondary market. In fact, some economists have hypothesized that

[120] Determining what the “market price” of an IPO share would be, even ex post, is problematic. I would argue that the price as of the close of the first day of the offering should not be used as a benchmark for what the fair price of the IPO share should have been at the beginning of the offering. The underpricing itself creates artificial demand that may drive the closing price above what the “fair price” would have been in the absence of underpricing. In addition, the other practices described below, such as laddering, threatening flipping penalties, and issuing biased analyst reports, adds to the problem of accurately measuring what the IPO share price would be in the absence of the moral hazard problem of the underwriter.

[121] See also Ritter & Welch, supra note 6, at 1810 (hypothesizing that the commission that the underwriter left on the table could be eclipsed just by original allocation recipients incurring commissions from resales).

[122] See Press Release, NASD Sanctions Investment Bankers for IPO Violations (May 18, 2004), available at http://www.nasdr.com/news/pr2004/release_04_033.html. In addition, NASD charged Invemed Associates LLC in April 2003 for “unlawful profit-sharing activities” in connection with receiving inflated commissions ($2 per share as opposed to approximately six cents per share) in return for allocating customers underpriced original IPO shares in 1999 and 2000. Press Release, NASD Charges Invemed Associates with Sharing in Customers’ Profits from Hot IPOs (April 15, 2003), available at http://www.nasdr.com/news/pr2003/release_03_014.html [hereinafter Invemed Press Release]. One example cited was a customer who received allocations of original IPO shares in VA Linux Systems, Inc. and FogDog Sports on the same day in December 1999. Id. On that day, the customer profited $550,000, and entered into a wash trade in a different liquid security, paying Invemed $140,000 in inflated commissions for the trade. Id. On the days that IPOs were launched, Invemed’s earned brokerage commissions were up to six times more than on an average day. Id.

[123] But see Derrien & Womack, supra note 14, at 32 (noting that some amount of underpricing
because severe underpricing is positively related to poor long-term returns, issuers suffer long-term effects from not generating sufficient capital in the IPO because of underpricing. One writer has estimated that for every $1 raised in an IPO in 1999-2000, the issuer paid 57 cents in fees and un-received proceeds due to underpricing, causing these issuers to run short of cash later.

Agency problems and moral hazard created by lack of information have traditionally been reduced by monitoring, but in this situation neither the issuer, operating through the founders, or the future shareholders have an ability to monitor the bookbuilding process. Only the underwriter is aware of the price information that he is receiving, and only the underwriter is aware of the identity of the original IPO share recipients. This information is not made public through the registration process or afterward, so neither the issuer or future shareholders are able to make a determination as to whether the pricing and allocation process was efficient.

B. Road Shows

One integral component of the bookbuilding process is the road show. During the waiting period, underwriters are prohibited by SEC rules from making written offers to sell the security, but underwriters may make oral statements in connection with the security. This distinction allows the underwriters and issuers to hold presentations for

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124 See Aggarwal et al., Lockup, supra note 44, at 106.
125 See Tully, supra note 41, at 84 (describing the money left “on the table” as causing many dotcoms to eventually fail).
126 Aggarwal et al., Institutional Allocation, supra note 91, at 2 (stating that the SEC does not mandate public disclosure of allocations, making this facet of the IPO process “opaque”).
127 Specifically, section 5(c) of the Securities Act prohibits any “offer to sell” through “the use or medium of any prospectus.” 15 U.S.C. § 77a(5)(c) (2000). An “offer” is defined to include “every attempt or offer to dispose of, or solicitation of an offer to buy” a security. 15 U.S.C. § 77a(2)(a)(3). In addition, a “prospectus” is defined as “any . . . communication, written or by radio or television.” 15 U.S.C. § 77a(2)(a)(10). Prior to the effective date, issuers may distribute a preliminary prospectus conforming to section 10(a) that has been filed with the registration date. See 17 C.F.R. § 230.430 (2003).
128 Oral statements generally do not run afoul of Section 5 of the Securities Act. See THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 2.4[2][A] (4th ed. Supp. 2004). However, such statements are subject both to antifraud provisions such as Section 12 and Rule 10b-5 and to the SEC’s prohibition on “conditioning the market.” See Publication of Information Prior to or After the Effective Date of a Registration Statement, Exchange Act Release No. 33-3844, 22 Fed. Reg. 8359, 1957 WL 3605 (S.E.C. Release No.) (Oct. 8, 1957).
potential investors at which investors may ask questions and receive answers about the future of the issuing company.\textsuperscript{129} In addition, the issuer may display a slide presentation that contains financial projections, although copies of the presentation are not provided for the investors.\textsuperscript{130} Although the issuer may hesitate to make future projections about the company that are not included in the registration statement, analysts may do so; therefore, including a star analyst in the road show format was increasingly common during the 1999-2000 Boom.\textsuperscript{131} Furthermore, the issuer may hold road shows in numerous cities during the waiting period and may hold smaller, individual meetings with large investors in connection with the road shows.\textsuperscript{132}

However, the nature of the road show does not increase the flow of information to all investors but instead guarantees informational asymmetry between influential institutional and individual investors and retail investors. Road shows are generally not open to the public and instead are only held for invited investors.\textsuperscript{133} Retail investors are not invited or allowed to view the road shows.\textsuperscript{134}

Issuers and underwriters argue that road shows cannot be open to the general public without exposing them to greater liability for forward-looking statements.\textsuperscript{135} This argument assumes that the underwriter trusts those investors that are invited to the road shows and therefore can encourage the issuer to speak candidly about the future

\textsuperscript{129} See Raymond Hennessey & Phyllis Plitch, Next on Regulators' Wish List: Open Disclosure for New Issues, WALL ST. J., May 27, 2003, at C5 (remarking that issuer representatives will answer questions from invited investors at road shows).

\textsuperscript{130} See The Regulation of Securities Offerings, Exchange Act Release No. 7606A, 63 Fed. Reg. 67174, 67215 (Dec. 4, 1998) (noting that participants at road shows are not permitted by the organizers to take any materials from the presentation besides the preliminary prospectus) [hereinafter SEC Release 7606A].

\textsuperscript{131} See Hennessey & Plitch, supra note 129, at C5 (describing how investment banks routinely have had research analysts give projections at road shows).

\textsuperscript{132} See generally Brian C. Eddy, Internet Road Shows: It's Time to Open the Door for the Retail Investor, 25 J. CORP. L. 867, 869-71 (2000) (describing the process of holding road shows in several cities until days before the end of the quiet period); see also Reena Aggarwal, Allocation of Initial Public Offerings and Flipping Activity, 68 J. FIN. ECON. 111, 115 (2003) (noting that the 1999 Goldman Sachs IPO included road shows in thirty-eight cities and eighteen countries, sixty-three face-to-face meetings and twenty-seven group meetings, resulting in contacts with 1,100 institutional investors) [hereinafter Aggarwal, Flipping].

\textsuperscript{133} See Adam Lashinsky, It's Time to Open Up the Road Show: What the SEC Doesn't Want you to Know, FORTUNE, Nov. 8, 1999, at 338; see also Hennessey & Plitch, supra note 129, at C5 (describing how the asymmetry of information between what is given to clients at road shows and what is given to uninvited retail investors ensures that "the playing field for IPOs isn't level"); SEC Release 7606A, supra note 130, at 67214 (noting that the limited audience at road shows generally comprises selected broker-dealers and large investors).

\textsuperscript{134} See Eddy, supra note 132, at 879 (noting that retail investors are prohibited from viewing traditional road shows).

\textsuperscript{135} But see SEC Release 7606A, supra note 130, at 67215 (commenting that the oral nature of road shows may encourage issuers to present complex information only orally, knowing that investors will not be able to reference the oral statement at a later date).
prospects of the company. Moreover, one might argue that if road shows were required to be open to the public, issuers would not make forward-looking statements at them and instead only provide information already found in the prospectus. Thus, no investor would benefit from making road shows more accessible because the result would be less information overall.

Furthermore, the road show is an integral piece of the underwriters’ claim that IPO underpricing and allocation is necessary consideration for investors who provide valuable pricing information during the bookbuilding process. Because institutional investors are the only investors invited to the road shows, they are the only investors who can swap price information for IPO share price discounts. Retail investors are caught in a vicious cycle that renders them unable to participate in that bargain given that they are barred from providing pricing information during the bookbuilding process. Whatever the reason for maintaining exclusivity for road shows, the result is that retail investors are restricted from fully participating in the market for IPOs because they are not privy to the same information as the institutional investors.

C. Discretionary Allocations: Spinning

At the heart of the moral hazard problem facing underwriters is the ability of the underwriter in the bookbuilding process to allocate IPO shares to whomever the underwriter chooses. For the purposes of this Article, this process of allocating IPO shares to designees of the underwriter will be referred to as “spinning.” Although the term may be used to describe only allocations that are made pursuant to an agreement that a corresponding benefit has been or will be returned to the underwriter, what constitutes an “agreement” and a “benefit” is murky. This Article argues that any underwriter-driven allocation has some expected or desired economic reward in mind, so the term “spinning” will be used more liberally.

Most spinning to favored clients is not prohibited under either SEC rules or NASD rules. Some have argued that underwriters require free discretion in allocations to place shares in the hands of long-term

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136 One journalist reported on this fact after he listened in on a conference call with institutional investors and underwriters of Webvan and heard much more information than he found in the preliminary prospectus. See Lashinsky, supra note 133, at 338.

137 See id. ("After all, if a young company is following SEC rules and not making further material disclosures during its chitchats with professional investors, what does it have to hide?").

138 See Sherman & Titman, supra note 113, at 4 (arguing that investment bankers must underprice in order to extract necessary information for institutional investors).
investors, providing a benefit to the issuer. This argument is easily refuted, however, by noting that institutional investors flip shares with more frequency than retail investors. In addition, although the underwriter benefits from a smaller group of shareholders to track, the issuer may actually benefit from diffuse ownership by more investors. However, underwriters have other reasons to allocate IPO shares to particular investors that benefit the underwriter alone, and not the issuer.

Although spinning IPO shares to investors as a quid pro quo for an economic benefit has historically been prohibited by SEC and NASD rules, recent reports have focused on widespread use of IPO allocations by underwriters not only to generate more commissions, and even to generate higher-than-usual commissions, but also to induce future underwriting business. The NASD and SEC have recently been aggressive in investigating and charging defendants that were spinning IPO shares to brokerage customers in return for increased commissions. In conjunction with an investigation regarding conflicts of interest between the research analysts and the investment banking department at Credit Suisse First Boston, the SEC charged that CSFB violated securities laws by allocating shares in hot IPOs to certain clients of CSFB who in turn agreed to return part of their IPO windfalls to CSFB in the form of excessive brokerage commissions. In

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139 See Aggarwal, Flipping, supra note 132, at 113 (presenting the traditional argument that institutional investors are "strong hands" who will be long-term investors). But see Ljungqvist et al., Hot Markets, supra note 15, at 2-3 (arguing that institutional investors play a slightly different role, slowly and gradually selling IPO shares to retail investors over a period of time in order to sustain IPO share price).

140 See Aggarwal, Flipping, supra note 132, at 113 (presenting the fact that institutional investors flip more than retail investors, especially in hot offerings, by selling 46.74 percent of their holdings in the first few days); Tully, supra note 41, at 84 (stating that during 1999-2000, typically 80 percent of IPO shares were allocated to 125 funds, but ninety percent of those funds sold the shares within two weeks).

141 See Kiloharju & Torstila, supra note 88, at 370.

142 Plaintiff’s Complaint against CSFB in SEC v. CSFB LLC (Apr. 28, 2003) (charging CSFB with improper spinning practices in violation of section 17(a) of the Securities and Exchange Act of 1934, Rule 17a-3, NASD Rule 2110, and Rule 3110).

143 John Hechinger & Randall Smith, FleetBoston Proposes Settlement of Charges Against Robertson IPOs, WALL ST. J., Nov. 18, 2002, at C10 (reporting that the SEC charged Robertson Stephens with extracting excessive fees in return for allocations of IPO shares). The excessive commissions were up to 4,000 percent higher than usual and were charged on matching “buy” and “sell” trades with no economic effect except the payment of the commission. These charges were settled in January of 2003 for $28 million. See Firm Fined, supra note 76; Invemed Press Release, supra note 122 (charging that excessive commissions paid by spinnees of hot IPO shares accounted for one-third of Invemed’s total commission revenue).

144 Randall Smith, NASD Proposes Tougher Rules on IPO Abuses, WALL ST. J., July 29, 2002, at A1 (recounting 1997 story of GT Interactive Systems executive Joseph Cayre, who received 100,000 shares of Pixar Animation Studios from Robertson Stephens, profited $2 million on the first day of trading, and then chose Robertson Stephens as the lead underwriter for GT’s IPO).


January of 2003, CSFB settled with regulators regarding both research analyst improprieties and IPO allocations.\textsuperscript{147} Another practice that was widespread during the 1999-2000 Boom but more difficult to monitor was the practice of underwriters spinning IPO shares to start-up company executives\textsuperscript{148} and VC firms\textsuperscript{149} in order to encourage future investment banking business from these individuals. This practice was also widespread at CSFB, the firm that employed Frank Quattrone,\textsuperscript{150} one of the most celebrated technology stock analysts during the 1990s and early 2000s. Although Quattrone’s initial trial for obstruction of justice ended in a mistrial in October 2003, prosecutors retried him for the same charges in April 2003 and secured a conviction.\textsuperscript{151} In just one scenario depicted in Quattrone’s trial, emails between him and Michael Dell were entered into evidence, showing Mr. Dell as saying: “We would like 250,000 shares of Corvis. I know there have been efforts on both sides to build the relationship [between Dell Inc. and CSFB], and an offering like this would certainly help.” In another set of emails, Quattrone apparently allocated IPO shares of Corvis to Amerindo Investment Advisers after a principal of that company indicated that he might recommend CSFB to start-up companies in return.\textsuperscript{152}

Spinning to current and future customers in return for future banking business is not clearly prohibited by the Free-Riding and Withholding Interpretation.\textsuperscript{153} In addition, investment banks and IPO

\textsuperscript{147} See Letter of Acceptance, Waiver and Consent, No. CAF030026 from Gary G. Lynch, Global General Counsel, CSFB Corp., to Department of Enforcement, NASD 3 (Apr. 21, 2003), available at http://www.nasdr.org (explaining how CSFB’s $100 million settlement, including disgorgement of $70 million in illegal commission monies, in January 2003 was part of its total $200 million liability under the Global Settlement) [hereinafter CSFB Consent Letter].

\textsuperscript{148} See Tully, supra note 41, at 84 (quoting Scott Painter, creator of Build-to-Order and Cars-Direct: “When they want your IPO, the banks get their private-client guys to call and say they’ll put you into other companies’ hot IPOs”).

\textsuperscript{149} See Smith et al., Something Ventured, supra note 53, at C1 (reporting that Robert C. Kaggle, a partner at VC firm Benchmark Capital, and his family members, received hot IPO allocations from Goldman Sachs, the investment bank that Benchmark sent most of its start-up companies to for underwriting services).

\textsuperscript{150} See Gardner & Gardner, supra note 66 (quoting one CEO as claiming that Quattrone received 50 percent of the IPO profit he provided clients as kickbacks and concluding, “This is how Wall Street operates.”); Kessler, supra note 101, at A18 (noting that Quattrone made $120 million a year during the time period in question).

\textsuperscript{151} Although not currently facing charges relating to the underlying IPO allocation practices, Quattrone was prosecuted on charges relating to email instructions to CSFB employees to destroy documents relating to an SEC investigation into those practices. Kara Scannell & Randall Smith, Quattrone Mistrial May Give Prosecutors Reason to Hesitate, WALL ST. J., Oct. 27, 2003, at C1. On May 3, 2004, the jurors in the second trial quickly convicted Quattrone on two counts of obstruction and one count of jury tampering. Randall Smith, Quattrone Found Guilty on 3 Counts in Big U.S. Win, WALL ST. J., May 4, 2004, at A1.


\textsuperscript{153} See Maynard, supra note 110, at 2043 (concluding that the text of the Free-Riding and
allocation recipients do not enter into written contracts whereby IPO shares will be spun and investment banking business will be given. These understandings are rarely that explicit, even if verbalized, and the line between “non-binding banter” and quid pro quo is fairly nebulous.\footnote{Withholding Interpretation seeks to prevent “mutual back scratching” among financial services institutions but does not anticipate investment banking quid pro quo relationships).}

Superficially, spinning IPO shares does not seem to have negative effects for the investing public as a whole.\footnote{See id. at 2053-54 (suggesting that spinning may violate NASD Rule 3060, which prohibits payments and gratuities of over $100 to persons if in relation to the business of the person or the person’s employer, but that proving the quid pro quo connection would be difficult).} The lucky “spinnees” are not taking away any right of a specific individual to IPO shares,\footnote{See Coffee, Victim, supra note 34, at 5 (pondering whether the public is affected by whether the allocation recipient, who extracts wealth, by flipping paid the underwriter for the privilege).} and spinning itself does not necessarily inflate the share price in the aftermarket. However, the practice of spinning in the 1999-2000 Boom, combined with underpricing, created serious problems in the IPO process. The act of spinning primarily offends the sensibilities as being unfair,\footnote{Cf. Carol B. Swanson, Insider Trading Madness: Rule 10b-5-1 and the Death of Scienter, 52 U. KAN. L. REV. 147, 159 (2003) (describing how proponents of regulating insider trading have difficulty articulating the dangers of insider trading but have “the gut instinct that insider trading is just plain wrong”).} but it may also facilitate market manipulation. First, underwriters generally allocate 80 percent of an offering.\footnote{See Boehmer et al., supra note 11.} Combine that number with the number of shares allocated in directed share programs, and the retail investor attempting to participate in the original IPO distribution has little chance of such participation. Additionally, the ability to spin IPO shares is the ability to artificially constrict supply in the face of high demand. Because most of those allocated shares and directed shares will be subject to either a written agreement or a verbal understanding that they are not to be sold in the first few days or even for a longer period,\footnote{See discussion infra Section IV.E. (flipping restrictions).} the supply of shares available to be bought in the aftermarket is very low. The retail investor will buy in an era of short supply, and may see the price decline once the supply of shares increases when original allocation recipients begin to sell later.

Furthermore, the underwriter who spins IPO allocations is acting opportunistically in a conflict of interest with the issuer to maximize the amount of capital raised in the offering.\footnote{See Coffee, Spinning, supra note 46, at 5.} If the underwriter is hoping to allocate guaranteed IPO profit to customers as incentive for a future benefit, then the underwriter will do whatever necessary to guarantee
that built-in profit.\textsuperscript{161} Therefore, the underwriter's incentive to underprice is directly related to his ability to spin the IPO shares. Without the ability to grant these winning lottery tickets, the underwriter would price the shares with the motivation to raise more money for the issuer and increase his percentage underwriting commission.\textsuperscript{162} Otherwise, the underwriter extracts wealth from the investor that should have gone to the issuer and gives it to persons as an inducement to receive an even more valuable benefit later.\textsuperscript{163} Thus, the processes of unfettered allocation and underpricing to the detriment of the issuer are inextricably linked.

The process of spinning implicates the self-interest of the recipient as well. If the recipient is an executive of a company and chooses the investment bank for an upcoming company offering, then the executive may be breaching fiduciary duties to the company by using his position in the company to usurp a corporate opportunity or to accept a bribe.\textsuperscript{164} In addition, if the recipient is a principal at a VC firm, then the principal may be breaching duties of loyalty to the investors in the VC firm.\textsuperscript{165}

Although the public investor in the IPO being spun would have difficulty proving that the spinning activity harmed him, private lawsuits concerning IPO spinning have been brought by investors in the companies that employ the spinnees under the theory of breach of fiduciary duty. Under this theory, the opportunity to buy IPO shares would have to be closely related to the business of the company or of some interest as an investment opportunity to the company.\textsuperscript{166} In \textit{In re eBay, Inc. Shareholders Litigation},\textsuperscript{167} shareholders of eBay, Inc. sued seven directors of the company for breaching their fiduciary duty of

\begin{itemize}
  \item[\textsuperscript{161}] See Coffee, \textit{Victim}, supra note 34, at 5 (noting that if the first-day pop is large, then the underwriters intentionally underpriced the shares with the purpose of being able to grant “free money” to designated clients).
  \item[\textsuperscript{162}] Cf. id. (concluding that the SEC’s focus on side payments of allocation recipients is focusing on the symptom of the problem that the underwriter can control the first-day gains, and thereby create guaranteed value in an original IPO share, through stabilization techniques).
  \item[\textsuperscript{163}] See Tully, supra note 41, at 84 (remarking that the practice of spinning is “tantamount to using what should have been another issuer’s money to pay for the firm’s own marketing expenses”).

  The value to be gained by the underwriter must be more than the additional incremental commission and even more than the nonrealized gain in capital because when Goldman, Sachs went public in 1999, Goldman underpriced its shares and spun itself. See Smith et al., \textit{Something Ventured}, supra note 53, at C1 (describing how during its own IPO, Goldman allocated shares to several venture capital companies that steered IPO clients to Goldman, including Benchmark Capital).
  \item[\textsuperscript{164}] See Coffee, \textit{Spinning}, supra note 46, at 5; Pocket, supra note 1, at 71.
  \item[\textsuperscript{165}] See Smith et al., \textit{Something Ventured}, supra note 53, at C1 (noting that some institutional investors in VC funds do not like principals being enriched by being able to use institutional investors’ money to steer investment banking business).
  \item[\textsuperscript{166}] See Maynard, supra note 110, at 2070.
  \item[\textsuperscript{167}] \textit{In re eBay, Inc. Shareholders Litig.}, No. Civ. A. 19988-NC, 2004 WL 253521 (Del. Ch. Jan. 23, 2004).\end{itemize}
loyalty to the company by accepting IPO allocations from Goldman Sachs and selling them for profits of many millions of dollars. Between 1998 and 2001, eBay, Inc. retained Goldman on three different occasions to provide underwriting services. During that same time period, four of the defendants, who were directors, officers, and major shareholders of eBay, received hot IPO allocations in over 200 total Goldman IPO offerings. These defendants quickly sold these shares in the aftermarket for millions of dollars in profit. The plaintiffs allege that the defendants received these shares as rewards for past investment banking business or inducements for future banking business and that these investment opportunities should have been for the benefit of the company, not the individuals. The Delaware Court of Chancery denied a motion to dismiss filed by the eBay defendants and Goldman Sachs, which was charged with aiding and abetting the breach of fiduciary duty. As to whether the facts alleged a usurping of a corporate opportunity, the court reasoned that even if the allocations were not a corporate opportunity the directors still had a duty to "account for profits obtained personally in connection with transactions related to his or her company." This case is ongoing.

Led by New York Attorney General Eliot Spitzer, the State of New York instituted a lawsuit that also focused on the "spinnee," not the investment bank "spinner." This lawsuit named as defendants certain executives of public companies who allegedly received IPO shares, as well as positive analyst recommendations, from New York investment banks in return for taking lucrative investment banking

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168 See id. at *1 (recounting that Goldman was the lead underwriter in eBay's 1998 IPO, the underwriter in its 1999 secondary stock offering, and its financial advisor in its acquisition of PayPal, Inc.).

169 See id. (Pierre M. Omidyar, co-founder and former CEO, CFO and President, owns 23 percent of eBay and received IPO allocations in at least forty IPOs; Margaret C. Whitman, current CEO, President and director, received allocations in over 100 IPOs; Jeffrey S. Skoll, co-founder and former Vice-President, President and director, owns 13 percent of eBay and received allocations in at least seventy-five IPOs; Robert C. Kagle, director, received allocations in at least twenty-five IPOs).

170 See id. at *5 (reasoning that because Goldman knew or should have known that the defendants owed a fiduciary duty to eBay and that eBay had investments in marketable securities, the allegations were sufficient to adequately plead the aiding and abetting allegations).

171 See id. at *4.


173 Bernard Ebbers (WorldCom), Philip Anschutz (Qwest), Joseph Nacchio (Qwest), Stephen Garofalo (Metromedia Fiber), Clark E. McLeod (McLeod USA). For example, Mr. Ebbers, an executive at WorldCom, was accused in the complaint of receiving shares in twenty-one different IPOs that generated a profit of $11 million during a four year period in return for granting Salomon pieces of twenty-three investment banking transactions, which garnered $107 million in fees to Salomon. See N.Y. Attorney General Sues Top Execs for Proceeds of Hot IPOs, 16 No. 12 ANDREWS WHITE-COLLAR CRIME REP. 20 (Nov. 2002) (reporting that the case alleges that the five defendants recognized a total of $28 million in profits from the sale of IPO stock and $1.5 billion from the sale of stock in their own companies due to inflated research analyst's ratings, which were part of the complete spinning relationship).
business to those same investment banks. The complaint argued that an officer’s act of receiving profitable IPO shares from an investment bank and then directing underwriting business in a subsequent offering to that bank is a material fact that would need to be disclosed to the public in connection with that offering under New York’s Martin Act\(^\text{174}\) and Executive Law. Under the New York state statute, the prosecution does not need to prove that the defendants received the shares with the intent to return any favor to the investment bank but can instead simply prove that the relationship between the defendant and the investment bank was material.\(^\text{175}\)

D. **Friends and Family Programs: Spinning by Any Other Name\(^\text{176}\)**

Issuers can also use underpricing to allocate locked-in profits to fortunate persons. Also known as directed share programs, most\(^\text{177}\) issuers reserve some IPO shares for “friends and family.”\(^\text{178}\) As the name suggests, this legal practice originated as a way to give a token amount of IPO shares to relatives and friends of founders and employees.\(^\text{179}\) However, in the IPO bubble, these programs grew to include not only relatives, friends, and employees, but also potential business partners, analysts, venture capitalists, members of the media, attorneys, and other industry players.\(^\text{180}\) Although friends and family shares had historically accounted for a small, single-digit percentage of an offering, in the last decade these shares have grown to a substantial

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\(^{174}\) N.Y. GEN’L BUS. LAW § 352-c (McKinney 2004).

\(^{175}\) See Steve A. Radom, Balkanization of Securities Regulation: The Case for Federal Pre-emption, 39 TEX. J. BUS. L. 295, 302 (2003) (noting that the Martin Act does not have a scienter or intent to defraud element).

\(^{176}\) See William Wright, Talking Point: Friends and Family IPO Relic Should Freshen Up or Be Banned, FIN. NEWS, Dec. 8, 2002, at http://www.efinancialnews.com/index.cfm?nav=999&action=print_view&passedref=1850 (arguing that when these programs are extended to business contacts, they are just disguised spinning).

\(^{177}\) But see Kathleen Pender, Be Cautious When Business Associates Offer Access to IPO Shares, S.F. CHRON., Apr. 7, 2000, at B1 (reporting that Hewlett-Packard did not offer a directed share program when it conducted an IPO for its subsidiary Agilent because the company believes such program to be “unethical”).

\(^{178}\) See Bonham & Norris, supra note 30.

\(^{179}\) See Warner, supra note 20, at 104.

\(^{180}\) See Pender, supra note 177, at B1 (commenting that directed shares originally went to 10 or 15 friends or relatives but now are given to “thousands of people ranging from hairdressers to business associates”); Renee Deger, IPO Directed Share Plans Pose Risks, NAT’L L.J., Sept. 13, 1999, at B5 (quoting a Silicon Valley investment banker as saying, “A lot of companies are looking at it as an opportunity to reward historical, prospective or future partners”) [hereinafter Deger, Risks].

Companies can also distribute shares to these groups absent an IPO in either a small private placement or by issuing warrants or options in anticipation of a future IPO.
amount of a “public” offering.\textsuperscript{181} In one highly publicized IPO, friends and family shares constituted 42 percent of the offering.\textsuperscript{182}

Directed shares became a type of currency in the late 1990s,\textsuperscript{183} with an opportunity to receive friends and family shares approaching the equivalent of a sure bet.\textsuperscript{184} Receiving friends and family shares even became a status symbol in some social and business circles.\textsuperscript{185} Because of their almost unlimited value, directed shares were also very valuable ways to entice or reward business people in a given industry. Although the SEC has focused attention on some directed share programs, this attention merely concerns whether companies were improperly distributing written communications to distributees\textsuperscript{186} or making offers\textsuperscript{187} before the effective date of the registration date.

The most insidious, but as yet legal,\textsuperscript{188} use of directed shares creates a house of cards in which directed shares are used to purchase IPO share value, with the increased IPO share value thereby giving value to the directed shares. Company A is a start-up company without a positive record of earnings or profits. However, Company A is planning an IPO. Company A is in negotiations with Company B, a well-respected company in the industry,\textsuperscript{189} concerning a long-term

\textsuperscript{181} See Deger, Risks, supra note 180, at B5 (noting that traditional programs constituted 10 percent or less of an offering, but have grown to distribute that much for a single recipient).

\textsuperscript{182} See Renee Deger, Delicate Dance With the SEC, LEGAL INTELLIGENCER, Dec. 13, 1999, at 4 (reporting that in the mp3.com IPO, 27 percent of the offering was reserved to one investor group and another 15 percent to musicians) [hereinafter Deger, Dance].

\textsuperscript{183} See Chris Nolan, How I Got A Chance at Dot.com Wealth, FORTUNE, Sept. 6, 1999, at 261 (giving as evidence that the opportunity to receive IPO stock was a guaranteed sure bet the fact that some persons offered a chance to buy friends and family stock were not even asked to provide the initial purchase price before receiving the allocation).

\textsuperscript{184} See id. (describing the author’s being offered friends and family stock as similar to “being at Pimlico Racetrack with Granddad, the trifecta winners printed in the racing form just for us”); Pender, supra note 177, at B1 (arguing that the receipt of direct shares is almost a guarantee of making a profit if those shares are sold shortly after the offering).

\textsuperscript{185} See Warner, supra note 20, at 104 (describing the social cachet of “getting in” on an IPO).

\textsuperscript{186} See Bonham & Norris, supra note 30, at 233 (warning issuers and underwriters to ensure that all writings, including e-mail communications, conform to Section 5 and rule 134); see also Deger, Risks, supra note 180, at B5 (describing the SEC as being in a “tizzy” worrying whether these acquaintances were given proper information).

\textsuperscript{187} See Deger, Dance, supra note 182, at 4 (describing the SEC’s scrutiny of registration documents to ensure that the arrangement for venture capitalists receiving directed shares is not guaranteed in the venture capital agreement and therefore a pre-effective date “offer” or “sale”).

\textsuperscript{188} See Bonham & Norris, supra note 30, at 233 (noting that the SEC is not troubled by the participation of business partners in large public offerings but is concerned with private placements of stock with customers and vendors because of accounting issues arising from future revenues that are not discounted for the value of the stock given to receive that revenue). \textit{But see} Pender, supra note 177, at B1 (considering a scenario whereby the business associate recipient of the directed shares might be charged with commercial bribery under California state law for accepting something of value “in return for using or agreeing to use his or her position for the benefit of that other person”); CAL. PENAL CODE § 641.3 (West 2004).

\textsuperscript{189} Company B does not necessarily need to be a seasoned company. During the IPO bubble, start-up company founders often put each other on directed share lists in a mutual back-scratching
relationship, such as a five-year contract for Company B to purchase large amounts of Company A's products. Company A offers the executives of Company B some directed shares in the upcoming IPO. The executives accept the investment opportunity and recommend the contract between Company A and Company B, which is then signed and announced to the public. Now Company A has a guaranteed revenue stream heading into the IPO. The market responds to the news of the contract and shares increase five- or six-fold in the first few days, creating substantial wealth for the Company B executives. This scheme may be repeated by Company A with both large and small customers.

One example of this scenario involved the 1999 IPO of Sycamore Networks. Sycamore, a new company, had earlier announced that Williams Communications, a large communications company, would buy $400 million of fiber-optic network-related products from Sycamore. The market reacted favorably to this announcement and helped to give Sycamore one of the best first days in IPO history, with a share price that rose from $38 to $270 at the beginning of trading on the first day. However, two executives and a handful of other employees

system. See Nolan, supra note 183, at 264 (quoting another Silicon Valley player as saying, "It's a select group of people who are giving each other money.").

190 Some seasoned companies have policies that either forbid employees participating in IPOs with the companies' business contacts; some companies require notice and approval. See Pender, supra note 177, at B1 (listing SBC Communications and Cisco Systems as two companies with prohibitory policies).

191 See Warner, supra note 20, at 104 (quoting venture capitalists as saying that giving current and future customers a "small hit" is good business).

192 Other similar schemes have also been exposed. One also involves Williams Communications in a transaction whereby two other Williams executives were given the opportunity to buy pre-IPO shares in ONI Systems Corp. for $6.32 each. See Gretchen Morgensen, Sweetheart Stock Deals Common in Telecom, TULSA WORLD, Sept. 1, 2002, at E1. A few months later, Williams announced that they had signed a $30 million contract for ONI Systems Corp.'s fiber optic network-related products. Id. Three months later, IPO shares in ONI were offered for $25, with that price rising to $136.75 within the month. Id. One executive's gain was $43 million, which could be seen as a "huge financial inducement for [the executive] to buy from that potential vendor." Id. The same newspaper article details an identical transaction between Michael R. Rouleau, an executive at Time Warner who received 4,500 shares of friends and family stock in Sonus Networks two months before Time Warner announced a major contract with Sonus, causing the stock to rise to $83.62 before plummeting to less than a dollar a share two years later. See id.; see also Jeff Smith, N.Y. Puts Heat on Nacchio Hot IPOs, ROCKY MOUNTAIN NEWS, June 21, 2003, at 1C (detailing another ONI transaction that rewarded Joe Nacchio, former Qwest CEO, with friends and family shares that tripled in price the first day of trading three months before the announcement of a contract between ONI and Qwest that caused the shares to soar 15 percent); Dennis K. Berman, Grand Jury Examines Deals by Qwest, WALL ST. J., Oct. 10, 2003, at A3 (detailing federal grand jury investigations of several Qwest executives who received friends-and-family stock from suppliers and possible charges of depriving the company of the "honest services of the executives").

193 See Warner, supra note 20, at 103 (noting that Williams was Sycamore's only customer and that the $400 million figure was only a "target").

194 See id. at 101 (detailing how the stock immediately opened at $270 and fluctuated that day between $200 and $250, making a company with $11 million in annual revenue a $15 billion company).
MORAL HAZARD AND THE IPO

at Williams profited more from the IPO than most other people because they had been given friends and family stock in Sycamore, in addition to stock options. Wayne Price, a vice president at Williams, received $500,000 worth of stock and $10 million in options.

A chicken-and-egg question arises as to whether without these shares and options, would the Williams executives have granted Sycamore the contract and whether without this contract would the IPO have been so successful. In addition, this relationship questions whether the pricing of the IPO shares by the issuer and the underwriter was intentionally low so as to guarantee profit to these executives as consideration for the lucrative contract. This scenario presents a difficult problem assessing both moral blame and possible legal liability. If the Sycamore executives agreed to underprice the offering in order to create a currency to entice Williams to enter into a lucrative contract, then these corporate officers were arguably acting to benefit the company, even if they may have severely decreased the net capital that Sycamore Networks was able to raise. However, the end result of this scheme may have been to entice the investing public to invest in Sycamore, and thus raise the share price, based on the implied suggestion that Sycamore was a good company as evidenced by Williams’ faith in its products. Sycamore’s signaling to the market in this instance is merely a sophisticated form of “pumping” stock for the purpose of personal gain from cheaply bought shares. The Sycamore shares jumped 386 percent the first day; this IPO is one of many that are the subject of a class action lawsuit against Sycamore’s underwriters, CSFB.

In this situation, the Williams executives allegedly acted similarly to the eBay executives that accepted IPO “bribes” in consideration for awarding important business to the person offering the IPO opportunity. Consequently, the opportunism of the Williams executives to increase their personal wealth may have negatively impacted Williams in the form of a contract that may not have been in Williams’ interest.

Another creative use of the friends and family program is to allow

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195 See id. (listing as one winner Williams Chief Technical Officer Matt Bross, whose friends and family stock was worth nearly $1 million at the end of the first day of trading).

196 See id. (noting that Mr. Price’s options were granted to him when he agreed to serve on Sycamore’s technical advisory board).

197 See id. at 103 (reporting that 775,000 of Sycamore’s shares went to employees, vendors, suppliers, and customers).

198 See id. (citing a fund manager as saying that “without knowing about the friends-and-family stock, the market could not fairly evaluate the company”).

the underwriter to direct shares to restricted persons under NASD rules or other questionable recipients. Although the underwriter has generally been precluded from allocating IPO shares to portfolio managers, other NASD members, and other restricted persons, some underwriters have been able to sidestep this prohibition by having the issuer direct these shares instead. Analysts, who are employees of NASD members, also enjoyed receiving directed shares in IPOs of companies the analysts covered. In these ways, directed share programs become ways for both issuers and underwriters to engage in spinning activities.

E. Flipping & Flipping Restrictions

To ensure recipients of IPO allocations that they will be able to capitalize on the built-in profit before the price declines, the underwriter has an incentive to restrict at least some recipients from dumping their shares too quickly and flooding the market with sellers, thereby causing the price to decline. “Flipping” refers to the act of selling original IPO shares at a profit during the first few days of an offering rather than holding them as a long-term investment. Flipping is not prohibited under any state or federal law and is common practice. However, underwriters generally attempt to restrict members of an offering syndicate and investors from flipping IPO shares. Therefore, the lead

200 See Smith, supra note 192, at 1C (noting that when charged with favoring investment banking clients in allocating IPOs, Goldman Sachs claimed that the CEO recipients were directed shares by the issuers themselves).
201 See id. (describing the pressure that a CEO would feel if an analyst, a restricted person, requested friends and family shares).
202 The original IPO shareholders in a pump and dump scheme are in a type of Prisoner’s Dilemma. See Melvin Aron Eisenberg, Corporate Conduct that does not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, the Prisoner’s Dilemma, Sheep’s Clothing, Social Conduct, and Disclosure, 28 STETSON L. REV. 1, 10 (1998). The prisoner’s dilemma is:

a generic name for the dilemma that actors face when (1) they can maximize their joint and individual utility by taking a given action, but (2) they cannot secure binding commitments from each other to take that action, and (3) in the absence of such a commitment, the best course for each actor is to chose a second- or third-best alternative.

Id. The first shareholders to sell at the increased share price are guaranteed to recognize some profit, possibly to the detriment of slower sellers. However, if all shareholders hold their shares, they can realize an even greater profit derived from hoarding and artificially increasing demand. All holdings are also subject to unknown, exogenous factors, a fact which creates other incentives to sell early. However, unlike in a Prisoner’s Dilemma, these shareholders have a common agent who can coordinate their actions: the underwriter.
203 See Aggarwal, Flipping, supra note 132, at 112.
204 See Nolan, supra note 183, at 264 (describing the pressure that underwriters exert on investors not to flip shares).
MORAL HAZARD AND THE IPO

2005

The underwriter will usually bind other syndicate members and broker-dealers by including a penalty term in all agreements.205 Under this term, the underwriter may revoke commissions from the broker-dealer if that broker-dealer's customers flip their shares before the end of a specified time period, ranging from a few days to six months.206 In turn, the broker-dealer may penalize specific customers who flip their shares, regardless of whether the lead underwriter has invoked a penalty bid against the broker-dealer.207 This penalty may be in the form of an increased or additional commission or merely in the form of refusing to grant that investor future IPO allocations.208 These industry customs are difficult to monitor or quantify because agreements between the broker and the customer may be unwritten or even unspoken.209

Underwriters argue that one of the reasons that discretionary allocations positively benefit the issuer is that the underwriter can effectively gauge the long-term interest of regular customers and institutional investors and place the original shares in the hands of a long-term investor.210 An extension of this argument would be that agreements with customers not to flip shares ensures that customers that agree to the terms of IPO allocations will be long-term investors.211 However, the immediate benefit to the underwriter is that restricting supply supports the IPO price and retards a sell-off that will eventually drive the price downward.212 Note that the amount of shares that will be restricted could be very large due to the fact that allocated shares may constitute up to 80 percent of an issue.213 In addition, a restriction from selling shares for the first few days would not guarantee that the

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205 See 17 C.F.R. § 242.100(b) (Regulation M) (stating that a penalty bid is "an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.").

206 Royce de R. Barondes, Adequacy of Disclosure of Restrictions on Flipping IPO Securities, 74 Tul. L. Rev. 883, 885 (2000) (describing the system that underwriters have developed to discourage broker-dealers from allocating IPO shares to customers who flip those shares).

207 See id. at 886.

208 See id.; Invemed Press Release, supra note 122 (describing process whereby Invemed's retail customers would pay $8 per share as a commission if they flipped original IPO shares, as opposed to an ordinary six cents per share commission).

209 See Shayne & Soderquist, supra note 74, at 986.

210 See Aggarwal, Flipping, supra note 132, at 15 (noting that issuers may be disappointed if flipping is excessive, reflecting few long-term investors).

211 But see Shayne & Soderquist, supra note 74, at 983 (noting that most anti-flipping agreements are for periods as short as five days, which would not be considered "long-term").

212 See id. at 984 (recounting one syndicate manager's complaint that anti-flipping agreements create overpricing in the aftermarket).

213 See Tully, supra note 41, at 86 (reporting that 80 percent of original IPO shares in 1999-2000 Boom were allocated to 125 firms by the underwriters); Aggarwal, Flipping, supra note 132, at 112 (noting that in that sample, 80-90 percent of original IPO shares went to institutional investors); Aggarwal et al., Institutional Allocation, supra note 91, at 5 (noting that in one study of 174 issues, 74.26 percent of the original IPO shares were allocated by the underwriter).
investor will be a long-term investor; the restriction does, however, guarantee that supply will be artificially restricted and that the share price will be artificially supported.\textsuperscript{214} If most recipients sell the first day, the profits will be smaller and slower sellers may not realize any profit.

The act of flipping is not necessarily bad for the market\textsuperscript{215} or for retail investors. If the market for the IPO shares is going to move the price to equilibrium, then investors who wish to sell (who value the shares less than the current price) must be able to flip their shares to create liquidity and buying opportunities.\textsuperscript{216} In addition, the "price support" that the underwriter is achieving is artificial and short-term. Retail buyers who purchase IPO shares during this lock-up period may then see the price plummet if a large group of original investors sell close in time at the end of the restricted period.\textsuperscript{217} Retail investors would be better served by a regime that allows for no restraint on the sale of original shares.

Discrimination exists when broker-dealers assess penalties against lucky retail customers who received original IPO shares then flipped them, but not against institutional investors that do the same thing.\textsuperscript{218} This disparate treatment affects not only the penalized customer, but also the customer who chooses not to flip her shares because of the threat of the penalty. Assuming that other original investors will honor their agreements or be penalized, a retail customer may hold IPO shares that are losing value or not capitalize on an increase in price in the IPO shares. Although the regulators seem unconcerned with the existence of flipping restrictions,\textsuperscript{219} regulators have focused attention on investment

\textsuperscript{214} See \textit{In re Initial Pub. Offering Antitrust Litig.}, 287 F. Supp. 2d 497 (S.D.N.Y. 2003) (stating as one of the allegations of the plaintiff class that defendant underwriters allocated to buyers who would not flip IPO shares "to assure an excess of purchasers over sellers and to drive the market price of the securities upward" in violation of federal securities laws).

One study shows that only approximately 19 percent of original IPO shares are flipped in the first two days, so the high trading activity observed in those two days is attributable to retail investors buying and selling the same shares repeatedly, raising the share price. See Aggarwal, \textit{Flipping}, supra note 132, at 113.

\textsuperscript{215} But see Barondes, \textit{supra} note 206, at 885 (noting that in a worst case scenario, flipping shares before an IPO distribution is complete could create a situation where underwriters cannot sell their allocations because of the creation of a secondary market at a below-IPO distribution price).

\textsuperscript{216} See \textit{id.} at 886 ("Of course, if no securities sold in IPOs were flipped, there would be no immediate aftermarket trading in the securities, since there generally is no other source for the securities that are sold in market transactions.").

\textsuperscript{217} See Ljungqvist et al., \textit{Hot Markets}, \textit{supra} note 15, at 34 (noting that several economics studies show that IPO share prices "fall significantly" when lock-up agreements expire).

\textsuperscript{218} See \textit{id.} at 34 (stating that larger investors are allowed to flip by underwriters, but not retail investors); Aggarwal, \textit{Flipping}, \textit{supra} note 132, at 113 (noting that institutional investors flip twice as many of their original IPO shares than retail investors do).

\textsuperscript{219} 17 C.F.R. § 229.508(l)(1) (2003) (requiring registration statements and prospectuses to disclose stabilization practices, including penalty bids, that may be used in connection with the
banking practices that selectively impose flipping penalties.220

F. Laddering, Stabilization, and Market Making

The underwriter has other tools to artificially inflate IPO share prices in addition to flipping restrictions: laddering agreements, stabilization techniques, and market making power. The term "laddering" refers to the practice of underwriters encouraging or requiring customers to buy additional IPO shares in the secondary market as consideration for the privilege of being allocated original IPO shares.221 Not only does the underwriter in an IPO have an incentive to discourage or restrict original investors from flipping original shares in order to maintain a high IPO share price,222 but he also has the incentive to encourage or require those same investors to purchase additional shares in the aftermarket for the same reasons.223 Also referred to as "tie-in" agreements, explicit laddering agreements are generally prohibited by SEC and NASD rules.224 However, because these agreements are not written agreements and may not even be explicitly verbalized at all, monitoring is especially difficult.225 Also, perhaps because the SEC’s position on laddering is not explicit226 and because

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220 See NYSE/NASD IPO Advisory Committee, Report and Recommendations of a Committee Convened by the New York Stock Exchange, Inc. and NASD at the Request of the U.S. Securities and Exchange Commission 7 (May 2003) (naming discriminatory imposition of penalty bids as a "harmful practice" that decreases public confidence in the IPO process) [hereinafter IPO Advisory Report].


222 See id. (commenting that underwriters have an incentive to artificially increase the share price after an IPO in order to maintain their reputations in the industry).

223 See Shayne & Soderquist, supra note 74, at 980 (reasoning that underwriters benefit from share price supports by: (1) receiving additional underwriter business from the happy issuer; (2) receiving additional brokerage business from happy customers and impressed future customers; and (3) avoiding shareholder lawsuits under section 11 of the 1993 Act that use price decline as a measure of damages).

224 See 17 C.F.R. § 242.101(a) (2003) ("In connection with a distribution of securities, it shall be unlawful for a distribution participant or an affiliated purchaser of such person, directly or indirectly, to bid for, purchase, or attempt to induce any person to bid for or purchase, a covered security during the applicable restricted period . . . .")

225 See Sapsford & Davis, supra note 221, at Cl (describing the practice as involving "secret" agreements and as being "widespread"); Pocket, supra note 1, at 71 (noting the difficulty in proving that an investment banker crossed the line between making "vague requests" to buy aftermarket shares and "demanding . . . binding promises").

226 See In re Initial Pub. Offering Antitrust Litig., 287 F. Supp. 2d 497, 519-23 (S.D.N.Y. 2003) (describing how the SEC has proposed several times to create a "bright-line" rule distinguishing manipulative laddering activity from legal stabilizing practices but has repeatedly chosen not to promulgate such a rule); Notice of Proposed Rules 10b-20 and 10b-21 and Amendments to Rule 17a-3(a)(6) and 17a-3(a)(7) under the Securities Exchange Act of 1934,
the SEC does allow underwriters to engage in stabilization practices,\(^{227}\) laddering activities seem to occur frequently.\(^ {228}\)

In fact, some firms claim that allocations to investors with a continued interest in the stock, as reflected in expressed plans to purchase more stock, makes the IPO distribution more effective.\(^ {229}\) However, binding customers to purchase additional shares in the aftermarket by capitalizing on the fear of not receiving IPO allocations in the future\(^ {230}\) has the effect of artificially supporting a high share price by manufacturing demand.\(^ {231}\)

Traditional stabilization practices, authorized by the SEC, also manipulate the IPO share price by dishonestly signaling the market that buyers are valuing the IPO shares at a certain price. Although the SEC has recognized that stabilization is a form of manipulation,\(^ {232}\) the SEC has historically allowed underwriters to buy IPO shares at the offering price during the distribution, even if that price is above the market price, for the purpose of preventing or slowing a decline in price.\(^ {233}\) The underwriter can intentionally sell some percentage number of shares over the original IPO allotment and then buy those over-allotted shares

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\(^ {229}\) See Sapsford & Davis, supra note 221, at C1 (noting that the securities industry was unconcerned with charges of laddering for this reason); Pocket, supra note 1, at 71 (recounting investment bankers' defense that asking clients about eagerness to buy aftermarket shares was important to gauge the commitment of the investor in the IPO).

\(^ {230}\) See Sapsford & Davis, supra note 221, at C1 (quoting a JP Morgan sales representative who told customers they would be "sort of out of the game" if aftermarket purchases were not "aggressive").

\(^ {231}\) See SEC Bulletin No. 10, supra note 228. This SEC Bulletin states:
Solicitations and tie-in agreements for aftermarket purchases are manipulative because they undermine the integrity of the market as an independent pricing mechanism for the offered security. Solicitations for aftermarket purchases give purchases in the offering the impression that there is a scarcity of the offered securities. This can stimulate demand and support the pricing of the offering. Moreover, traders in the aftermarket will not know that the aftermarket demand, which may appear to validate the offering price, has been stimulated by the distribution participants.

\(^ {232}\) See Shayne & Soderquist, supra note 74, at 979 (quoting the SEC as saying in 1940 that: "[t]here are many who feel that stabilizing, since it is a form of manipulation, is inherently fraudulent and hence should be wholly prohibited under all circumstances").

\(^ {233}\) 17 C.F.R. § 240.16a-7 (2003) (exempting stabilization activities from requirements of Rule 16(a); 17 C.F.R. § 229.508(l) (2003) (merely requiring proposed stabilization activities to be disclosed in the registration statement and prospectus).
back at the market price. Studies show that during a period of stabilization, institutional investors, not retail investors, will take advantage of stabilization and sell shares, indicating that stabilization measures are for the purpose of allowing regular customers to exit before the price declines.

Another interesting aspect of the IPO process is the ability of the underwriter to make a market in the same IPO shares. The underwriter allocates approximately 80 percent of the shares to its own customers, who when they sell, sell to the underwriter. The underwriter buys the flipped shares during the time the price is rising and then profits from the spread between that price and the higher sell price. As a former CSFB analyst said, this "near-monopoly" of the underwriter makes profiting from an IPO "like shooting fish in a barrel."

These practices, acting in concert, artificially sustain the IPO price at higher levels than if the market were allowed to function freely. Designated buyers, the underwriters, and investors, purchase shares in the aftermarket at a pre-determined price, signaling the market that other buyers continue to value these shares at a high price. This valuation attracts more retail investors to purchase shares at the artificially inflated price. Unfortunately, the retail investors are at the bottom rung of the ladder when the price supports end.

Although explicit laddering agreements are hard to prove, the SEC instituted a lawsuit against J.P. Morgan for encouraging IPO customers to buy more shares of the same stock after the initial offering and hinting to customers that aftermarket purchases were necessary to secure future IPO allocations. The SEC claimed that these practices violated Rule 101 (Regulation M) of the 1933 Act against offering and selling shares during the registration period, NASD Rule 2110, and the

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234 See Ritter & Welch, supra note 6, at 1813 (commenting that both the over allocation and the repurchase artificially boosts the market demand for the shares).
235 See Ljungqvist et al., Hot Markets, supra note 15, at 33-34.
236 See Tully, supra note 41, at 84 (noting that between 1998 and 1999, revenues from commissions and spreads increased 50 percent); Ritter & Welch, supra note 6, at 1815 (reporting that in the first three months, profits from market making by lead underwriters equal 2 percent of the total offering).
237 See Tully, supra note 41, at 84 ("You're the only market-maker, so it's a license to print money.").
238 See Sapsford & Davis, supra note 221, at C1 ("Regulators have long suspected that prices of at least some oversubscribed IPOs soared because Wall Street firms had secured secret agreements from their clients, big institutional investors, to buy shares at higher, agreed-upon prices after the initial debut of shares in return for an allocation of shares in the IPO."). Shayne and Soderquist also credit several under-the-table activities of broker as leading to price stabilization, such as a broker's refusal to execute sell orders or at least to only execute the order once a complementary buy order was placed. See Shayne & Soderquist, supra note 74, at 985.
Although the complaint did not use the word “laddering,” the actions alleged were at the very least pressure tactics designed to have the effect of laddering agreements. The lawsuit additionally alleged that customers receiving IPO allocations were induced to participate in a “cold” IPO, Biopure, as a condition of being allowed to participate in an oversubscribed “hot” IPO, IPIX. J.P. Morgan eventually settled this lawsuit for $25 million.

Laddering agreements are also depicted as part of a scheme to manipulate IPO share prices in one investor class-action case involving over two thousand claims against 309 issuers and their underwriters, In re Initial Public Offering Securities Litigation. One of the factual allegations that are outlined in the complaint concerns CacheFlow, Inc., whose underwriters allegedly conditioned IPO allocations on the requirement that customers agreed to purchase additional shares in the aftermarket at escalating prices and amounts in violation of Regulation M.

G. Lock-up Agreements

Underwriters also control the supply of IPO shares both by requiring insiders to enter into lock-up agreements for their shares and by being able to waive these agreements. Most underwriters restrict company insiders from selling IPO shares within the first ninety to 180 days. Increasingly, underwriters are also requiring recipients of directed shares not to sell their shares for the same period, possibly due to the growth in size of such programs. This window of restricted

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241 See Sapsford & Davis, supra note 221, at C1 (describing e-mails from J.P. Morgan employees seeking promises from customers to buy as many shares in the issuing company after the IPO as the customers were originally allocated).
242 See J.P. Morgan Pays, supra note 240 (quoting a J.P. Morgan e-mail: “‘IPIX allocations (very strong deal) will be heavily weighted toward those investors that participated in the Biopure offering.... Given that we have fully allocated all accounts in the Biopure deal... it is extremely important that your investors take these allocations. I want to reiterate that we will provide you with the means to reward these clients.”).’
243 Id.
244 241 F. Supp. 2d 281 (S.D.N.Y. 2003); see also discussion infra Section VIII.C.
246 See Fisch & Sale, supra note 52, at 1050-51 (noting that the underwriter effectively decides when the lock-up ends by having the ability to waive lock-up agreements).
248 See id. at 389.
supply allows the institutional investors, who are usually asked not to flip for a period as short as a few days, to exit before the issuer insiders and without competing with them for buyers. Once institutional investors have exited, underwriters in 60 percent of offerings waive the lock-up agreements for insiders.\textsuperscript{249} Once selling restrictions and resulting artificial supply curtailments end, then the share price predictably drops.\textsuperscript{250} Studies have shown that share prices fall significantly at the end of lock-up periods,\textsuperscript{251} with VC firms being the most aggressive sellers on those dates.\textsuperscript{252}

Because these agreements are entirely within the control of the underwriter, some investment banks have begun to tailor these agreements to further micromanage the supply and allow some insiders to systematically sell restricted shares, thereby staggering downward price pressure and allowing for maximum profit extraction in offerings that have experienced large returns.\textsuperscript{253} Of course, the underwriter always has the power to release shares without these terms and can even time early releases to coincide with positive earnings reports.\textsuperscript{254} On the other hand, if the IPO has been particularly disappointing, the underwriter may encourage certain insiders to extend their lock-up periods, thus avoiding the possibility that selling a huge block of shares would create a much lower market price for those shares.\textsuperscript{255} Through these lock-up agreements, the underwriter has great ability to control the timing of the sales of large percentages of the total IPO issue and therefore control the supply and affect the IPO share price.

H. Independent Research & Analyst Reports

What could be the saving grace for the retail investor, the independent research report, has also been exposed as another tool in the arsenal of industry players to extract wealth from retail investors in the IPO process. If analysts were truly independent, then research reports about companies entering the stock market would alert investors

\textsuperscript{249} See Ljungqvist et al., Hot Markets, supra note 15, at 34.
\textsuperscript{250} See Marshall, supra note 247, at 374 (noting in some cases that the end of the lockup period creates a 40 percent increase in the number of publicly-traded shares of a company).
\textsuperscript{251} See Ljungqvist et al., Hot Markets, supra note 15, at 34.
\textsuperscript{252} See Marshall, supra note 247, at 373 (listing as examples on June 2, 2000, Agilent Technologies, Inc. (down 11 percent); McAfee.com Corp. (down 14 percent); and Vitria Technology, Inc. (down 16 percent)).
\textsuperscript{253} See id. at 377-79 (describing terms that allow for the sale of certain percentages of shares upon the occurrence of the share price achieving certain goals).
\textsuperscript{254} See id. at 367.
\textsuperscript{255} See id. at 387-88 (giving as one example the extension by ninety days of lock-ups of insiders and VC investors in Preview Systems, thereby avoiding a sell-off of approximately 35 percent of the company’s shares).
to differences between the original offering price and both the market price of IPO shares and the fundamental value of a company. The reports could also alert the public about characteristics of the offering that might create artificial demand, such as 80 or 90 percent of the IPO offering being allocated before the opening. Analysts could also report on any suspicions arising from friends and family shares being allocated to key contract parties, if known. However, during the 1999-2000 Boom, analysts were part of the problem, maintaining positive outlooks for IPO stocks so that industry insiders, including themselves, could sell shares before the share price dropped.

By industry custom, analysts employed by the lead underwriter have honored the “quiet period” following the offering, during which the issuer is restrained from issuing prospectus material. During this period, twenty-five calendar days, these analysts do not issue new reports on the issuer. However, analysts routinely issue positive reports concerning new issues at the end of the quiet period, and these reports have a profound impact on the share price. In fact, according to one study of IPOs during the period 1996-2000, the share price of new issues rose an average of 4 percent at the end of the quiet period if an analyst report was issued, and 0 percent if no report was issued. This increase in share price is crucial to maintaining value for insiders who are still subject to a lock-up period during this time. Analysts also routinely issued positive reports at the end of any lock-up period, allowing insiders to sell before the price dropped.

Although the investing public saw these reports as being not only independent but also the true opinion of the analysts, recent lawsuits have uncovered evidence that the analysts were issuing reports that their analysis did not support, largely due to pressure from the investment

258 See Ritter & Welch, supra note 6, at 1808 n.9 (describing as an example the IPO of Corvis, whose share prices increased in first-day trading from $36 to $84.710 per share; however, the five underwriting investment banks all rated Corvis a “buy” or “strong buy” on the date at the end of the quiet period, although the share price subsequently fell 96 percent over the next ten months). In 2002, one study showed that in 87 percent of reports released at the end of the quiet period during the years 1996-2000, the recommendation was “buy” or “strong buy.” Id.
259 See id. at 1825 (marveling that the public does not recognize the extent of the bias and therefore reacts to the virtually automatic issuance of positive reports twenty-five days after the IPO).
260 Laura S Unger, Written Testimony Concerning Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts (July 31, 2001).
261 See Donaldson Testimony, supra note 76, at 5 (testifying that “Bear Stearns, CSFB,
banking departments of their employers. During the CSFB litigation, emails were uncovered by analysts that reveal such a scenario. In May 2001, a technology research analyst wrote an email to the Head of Technology Research, complaining of unwritten Rules for Tech Research:

Based on the following set of specific situations that have arisen in the past, I have “learned” to adapt to a set of rules that have been imposed by Tech Group banking so as to keep our corporate clients appeased. I believe that these unwritten rules have clearly hindered my ability to be an effective analyst in my various coverage sectors.

The disconnect between analyst reports and true analyst opinion was not isolated to CSFB, but widespread among the Wall Street investment banking firms. Jack Grubman, a star analyst at Salomon Smith Barney, was also an individual defendant in a major lawsuit against Salomon and himself individually that was consolidated into the SEC’s lawsuit involving ten investment banking firms that resulted in the Global Settlement of Analyst Conflicts of Interest. Emails uncovered during that litigation show that on the same day Grubman rated an issuer as a “buy,” he emailed two colleagues that the company should be rated “underperform” and called the company a “pig.”

Goldman, Lehman Brothers, Merrill Lynch, Piper Jaffray, SSB and UBS Warburg issued research reports that were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about covered companies, and/or contained opinions for which there was no reasonable basis.

Letter of Acceptance, Waiver and Consent, No. CAF 030018 from Charles O. Prince, CEO of Citigroup Global Markets, to Department of Enforcement, NASD 6 (Apr. 21, 2003), available at http://www.nasdr.org (consenting to the NASD entering factual allegations without admitting or denying the truth of those allegations, including that: “[i]nvestment banking concerns [at Salomon Smith Barney] sometimes affected research analysts’ decisions to initiate coverage, rate companies, and drop coverage. SSB’s research analysts were generally expected to initiate coverage of SSB’s investment banking clients with favorable ratings”).

CSFB Consent Letter, supra note 147 (detailing the pressure on research analysts to provide and maintain positive research recommendations on investment banking clients).

See SEC v. Bear, Stearns & Co., 2003 WL 22466156 (S.D.N.Y. Oct. 31, 2003) (holding that consent judgments in SEC action against ten investment banks, Jack Grubman and Henry Blodget, an analyst at Merrill Lynch, were fair, adequate, and in the public interest). Solomon’s parent, Citigroup Inc., was also the subject of a lawsuit specifically regarding one issuer, Worldcom Inc. Hevesi v. Citigroup Inc., 2004 WL 1008439 (2d Cir. May 7, 2004). This lawsuit, brought by certain investors in Worldcom, survived a motion to dismiss regarding the court’s willingness to certify a class and hold that analyst statements could be assumed to affect market price based on the fraud on the market theory. Id. at *4-7. Citigroup settled the lawsuit for a record-setting $2.65 billion shortly before an appeal of that ruling was to be heard, reportedly because the SEC had submitted an amicus curiae brief in support of the theory. Mitchell Pacelle, Citigroup Will Pay 2.65B To Settle Worldcom Investor Suit, WALL ST. J., May 11, 2004, at A1.

Citigroup Consent Letter, supra note 262, at 16 (accepting the allegation that Grubman published a report rating Focal as a “buy” at $30, even though the market price for the shares was $15.50, that the company was disappointed with this report, even though it was exuberant and
fact that Grubman’s reports were more marketing tools than financial analysis was not lost on the brokers at Salomon, who routinely gave Grubman poor evaluations, including one that stated: “I hope Smith Barney enjoyed the investment banking fees he generated, because they come at the expense of retail clients.”

The most lurid tale of an issuer virtually purchasing a good analyst recommendation also involves Grubman. In fall 1999, AT&T announced that it would spin-off the tracking stock for its wireless unit in the largest IPO in U.S. history. In November 1999, Sandy Weill, the CEO and Chairman of Citigroup, and member of the AT&T board of directors, asked Grubman to take a “fresh look” at AT&T. For a lengthy period prior to November 1999, Grubman had rated AT&T “neutral.” In consideration for Grubman’s upgrading the stock to a “buy,” Weill procured Grubman’s children placements at the 92nd Street Y preschool in return for a $1 million donation to the school from Weill. In February 2000, AT&T named Salomon one of the lead underwriters for the IPO, generating $63 million in investment banking fees.

Although the SEC was successful in litigation against the major investment banks that resulted in the unprecedented Global Settlement, as discussed in Section VIII.A., infra, substantial obstacles exist to prevent a retail investor from successfully instituting a lawsuit against research analysts or firms that issue research reports. In a securities fraud action based on misrepresentation and omissions, the plaintiffs must be able to prove that the misrepresentation proximately caused not only the artificial increase in share price but also the decline.


270 In re Merrill Lynch Tyco Research, 2004 WL 305809, at *2.
I. Noise Trading

Although not an intentional practice, the remaining factor in the IPO con game that creates a conducive environment for the other practices to occur is a dynamic known as “noise trading.” Neoclassical economics theorizes that the market price of a company’s shares, as determined by the willingness of buyers to buy and sellers to sell at a certain price, reflects all information about the fundamental value of that company.\(^1\) In its semi-strong form, the efficient capital market hypothesis (ECMH) posits that the price for a publicly-traded company will accurately reflect all publicly-known information about that company and that investing in a company at that price should present neither an arbitrage opportunity for the investor nor a loss from overpayment.\(^2\) Proponents of the ECMH would then argue that the IPO share price is “underpriced” if the true market price will be much higher once trading is underway. However, during the IPO life cycle, the price will then decline again, without any substantive change in the business of the issuer. These inconsistencies lead economists to assume informational asymmetry between the original IPO investors and the investors in the secondary market, which may contribute to price differentials.\(^3\)

From what we know about the disturbed flow of information via biased analyst reports and artificial price signals generated by flipping restrictions, stabilization techniques, and lock-up agreements, these phenomena may explain some of the aberrations in the share price fluctuations in a way consistent with ECMH.

However, informational asymmetry cannot explain all price movements in the capital markets,\(^4\) especially in IPOs; therefore, another theory, noise trading,\(^5\) has been posited. According to noise theory, investors make investment decisions based not only on the available information, but on “sentiment.”\(^6\) Likewise, investors are


\(^2\) See William T. Allen, Securities Markets as Social Products: The Pretty Efficient Capital Market Hypothesis, 28 J. Corp. L. 551, 553 (2003) (stating that the important claim of the efficient capital markets theory is that the market price for a security will rationally reflect the meaning of all available information and should not deviate from the fundamental value of the security).

\(^3\) See Ritter & Welch, supra note 6, at 1803 (exploring theories of underpricing based on different types of asymmetric information).

\(^4\) See Allen Ferrell, If We Understand the Mechanisms, Why Don’t We Understand Their Output?, 28 J. Corp. L. 503, 505 (2003) (stating that the arrival of new price information only accounts for 20 percent of share price fluctuations).

\(^5\) See id. at 511 (describing the use of the term “noise trading” to mean trading that sends a signal that does not contain information, just noise, like a signal transmission line).

\(^6\) See Ljungqvist et al., Hot Markets, supra note 15, at 3-4 (describing some retail investors as “exuberant” and suggesting that they suffer from “overconfidence” in investment ability and may not learn from mistakes due to self-attribution of gains, but not losses). Noise theory is not
attracted to investments based on factors other than economic factors. These “uninformed” investors attract other investors (the “herd”), and soon even professional investors are making investment decisions based on predictions of where investor demand will focus next. For example, if an investor can predict the next hot stock and buy it today, then the investor can sell at a profit at some point before the popularity of that stock ends. The stock price begins to reflect the demand for the stock, not just the publicly available information for that stock. Of course, if investors were always rational, the demand for a stock would be consistent with the publicly available information, but that is not always true. What creates this demand can be simply fads or industry trends. If many people are touting the technology industry or a certain technology stock, then investors may be attracted to the next new technology stock, hoping that they will be original owners of the next big thing.

In the IPO context, investors may also be irrationally attracted to an upcoming issue because of the possibility of regret. This heuristic-driven bias occurs when investors have recently observed other offerings with large first-day pops and fear being left out of a profitable opportunity once again. The risk of not investing in a venture that might also generate large first-day gains seems too great, and investors clamor to participate in upcoming IPOs whether the financial data supports the decision or not.

inherently inconsistent with the efficient capital market hypothesis. Proponents of ECMH would explain that noise traders attract professional arbitrageurs who see the profit potential in counter trading with the noise traders, ultimately bringing the market price back to equilibrium. See Ferrell, supra note 274, at 511.

277 Under the ECMH, each uninformed investor’s trade would eventually be “washed out” either intentionally by a professional arbitrageur recognizing that the investor overvalued or undervalued a stock or randomly by another uninformed investor making a different trade. Gilson & Kraakman, supra note 271, at 581. In a noise trading situation, however, the uninformed investors may make parallel trades, acting on the same irrational bias and exaggerating the difference between the fundamental value of the shares and the market value.

278 See Shleifer & Summers, supra note 98, at 28 (describing the dynamics of positive feedback trading and the occurrence of speculators “jumping on the bandwagon” and producing short-term gains before jumping off again).

279 See Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC, 56 STAN. L. REV. 1, 14 (noting that in recent history, firms that added “dot.com” to their names experienced abnormal gains in share price and that after the Internet bubble ended, firms could also experience abnormal gains in share price by dropping “dot.com” from their names, with no other change in fundamental value).

280 See id. at 15 (describing as a possibly rational “preference” the choice that some investors make to use the stock market as a vehicle for gambling).

281 See Shefrin, supra note 61, at 241-43 (noting that in hot-issue markets, the heuristic-driven biases of similarity, betting on trends, representativeness, and possibility of regret frequently lead to investment decisions of sentiment investors).

282 See id. at 242 (theorizing that investors demanded participation in the 1993 Boston Chicken IPO, even though the prospectus disclosed net income losses in 1992 and 1991, because of the recent successful first-day showings of Discovery Zone and Callaway Golf, explaining why
This tendency for retail investors to engage in noise trading creates fertile ground for industry insiders to take advantage of investors in the IPO context. If IPO shares become popular for reasons other than their intrinsic value, then underwriters and founders can capitalize on that investor sentiment to extract wealth for themselves, clients, and associates. Because of the high amount of noise trading in the 1999-2000 Boom, underwriters could predict that the demand for IPO shares in the secondary markets would be uniformly high beyond the demand for comparable shares from seasoned issuers. With this knowledge, underwriters could engage in a scheme that would allow knowledgeable investors to buy before the sentiment demand was unleashed and sell before the sentiment demand dwindled.

V. THE PROBLEM

A. Market Efficiency

The ability to extract wealth from the public investor for the benefit of the underwriter and the founders does not lead to an efficient IPO market. Reflected in both the IPO Advisory Committee’s and the NASD’s reluctance to completely overhaul the IPO process is a policy position that to the extent underpricing can be contained so that first-day returns are in line with historical returns, 10-15 percent, and to the extent that we can eliminate clear abuses such as quid pro quo allocation arrangements, then the market should be allowed to operate without further regulation. However, existing private ordering practices that are expressly permitted by regulation are not allowing the market to operate. Flipping restrictions, lock-up agreements, stabilization techniques, and unspoken laddering agreements are private actions that impede the ability of the market to accurately price IPO shares. SEC positions and NASD rules condone these practices that artificially maintain IPO share prices. The existing regime, even as improved, is a “hands-on” regime that favors industry insiders over the retail investor.

The resulting IPO process has been created both by private agreements not prohibited by regulation and also by explicit prohibitory regulatory frameworks, such as outdated policies on communications during the waiting period that allow issuers and underwriters to speak freely to institutional investors but not to the public at large. Existing regulation creates asymmetry in information among classes of investors that leads to uninformed investing and an inefficient market for IPOs.

The framework of rules existing during the 1999-2000 Boom
encouraged insiders to exploit the system for profit. Tightening up the framework to increase costs of exploitation or increase penalties for breaking the rules instead of stretching them is inadequate. A complete reworking of the framework is necessary.

Allowing the IPO process to remain conducive to underwriter manipulation suggests that as the economy continues to cycle, the capital markets will encounter the same problems in the next IPO boom. Just as the 1999-2000 Boom was more pronounced than the one before it, the next boom may be more pronounced than this one.\textsuperscript{283} Unfortunately, companies decide to go public during IPO booms that otherwise may have decided that the costs did not outweigh the benefits, absent the enhanced ability to extract wealth during a boom period. In other words, in boom times firms may go public for the sole purpose of extracting wealth from retail investors, not because the issuer has projects that are worthy of outside investment.\textsuperscript{284} These offerings attract capital in a sub-optimal allocation of resources.\textsuperscript{285} The cyclical nature of IPOs caused by trying to time IPOs with booms may prevent companies from accessing capital markets both in boom times, when underwriting firms are busy, and in bust times, when venture capital and underwriting firms are not as motivated to support new issues.\textsuperscript{286} In addition, capital is being siphoned off as profits for underwriters and industry insiders instead of going to worthy capital projects. As a result, overpayment in IPOs was approximately $1.4 billion annually from 1970 to 1990.\textsuperscript{287}

Regulators have no problem viewing pump-and-dump schemes as manipulations of the market in violation of Rule 10b-5. Presumably, these schemes are undesirable because they create inefficient markets in which investors overpay for stock and then lose money once the hyping of the stock ends and the insiders dump their shares. The current IPO process, even the improved version if proposed Rule 2712 is approved, will continue to be a large-scale pump-and-dump scheme with an intricate group of colluding participants. The overall IPO process should be reformed to ensure that an even larger group of investors are not enticed into overpaying for a stock and then losing value when the

\textsuperscript{284} See Ljungqvist et al., Hot Markets, supra note 15, at 31 (noting that in 1997, 61.6 percent of companies going public had positive earnings in the last twelve months, compared with 23.6 percent in 1999); see also Mark Lewis, Online IPO Revolution Postponed, FORBES.COM, Mar. 14, 2001, at http://www.forbes.com/2001/03/14/01314back.html (noting that the OpenIPO auction system provides its investment bank owners, Hambrecht + Co., with stability in booms and busts because issuers are not attracted to that system in order to get “pops” as “pops” are not part of the auction process during a boom or a bust).
\textsuperscript{285} See Allen, supra note 272, at 556.
\textsuperscript{286} See Shayne & Soderquist, supra note 74, at 977.
\textsuperscript{287} See id. at 986 (calculating the dollar figure of IPO overpricing in 1990 dollars).
insiders and allocation recipients sell their shares.\textsuperscript{288}

B. Beyond Efficiency—Creating a Fair, Bona Fide Public Distribution System

Economists tend to analyze the IPO process from the perspective of whether the outcome creates efficient market pricing or whether the process efficiently allocates capital to worthy sources. However, the stated purpose of NASD regulation of the IPO process is not to promote efficiency but rather to "protect the integrity of the public offering process" and "[maintain] investor confidence in the capital raising and public offering process."\textsuperscript{289} If integrity and fairness is the goal, then price efficiency or allocative efficiency should be secondary concerns, although this Article argues that the current IPO process does not even meet these short-sighted goals. During the 1999-2000 Boom, the IPO process did not provide bona fide public distributions of shares at the offering price. Arguably, any distribution that pre-distributes 80-90 percent of the inventory is not a bona fide distribution. Retail investors are lured to the offering in hopes of receiving original IPO shares, but instead find themselves bidding for shares in the aftermarket, once the initial built-in profit has been taken. Because of this allocation facet alone, the IPO process is not a level playing field.

Although retail investors can certainly shoulder some of the blame for the exuberance of IPO investment during the 1999-2000 Boom, regulators should create a system that cannot so easily be abused at the expense of one class of investors over another. Using discretionary allocations, the underwriter is able to leverage the retail investor for the benefit of the institutional investor. The new NASD rules preserve this ability for the underwriter. If investors are going to have renewed faith in the capital markets, then investors should be able to believe that they are on equal footing with institutional investors.

\textsuperscript{288} However, if institutional investors are being enriched at the expense of the retail investor, the retail investor may be indirectly enriched as well. After all, institutional investors are merely conduits for retail investors such as mutual funds, pension plans, retirement funds, insurance companies and investment companies. The end result may be in more profits to the retail investors that invest in institutional investors. Perhaps the ultimate effect will be that more retail investors do the bulk of their investing via an institutional investment vehicle. Although the flipping activity of the institutional investor may increase costs, the profits accrued may compensate for those transaction costs.

\textsuperscript{289} See National Association of Securities Dealers, Notice to Members 03-79, 845 (Dec. 2003) [hereinafter NTM 03-79].
VI. IMPROVING THE IPO PROCESS THROUGH THE INTERNET AUCTION

The primary hero of the retail investor may be technology. The internet has created many opportunities to democratize other processes, such as the election process, the corporate director nominating process, the purchasing of goods, and the acquisition of information, and it has great potential to democratize the IPO process.\(^2\) In certain areas, technology could radically improve the IPO process by creating a transparent and accessible system open to the participation of all U.S. investors. In fact, the internet has already revolutionized the distribution of information to potential investors. However, the IPO revolution will be the obsolescence of the bookbuilding pump-and-dump mechanism and the emergence of the IPO auction.\(^3\)

A. Internet Auctions

As an alternative to the bookbuilding process, IPO shares can be distributed through an open auction process, widely used in other countries; in fact, a few investment firms have recently pioneered online auctions in the U.S.\(^2\) In 2004, Google announced that it would incorporate some aspects of the auction system into its much-awaited IPO.\(^3\) In the purest form of online auction, the underwriter has either no discretion or very little discretion in determining either the price of the IPO shares or the recipients of the distribution.\(^4\) The highest bidders receive shares pro rata, with some exceptions. Because the

\(^{290}\) See 2000 Address, supra note 5, at 1 (asserting that the Internet has “democratized Wall Street” and giving as evidence of that assertion the fact that in 1999, the number of retail investors participating in IPOs increased, almost solely due to the availability of online IPOs).

\(^{291}\) One of the first issues that arose concerning the intersection of securities offerings and the Internet was whether certain written materials, such as a preliminary prospectus, final prospectus, and even annual statements, could be posted on the Internet or delivered to recipients via the Internet. See Use of Electronic Media for Delivery Purposes, Exchange Act Release No. 7233, 60 Fed. Reg. 53,458 (Oct. 6, 1995). In addition, the Internet also allows for direct communication between the issuer and the public regarding the company, the company’s future offerings, current registered securities, and relevant markets, thus creating the potential for violating securities laws via statements, including hyperlinks, on a company’s website. See Use of Electronic Media, Exchange Act Release No. 33-7856, 65 Fed. Reg. 25,843 (Apr. 28, 2000) [hereinafter SEC Release 7856].

\(^{292}\) Although many traditional brokerage firms accept orders for IPO shares electronically, an online auction distributes all IPO shares via the Internet in an auction format. The most successful of these is the OpenIPO system used by W.R. Hambrecht + Co. See http://www.openipo.com.

\(^{293}\) See Google, Inc., Form S-1 Registration Statement under The Securities Act of 1933, at iv (Apr. 29, 2004) [hereinafter Google S-1].

resulting offering price should reflect full demand for the IPO shares, this process should lead to less underpricing and smaller first-day "pops." However, few underwriters have embraced online IPOs. To do so would mean the end of a system that grants underwriters a monopoly on IPO shares that are used to reward and entice selected recipients.

Although the SEC has issued several no-action letters that relate to the use of internet auctions for the distribution of IPO shares, follow-on and secondary offering shares, debt securities, and even municipal bonds, to date the number of IPOs conducted via an online auction mechanism have been small in proportion to the total number of completed IPOs. However, this trend may have been stalled by the stagnation of the IPO market generally from 2000 to late 2003. With the recent increase in IPOs, in addition to new attention being given to the speculation surrounding Google’s IPO, the number of online IPOs being conducted may continue to rise.

In July 1999, at the height of the most recent IPO boom, Wit Capital Corporation received a no-action letter from the SEC that allowed it to act as an underwriter, either alone or in a syndicate, in selling shares in an initial public offering via an online website. According to the facts provided by Wit Capital, a customer of Wit Capital could place either a limit order, specifying a maximum price per share that the customer would be willing to pay, or an order with no

297 See Lewis, supra note 284 (reporting that most IPOs in 2001 were still being conducted in the traditional way, although Walt Cruttenden, CEO of E*Offering, had predicted that by 2002, 80 percent of IPOs would be online).
298 Some firms that promised the online IPO auction suffered after the 1999-2000 boom to the point of elimination, such as E*Offering. See id.
299 See Raymond Hennessy, China Life, Four Others Join Revived IPO Market, WALL ST. J., Dec. 18, 2003, at C5 (discussing the continued revival of the 2003 IPO market and commenting that currently seasoned companies are more attractive to investors in IPOs than riskier ventures) [hereinafter Hennessy, Revived].
301 See 1999 Wit Capital Letter, supra note 294, at *22.
302 Only persons registered as customers of Wit Capital would be eligible to place a bid. In registering, would-be customers provide information on affiliations with restricted persons, investment objectives and experience, net worth, and income. See id. at *4. Presumably, this information would allow Wit Capital to screen customers to ensure that the investment is suitable to that customer. NASD Rule 2310 (requiring members to only recommend investments to customers that are suitable to that customer's need and financial situation).
price component, like a market order; both orders would indicate the number of shares requested. Then, prior to the registration statement becoming effective, Wit Capital would allocate shares on a “first-come, first-served” basis according to the date and time of each order. The no-action letter allowed Wit Capital to then ask bidders to reconfirm their “indications of interest” at the set price and amount via an email sent no earlier than 48 hours before the registration statement would be effective. At the time the bidder reconfirmed the bid, the bid would become an offer that Wit Capital could then accept after the registration became effective, at which time a final prospectus would be sent to the customer. In the no-action letter, Wit Capital stated that it “generally does not allocate more than 100 shares in an offering to any customer until all customers who have placed conditional offers to buy shares in the offering have been allocated 100 shares.” However, the letter also stated that: “at the request of the issuer, [we] may set aside a specified number of shares in an offering for certain categories of employees or customers of the issuer or other persons with an affinity relationship with the issuer.”

In 2000, Wit Capital sought and obtained an additional no-action letter extending its online operations to follow-on, secondary, and combination offerings. The auction format proposed by Wit Capital in its 2000 letter was similar in some respects to the 1999 method but had all the characteristics of a Dutch auction method. The letter does not indicate whether Wit Capital would then use this more mechanical method for initial public offerings. In the proposed Dutch offering, the bidders would be given a maximum bid price and a minimum bid price and would be asked to bid for a number of shares between those two prices. The price would then be set at the highest price for which all shares would be sold up to the maximum bid price. If not enough customers bid for shares at even the minimum price, then the minimum price would be the share price and the issuer would sell all the shares to the underwriter at the price under a firm commitment underwriting. If bids at the share price exceed the number of shares available, the

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303 See 1999 Wit Capital Letter, supra note 294, at *5.
304 See id. at *7.
305 See id. at *9, 23.
306 See id. at *10-11.
307 See id. at *7.
308 See id. (noting that any directed share program would be described in the “Plan of Distribution” section of the prospectus).
310 See id. at *1 (describing the method as a transparent, open auction and referring to its method as the “Vostockm auction method of distribution”).
311 See id. at *3.
312 See id. at *4.
313 See id.
issuer would allocate the shares to the bidders based strictly on the highest price bid by the bidder and the time of the bid.\textsuperscript{314} However, the issuer and the underwriter could agree to adjust the allocation to ensure that at least 25 percent of the allocation goes to small bids or large bids, as the case may be.\textsuperscript{315}

During this auction, any internet user could view the aggregate demand in the auction at each price point, making the pricing of the shares virtually transparent.\textsuperscript{316} Each bidder also would have the ability to change or cancel bids prior to the termination of the auction.\textsuperscript{317} In addition, all bids would be anonymous, further eliminating any discriminatory allocation practice.\textsuperscript{318}

Following the issuance of no-action letters like these, the potential for online IPOs seemed unlimited, although some investment professionals took a wait-and-see attitude.\textsuperscript{319} Other investment firms began to market their own online services,\textsuperscript{320} only to have the IPO market decline severely with the general stock market decline in the second half of 2000. Although a few online IPOs were conducted in 1999 and the first half of 2000,\textsuperscript{321} many investment firms halted plans for online IPOs and returned their business to more traditional underwriting practices, including Wit Capital.\textsuperscript{322} Online IPOs suffered doubly during this period because companies that were most interested in doing technologically-advanced capital raising were technology

\textsuperscript{314} See id.
\textsuperscript{315} See id.
\textsuperscript{316} See id. at *1.
\textsuperscript{317} See id. at *4.
\textsuperscript{318} See id. In a 2000 address to the San Diego Securities Institute, Laura S. Unger, then an SEC commissioner, described two ways to distribute IPO shares on the Internet without violating SEC rules on pre-effective sales. See 2000 Address, supra note 5, at 2. First, brokers can collect “indications of interest” in IPO shares that are reconfirmed after effectiveness and pricing. Id. Alternatively, brokers may collect “conditional offers to buy” shares within a certain price range, which are accepted after effectiveness, pricing, and notification to investors. Id.
\textsuperscript{319} See Emily S. Plishner, E-Bonds, Will They Fly?, CFO: MAGAZINE FOR SENIOR FINANCIAL EXECUTIVES, Mar. 2001 (“Many investors will likely sit on the sidelines until one system is established as de facto standard.”).
\textsuperscript{321} See 2000 Address, supra note 5, at 1 (stating that “about a dozen” firms by January 2000 had created online systems to distribute IPOs and that 38 percent of all IPOs in the last half of 1999 had an online component). However, these IPOs were not all exclusive online IPO auctions. WR Hambrecht + Co.’s OpenIPO website shows that the firm conducted three online IPO auctions in 1999, one in 2000, two in 2001, one in 2002, and two in 2003. See http://www.openbook.com (last visited Jan. 30, 2004).
\textsuperscript{322} Following an acquisition of Soundview Group, a traditional investment bank, in 2000, Wit Capital focused on traditional underwriting and is now part of Charles Schwab as Schwab Soundview Capital Markets. See http://www.witcapital.com (last visited March 1, 2004). In addition, Bear, Stearns has also abandoned its DAiSSsm method of distributing debt securities. See http://www.bearstearn.com (last visited March 1, 2004).
companies, companies that were hit hardest during this economic downturn.

However, the death of the online IPO auction has been greatly exaggerated. At least one investment bank, H.R. Hambrecht + Co., continued to invest in the future of online IPOs and has recently conducted several successful online IPOs during the recent resurgence in IPO activity.

B. The Google IPO

In Google’s April 29, 2004 registration statement, founders Larry Page and Sergey Brin announced that the Google IPO would utilize an auction method for pricing and distribution of shares. The founders explained that the inefficiencies inherent in the traditional IPO process are damaging to both the issuer and the long-term investor. Interestingly, the registration statement urged investors to bid only if they were interested in the company long-term. Google received some backlash in the media for pretending to have a democratic auction process when the auction actually would only be accessible by customers who were able to pay the high price per share range, and meet minimum account balances. Shortly thereafter, on May 21, Google amended its registration statement, naming thirty-one additional banks, including smaller and online banks that would also be able to distribute shares in the auction. The addition of these investment banks democratized the IPO process to the extent that individual investors would have the same opportunity to receive original IPO shares as industry investors.

However, the Google auction, which was eventually conducted on August 18, 2004, did not unleash the power of a true Dutch auction to create market pricing for the original IPO shares. Instead, the issuer stated a projected range of $85 to $95 per share and priced the shares at

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324 See id. (listing the tombstones of completed online initial offerings, including Outpost.com and Peet’s Coffee & Tea).
325 See Google S-1, supra note 293, at iv-v.
326 Id. at iv.
327 Id. at x.
329 See Google, Inc. Amendment No. 1 to Form S-1 Registration Statement under the Securities Act of 1933, at 25, 93. Three underwriters would later drop from the IPO, reducing the number of underwriters to eight. See Amendment No. at 25.
the bottom of that range. With the price of Google shares then soaring a modest 50 percent over the next six weeks, one is left to wonder whether even with the auction model, the shares were underpriced.

The Google IPO was a promising breakthrough in the market for IPOs in that the company showed the investment banks that it will engage in an IPO on its terms and according to its rules. Google did not rush to market during the technology boom and came to the negotiating table as a seasoned company with some power. Unlike many start-ups, Google did not have to court investment banks or rely on VC relationships to make introductions. Because of this power, Google was uncommonly able to determine unilaterally who would underwrite the IPO and how the IPO would proceed.

C. Future Effects on IPO Practice

The availability of online IPO auction mechanisms promise a much more democratic IPO process whereby the larger public has the opportunity to participate. Theoretically, the enhanced transparency of pricing and participation of investors should create a more efficient market for IPOs in which the offering price more accurately reflects the value investors place on the IPO shares. The elimination of the bookbuilding method would completely transform the IPO process, eliminating opportunities for profit allocations that spawn other unfair practices such as spinning and ladderling. Half of this combination has already been realized with the ability of issuers to conduct online IPO auctions. Although not all of the firms that proposed transforming their underwriting practice in this way in 1999 and 2000 are currently offering an IPO auction process, the mechanism is still alive and gaining in the IPO underwriting market. Any remaining regulatory hurdles to the emergence of the online IPO as a common practice may

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333 The WR Hambrecht + Co. website provides selected IPO pricing information for completed offerings, which tends to show that online auctions avoid the “pops” of bookbuilding IPOs. See http://www.openbook.com (last visited Jan. 30, 2004) (listing the opening/closing prices of Ravenswood ($10.50/10.88); Andover.net ($18.00/63.38); Nogatech, Inc. ($12.00/9.41); Peet's Coffee & Tea ($8.00/9.38); Briazz, Inc. ($8.00/8.03); and Overstock.com ($13.00/$13.03)). But see Laura S. Unger, Raising Capital on the Internet, 69 U. CIN. L. REV. 1205, 1207-08 (2001) (describing how in the online IPO auction of shares of Peet’s Coffee & Tea, the share price more than doubled in the first few days) [hereinafter Unger, Raising Capital].
be eliminated. 334

However, issuers generally choose an underwriter early in the decision-making process, and unless that underwriter is one of the few firms that offer online IPOs, that underwriter probably will not counsel the issuer to investigate the pros and cons of an online IPO. The underwriter would be not only giving up some control of the underwriting process to another underwriter, but also giving up control of the allocation process, a source of lucrative opportunism. Therefore, underwriters may be loath to implement their own auction mechanisms and thereby eliminate an allocation system that allows them to reward their regular customers. The industry power that allows the rare issuer such as Google to lay new ground rules with Wall Street investment banks is the exception, not the rule. The founders of the IPO company also may not want to forego the potential upside of reserved directed shares for friends and family and the ability to build in gain for themselves. Founders often rely on VC firms to choose investment banks, and VCs also may be hesitant to forego instant profits. 335 In addition, neither institutional investors spoiled by huge short-term gains from IPO allocations nor arbitrageurs and day traders will be attracted to the auction structure. 336

Ironically, because the auction process may entail “winner’s curse” problems, the share price may actually decline the first day. 337 The main players that gain from the bookbuilding system are necessarily the ones that will have to choose to adopt an alternative system, which may hamper the growth of the online IPO.

Although a paradigm shift will not happen overnight, if issuers begin to use online auctions to conduct offerings, then the role of the underwriter, and the underwriter’s power, will be diminished. 338 Just as

334 See IPO Advisory Report, supra note 220, at 9 (urging the SEC to eliminate pricing rules that might make true auction pricing burdensome); National Association of Securities Dealers, Notice to Members 03-72, 778-79 (Nov. 2003) (proposing text of new NASD Rule 2712 and requesting comments on potential regulation to ensure integrity in IPO pricing, including “requiring underwriters to . . . [u]se an auction or other system to collect indications of interest to help establish the final IPO price”) [hereinafter NTM 03-72].
335 See Dan Ackman, A Better, More Honest IPO, FORBES, Oct. 17, 2002, at http://www.forbest.com/2002/10/17/1017ipo_print.html (noting that venture capitalists were more tempted to steer an IPO to a traditional investment banking firm, not OpenIPO).
336 See Coffee, Dutch Auctions, supra note 26, at 5 (suggesting that the once-ignored individual investor will have to fill the void in auction distributions if they will be successful).
337 See Google S-1, supra note 293, at 18 (describing in the “Risk Factors” section how “investors may experience significant losses” due to the winner’s curse and how “[s]uccessful bidders hoping to capture profits shortly after our Class A common stock begins trading may be disappointed”)
338 Smaller firms have even conducted small offerings over the Internet without an underwriter. “Direct Public Offerings,” or “DPOs” have become an alternative for small businesses to avoid underwriting fees and offer shares to the public directly. Because these offerings are generally either under the $1 million threshold for [rule] offerings or under the $5 million threshold for [rule] offerings, the issuers save on both underwriting fees and legal fees. See Thomas P. Gallagher & Courtenay C. Hansen, N.J. LAW., Aug. 1999, at 39; Unger, Raising
the power of the internet has revolutionized the buying and selling of residential real estate, technology may allow issuers to see underwriters as mere middlemen that stand between sellers and buyers. To remain competitive, underwriters will be forced to offer issuers something more than just a distribution channel to potential investors. Underwriters will necessarily have to compete based on the quality of their advice, the strength of their reputation, and their ability to brand issuers.

VII. REGULATORY REFORM

A. IPO Process

In response to public outcry regarding unfairness in the IPO process following the end of the 1999-2000 Boom, the NASD has proposed two new rules to improve the IPO process. At the same time, the SEC created and charged the IPO Advisory Committee to analyze the IPO process and recommend improvements.

1. NASD/NYSE IPO Advisory Committee Report

On August 22, 2002, the former Chairman of the SEC, Harvey Pitt, had asked the former Chairman of the NYSE, Dick Grasso, and the Chairman of the NASD, Robert R. Glauber, to convene a committee of leaders in both the business and academic communities to complete this project. This committee was to focus on why IPO prices would increase dramatically at the beginning of an offering and how this phenomenon contributed to "aggressive" and possibly illegal underwriting practices. In May 2003, the NYSE/NASD IPO Advisory Committee released a document entitled "Report and Recommendations" that detailed the committee’s review of the initial

Capital, supra note 333, at 1207.


340 The committee comprised fourteen members of the investing and finance community, including the President of the American Association of Individual Investors: Geoffrey C. Bible (chair), John J. Brennan, Peter A. Brooke, Richard M. Burnes, Jr., Myra Drucker, William R. Hambrecht, Martin Lipton, John D. Markese, Robert C. Mendelson, Leon E. Panetta, Jay R. Ritter, Larry W. Sonsini, Daniel P. Tully, and John L. Vogelstein. See IPO Advisory Report, supra note 220, at I.

341 See id. at Appendix A (letter from Mr. Pitt to Mr. Grasso and Mr. Glauber dated August 22, 2002 asking that the committee review the IPO underwriting process, “particularly price setting and allocation practices”).

342 See id.
public offering process, its role in creating some of the problems observed in the IPO market of the 1990's and recommended improvements to restore the integrity of that process. The committee made twenty recommendations to “promote transparency in pricing and avoid aftermarket distortions,” “eliminate abusive allocation practices,” “improve the IPO information flow and information access,” and “improve the quality of underwriter performance and public awareness regarding IPOs.”

Although the committee did not denounce the bookbuilding process, the committee recognized that investors are losing confidence in the IPO market due to the “widespread perception that IPOs are parceled out disproportionately to a few, favored investors, be they large institutions, powerful individuals or ‘friends and family’ of the issuer.” Therefore, many of the committee’s recommendations are specifically directed at limiting, but not eliminating, the discretion of the underwriter to make these allocations. Specifically, the report recommends prohibiting the allocation of shares in an IPO (not just a “hot” IPO) to any executive officers or directors in a company that is an “investment banking client” of the underwriter in order to eliminate any quid pro quo allocations. The committee also recommended adopting “a more explicit restriction” on the prohibition against an underwriter allocating shares of an IPO in consideration of a promise of an excess commission or other return of profits, limiting “friends and family” programs to 5 percent of a particular offering, and requiring that the underwriter disclose the final IPO allocations to the issuer. However, although the report supported alternatives to bookbuilding,
such as Dutch auctions, the report clearly states that the Committee does not believe that bookbuilding is "inherently flawed" or that regulation should eliminator or even disfavor the traditional bookbuilding method.\textsuperscript{350}

The committee also commented on both flipping practices and laddering practices. Although underwriters might argue that both penalizing those original shareholders who flip their shares and encouraging original shareholders to purchase more shares in the aftermarket help support the price of and maintain a market for the IPO stock,\textsuperscript{351} the committee recognized that these practices have harmful effects on the retail investor.\textsuperscript{352} First, laddering is prohibited by both Regulation M and the anti-manipulation and anti-fraud provisions of the securities laws.\textsuperscript{353} The committee thereby encouraged the SROs and the SEC to "redress and prevent" these already illegal practices.\textsuperscript{354} Second, the committee recommended several improvements to underwriters' customary practices of penalizing only retail investors who flip shares and not institutional investors and regular brokerage customers.\textsuperscript{355} Unless a penalty bid has been imposed on a syndicate member, or possibly the entire syndicate, then an underwriter could not impose a penalty bid on a retail investor.\textsuperscript{356} In addition, the prospectus would have to clearly indicate whether the underwriter will waive lock-up requirements for directors, officers, and certain pre-IPO shareholders.\textsuperscript{357} Furthermore, before any of these shareholders can sell shares before the lock-up agreement, the underwriter will have to announce the sale to the investment community and the issuer would have to file a report on Form 8-K.\textsuperscript{358}

Interestingly, the report seems to indicate that underwriters are not the only group whose actions led to IPO abuses. The report also has

\begin{footnotes}
\item[350] See id. at 1, 9 ("The market, and not regulators, should determine whether bookbuilding, a Dutch auction or another method is desirable for a particular IPO."). But see Hambrecht, supra note 73 (criticizing his fellow members of the IPO Advisory Committee for not recognizing that bookbuilding is "closed and transparent" and that discretionary allocation of IPO shares by underwriters is the root cause of the abuses inherent in the current IPO system).
\item[351] See Randall Smith, SEC 'Laddering' Inquiry Reaches Two Firms, WALL ST. J., Nov. 6, 2002, at C1 (relating underwriters' view that asking customers about interest in IPO shares in the aftermarket helps underwriters place shares with long-term investors).
\item[352] See IPO Advisory Report, supra note 220, at 6 (recommendation #3: "Redress and prevent prohibited IPO laddering").
\item[353] 17 C.F.R. § 242.101; SEC Bulletin No. 10, supra note 228.
\item[354] See IPO Advisory Report, supra note 220, at 6.
\item[355] See id. at 7.
\item[356] See id.
\item[357] See id. at 16 (suggesting that all material terms, including terms relating to hedging, be disclosed in the prospectus, as well as any preexisting plans to waive those terms).
\item[358] See id. at 17-18 (noting that pre-transaction disclosure of insider sales is more helpful and appropriate than disclosure after the sale).
\end{footnotes}
recommendations that affect issuers,\textsuperscript{359} retail investors,\textsuperscript{360} and potential "spinnees."\textsuperscript{361} In this regard, two recommendations focus on agency problems created by conflicts between directors and officers and their corporations. First, the committee recommends that the issuer create a pricing committee from its board of directors with at least one independent director.\textsuperscript{362} This mechanism could result in eliminating the conflict between the opportunism of individual founders and the long-term capital needs of the issuer. In addition, the report also recommends that corporations institute a policy concerning whether the directors and executive officers of that corporation may accept allocations of IPO shares from an underwriter and under what circumstances.\textsuperscript{363} A restrictive policy could eliminate the potential for a key person to make decisions for the company based on a lucrative IPO allocation or could preserve that IPO opportunity for the corporation, not the individual.

2. Rule 2790

New Rule 2790 was proposed on October 15, 1999, but was amended by the NASD five times\textsuperscript{364} over the course of four years before

\textsuperscript{359} See id. at 4 (" Require each issuer to establish an IPO pricing committee of its board of directors—including at least one director who is independent of management (if any director qualifies)—to oversee the pricing problem."

\textsuperscript{360} See id. at 6 (" Prohibit, for the first trading day following the IPO, the placing of unpriced orders to purchase an issuer's shares."); see also id. at 19 (" Launch an education campaign for new issuers and IPO investors.").

\textsuperscript{361} See id. at 11 (" Provide that a listed company's code of business conduct and ethics should include a policy regarding receipt of IPO shares by the company's directors and executive officers.").

\textsuperscript{362} See id. at 4-5 (reflecting belief of the committee that open dialogue between the underwriter and the issuer's board of directors during the pricing process would ensure that the final pricing would not prejudice the issuer as a whole or its shareholders).

\textsuperscript{363} See id. at 11 (noting that the issuers should bear some of the burden to restore integrity to the IPO process by ensuring that individuals at the company do not breach their duty of loyalty to the shareholders of that company).

being approved by the SEC on October 24, 2003.\textsuperscript{365} \textsuperscript{365} Rule 2790 replaces the Free-Riding and Withholding Interpretation that previously offered guidance and prohibitions on IPO allocations to member broker-dealers. Among other things, Rule 2790 eliminates any distinction between initial public offerings generally and "hot" issues,\textsuperscript{366} thereby creating a much larger category of persons who are prohibited from receiving IPO allocations.\textsuperscript{367} Specifically, the category of "conditionally restricted" persons that were restricted recipients only in "hot" offerings under certain circumstances are now restricted recipients in all offerings under all circumstances.\textsuperscript{368} However, large institutional investors, such as large insurance companies and retirement funds, are exempt from this prohibition.\textsuperscript{369} In addition, the text of Rule 2790 specifically allows underwriters to sell IPO shares at the public offering price "as part of an accommodation to a non-restricted person customer of the broker/dealer."\textsuperscript{370} Therefore, underwriters can continue to allocate IPO shares on a discretionary basis to regular customers. Rule 2790 also left largely intact the ability of issuers to direct IPO shares to specific persons\textsuperscript{371} through friends and family programs.\textsuperscript{372} 

\textsuperscript{365} See Rule 2790 Approval Order, supra note 364. Because of the significant changes in this new rule, the NASD allowed for a three-month transitional period during which members could comply with either Rule 2790 or the Free-Riding and Withholding Interpretation. Beginning March 24, 2004, all members must conform practices to Rule 2790. See NTM 03-79, supra note 289, at 1.

\textsuperscript{366} A "hot" issue was interpreted to mean "securities of a public offering which trade at a premium in the secondary market whenever such secondary market begins." See Free-Riding and Withholding Interpretation, supra note 106, at (b).

\textsuperscript{367} See NTM 03-79, supra note 289, at 840 (noting as one reason for the elimination of the distinction between hot issues and other issues is the difficulty in predicting whether the issue will trade at a premium and, subsequently, what categories of persons could be allocated IPO shares).

\textsuperscript{368} Under the Free-Riding and Withholding Interpretation, certain classes of buyers would be "restricted" if the IPO shares traded at a premium. Those shares would be cancelled and returned, but only if the recipient could not demonstrate that the shares were bought as a "normal investment practice" and represented an insubstantial amount compared to the IPO shares bought by the public. See Free-Riding and Withholding Interpretation, supra note 106, at (b)(5). Under new Rule 2790, these buyers would be unconditionally restricted from buying IPO shares under any circumstances. See NASD Rule 2790(a)(1); NTM 03-79, supra note 289, at 840 (explaining that Rule 2790 has a smaller set of restricted persons than the Free-Riding and Withholding Interpretation, but has no exceptions based on "normal investment practice").

\textsuperscript{369} See NASD Rule 2790(c)(3)(A) (insurance company accounts with 1,000 or more policyholders); NASD Rule 2790(c)(1) (investment companies registered under the Investment Company Act of 1940); NASD Rule 2790(c)(7) (qualified ERISA benefits plans).

\textsuperscript{370} See id. 2790(a)(4)(B).

\textsuperscript{371} See id. 2790(d) (allowing issuers to direct IPO shares to otherwise restricted persons). But
3. Proposed Rule 2712

If approved, proposed NASD Rule 2712 will go further than Rule 2790 to reform IPO allocation practices. First proposed in August 2002, proposed Rule 2712, entitled “Proposed Rule Governing Allocations and Distributions of Shares in Initial Public Offerings,” was amended in September 2003 and supplemented in November 2003 to incorporate some of the recommendations of the IPO Advisory Committee.

The current text of proposed Rule 2712 would prohibit underwriters from allocating IPO shares to customers in consideration for either excessive compensation or future or current investment banking business. In addition, underwriters may not selectively impose a penalty bid for flipping. An earlier version of the rule would have prohibited underwriters from requesting that persons receiving allocations buy additional shares in the aftermarket, but this section was deleted. The latest round of amendments address the underwriting agreement and require that its terms require the underwriter to periodically update a pricing committee or the entire Board of Directors of the issuer of indications of interest and pricing

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see NTM 03-79, supra note 289, at 846-47 (warning members that issuer-directed shares must indeed be directed by the issuer and that underwriters should not ask issuers to direct securities to restricted persons for the benefit of the underwriter).

But see Wright, supra note 176 (“Best of all, these programs should be banned altogether. Allocations in an IPO should be made purely in the long-term interests of the company and its shareholders—not in the interests of its bankers, its business associates or the managing director’s dad and someone with whom he once shared a rather nice lunch.”).


See NTM 03-72, supra note 334 (proposing in new subsection (e) several recommendations of the IPO Advisory Committee, including enhanced disclosure of indications of interest to the issuer by the underwriter, uniform lock-up periods for officers and directors and recipients of issuer-directed shares, public announcement prior to the waiver of any restriction on any IPO shares, sales of returned shares on an exchange at the current price and not the IPO price, and prohibitions on accepting market orders for IPO shares on the first day of trading).

See NTM 02-55, supra note 373, at Exhibit A (Rule 2712(a), (c)).

See id. (Rule 2712(d)).

See Sept. 2003 Proposed Amendments, supra note 374, at 11-12 (noting that the first version of proposed Rule 2712 received comments from members such as the Securities Industry Association that a rule prohibiting underwriters from encouraging customers to buy shares in the aftermarket would be “difficult to supervise or monitor”). The outcry against this provision and subsequent withdrawal should not be surprising, given that the SEC proposed in 1974 to eliminate tie-in arrangements by enacting new Rule 10b-20; however, this proposal was withdrawn fourteen years later. See Withdrawal of Proposed Rules Under the Securities and Exchange Act of 1934, Exchange Act Release No. 34-26182, 53 Fed. Reg. 41,206 (October 14, 1988) [hereinafter SEC Release 26182].
information in the pre-effective period.\footnote{NTM 03-72, supra note 334, at 778 (Rule 2712(e)(1)(A)).} In addition, any lock-up agreement in the underwriting agreement would also apply to any issuer-directed shares,\footnote{See id. (Rule 2712(e)(1)(B)).} and any waiver of any lock-up agreement may only take place two days following a public announcement of that waiver.\footnote{See id. (Rule 2712(e)(1)(C)).}

In the Notice to Members publishing the November 2003 amendments, the NASD also asked members to comment on alternative regulatory approaches “to promote transparency in IPO pricing.”\footnote{See id. at 772, 776.} The three approaches suggested were: (1) requiring underwriters to deliver an opinion of an independent broker-dealer that both the initial IPO price range and the final IPO price were reasonable; (2) requiring underwriters to use a system such as an auction to accumulate indications of interest from investors; and (3) requiring the final prospectus to include a “valuation disclosure” section with financial data that supports the final IPO price.\footnote{See id.}

4. Potential Effect on IPO Practice

Although both Rule 2790 and Proposed Rule 2712, if approved, would improve the IPO process, the improvements would merely address the symptoms that are caused by a system rife with agency problems. The bookbuilding system, even as reformed,\footnote{In fact, reporters have already found large loopholes in the new Rule 2790, including the ability of an underwriter to siphon underpriced IPO shares to hedge funds in which the investment bank, employees of the bank, or relatives of the bank’s employees have a beneficial interest of up to ten percent. See Gregory Zuckerman, NASD Opens Door to Profit for Brokers on IPOs: Agency Tightens Some Rules, Eases Prohibition Meant to Limit Conflicts of Interest, WALL ST. J., Mar. 22, 2004, at A1.} is the inherent cause of these symptoms and provides incentives for underpricing, allocating underpriced IPO shares in return for excessive compensation or investment banking business, and distributing underpriced IPO shares to key executives in return for business for the issuer. The only long-term solution to this problem is to abolish the bookbuilding system wholesale. Without the ability to lock-in profits for certain recipients, underwriters would then have no incentive to manipulate the price in the aftermarket through laddering agreements, flipping restrictions, lock-up agreements, and stabilization activities. If IPO shares were distributed through a more transparent process, with all of the shares in the IPO being allocated anonymously at an auction price, then the unfair practices would disappear. The issuer would
receive the maximum amount the market will bear for its equity shares. The underwriter would no longer be able to use the representation of the issuer to attract wealth from brokerage customers or investment banking customers. The underwriter would not be able to benefit either directly or indirectly from underpricing the issuer’s shares and will only benefit by representing the issuer well and increasing its reputation as a competent underwriter. If an alternative method of distributing shares were used, such as a true Dutch auction, then the underwriter would be able to focus on achieving the best result for the issuer, not for the individual underwriter or the investment bank.

In addition, if shares were priced and allocated according to a blind auction process, the agency problems between the founders and the issuer would be minimized. The founders would also have no conflict of interest with the issuer during the offering and would not have the ability to use friends and family shares to unjustly enrich cronies or as bribes for potential business partners. Furthermore, if the distribution of shares via public auction produced an offering price more reflective of the actual market price, then the underwriter would not have to engage in manipulative aftermarket activities to ensure that the original buyers can sell at a higher price. The underwriter would not be concerned with whether any of the investors would flip their shares because the market price should be relatively stable in the first days of the offering, unlike in a bookbuilding offering. Underwriters would have no special interests pressuring them to sustain a price for a certain period, so flipping restrictions and lock-ups would not need to be used for this purpose.

At a minimum, more stringent reforms are necessary to restrain the moral hazard created by the bookbuilding method. Specifically, the underwriter should not be allowed to allocate a large percentage of the original issue. If we presume that the underwriter must be allowed some allocations to effectively conduct a bookbuilding offering, the amount of discretionary allocations should be small, perhaps 25 percent or less. Other proposals being considered under Rule 2712 would help the underwriter determine a price other than relying on price information from potential buyers. In addition, friends and family programs should be restricted as well. The IPO Advisory Committee suggested that these programs be restricted to 5 percent of the offering; combined with the underwriter’s 25 percent discretionary allocation, this plan would leave 70 percent for the public float. This loosening of the supply could also relieve demand pressure, creating a less frenzied environment for first-day returns. I would also argue that the underwriter should not be able to impose any flipping restrictions on the original IPO shares that are allocated.
B. Analyst Reports

Although analysts were only one piece of the larger IPO puzzle, analyst conflicts seemed to present a discrete and solvable problem that attracted regulators. In response to media attention on analyst conflicts of interest, the SEC, the NASD, the NYSE, and the federal legislature proposed new reforms designed to make analysts more independent or at least inform the investing public about possible connections between the analyst and either the covered company or the investment banking firm that employs the analyst.

1. Regulation AC

On February 27, 2003, the SEC approved Regulation AC, which requires research analysts to include in each research report a certification that attests to the independence of the report. Among other things, the certification must include statements that the views in the report accurately reflect the analyst's personal views about the issuer and that the analyst did not and will not receive compensation that is directly or indirectly tied to the recommendations or views expressed in the report. In the alternative, if the analyst cannot affirm that his compensation is not derived from the views expressed in the report, the analyst must include a statement detailing the particulars of the compensation and "disclosing that the compensation could influence the recommendations or views expressed in the research report." These requirements also apply to public appearances.

2. Rule 2711

In May 2002, the SEC approved a new NASD rule, Rule 2711, regarding conflicts between research analysts and the investment banks that employ them. This rule is much more detailed and far-reaching than Regulation AC. Although Rule 2711 was passed relatively

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385 See Fisch & Sale, supra note 52, at 1068 (observing the SEC's first reaction was to merely post a brochure, "Analyzing Analyst Recommendations," on its website to inform investors of the types of potential conflicts of interest that an analyst may have).
388 Id. § 242.501(2)(ii).
389 Id. § 242.502.
390 See Rule 2711 Approval Order, supra note 257.
quickly, the rule then was amended several times to incorporate new requirements imposed by the Sarbanes-Oxley Act of 2002. The current text of Rule 2711 generally addresses the relationship between an investment banking firm and its research department, compensation of analysts, analysts' personal trading practices, the circumstances surrounding and the timing of research reports, and additional disclosures in connection with research reports.

Much of the new rule addresses the conflicts that arise between the analyst and the investment banking client. Although the NASD maintains that promising favorable research reports to entice investment banking business was already prohibited under Rule 2110 as a violation of just and equitable principles of trade, Rule 2711(e) explicitly prohibits such practices. To further ensure that an analyst's report is unencumbered by issuer expectations, analysts are also prohibited from submitting a research report to an issuer prior to its release except for the sole purpose of verifying factual information in specific sections and then only under the supervision of legal or compliance personnel. In addition, analysts are prohibited from engaging in "efforts to solicit investment banking business." To relieve the pressure of analysts to


Section 501 of the Sarbanes Oxley Act of 2002 requires the SEC to adopt rules to separate analysts from investment banking departments and to increase disclosure of conflicts of interest. See 15 U.S.C. § 7201 et seq. (Supp. 2003); see also Fisch & Sale, supra note 52, at 1076-77 (describing the details of the Sarbanes-Oxley Act that pertain to analyst conflicts).

393 See Rule 2711(e) ("No member may directly or indirectly offer favorable research, a specific rating or a specific price target, or threaten to change research, a rating or a price target, to a company as consideration or inducement for the receipt of business or compensation.").

394 See Rule 2711(c).

395 Earlier amendments of the rule contained the language:

No research analyst may issue a research report or make a public appearance concerning a subject company if the research analyst engaged in any communication with the subject company in furtherance of obtaining investment banking business prior to the time the subject company entered into a letter of intent or other written agreement with the member designating the member as an underwriter of an initial
issue positive research reports at specific times during the IPO process to increase demand, Rule 2711 prohibits issuing reports for forty days after the date of an IPO\textsuperscript{396} and during the fifteen days before and after "the expiration, waiver or termination of a lock-up agreement"\textsuperscript{397} if the analyst's firm acted as the manager or co-manager of the IPO.

The new rule also attempts to decrease the institutional conflicts between the analyst and the investment banking firm. Rule 2711(b) outlines procedures that the firm must take to ensure that analysts are not subject to the "supervision or control" of the investment banking department, including "influence or control over the compensatory evaluation" of the analyst.\textsuperscript{398} In addition, no analyst compensation may be based on any relationship between the analyst's research reports and investment banking clients.\textsuperscript{399} Communications between analysts and the investment banking department concerning research reports must be supervised by legal or compliance personnel.\textsuperscript{400}

Although analysts and their firms may own securities in the companies that are subject to analysts' reports, Rule 2711 imposes some restrictions and disclosure obligations on those investments. Specifically, analysts cannot receive pre-IPO stock if the company is engaged in the same "types of business as companies that the research analyst follows."\textsuperscript{401} In addition, the analyst cannot buy or sell shares (or derivatives of such shares) for the thirty days before and the five days after the publication of any report concerning that company except under specific circumstances.\textsuperscript{402} On research reports and in public appearances, the analyst must disclose if he or any member of his public offering by the subject company.


\textsuperscript{396} See Rule 2711(f)(1)(A). If the analyst's firm was an underwriter or dealer in the IPO, then the analyst may not issue a report or make a public appearance for twenty-five calendar days regarding the issuer. See Rule 2711 (f)(2).
\textsuperscript{397} See Rule 2711(f)(4).
\textsuperscript{398} See Rule 2711(b).
\textsuperscript{399} See Rule 2711(b) (2) (giving as suitable factors in deciding analyst compensation: (1) the productivity and quality of research; (2) actual relationship between analysts' recommendations and actual stock price performance; and (3) ratings by either independent ratings services or non-investment banking peers and clients).
\textsuperscript{400} See Rule 2711(b)(3).
\textsuperscript{401} See Rule 2711(g)(1).
\textsuperscript{402} See Rule 2711(g)(2) (noting that an analyst could purchase or sell a security if legal or compliance personnel approved the change and the purchase or sale was due to either significant events impacting the company or a significant change in the analyst's personal financial circumstances).
family has a financial interest in the securities of the subject company\textsuperscript{403} or if the firm owns 1 percent or more of any class of common stock of the subject company.\textsuperscript{404}

Finally, research reports must also contain disclosures regarding both whether the analyst has received any compensation based on investment banking revenues from the subject company in the past year and the extent to which the firm has served as an investment banking service provider for the subject company in the past year or expects to do so in the next three months.\textsuperscript{405}

3. Potential Effect on IPO Practice

In contrast to the limited reforms reflected in Rule 2790, and even proposed Rule 2712, Rule 2711 is fairly far-reaching in its restrictions on research analysts and the firms that employ them. Although the NASD surely could have required analysts not to own shares in the companies that they cover, that restriction may have been seen as too stringent. In addition, requiring disclosure of the fact that an investment firm owned 1 percent or more of a public company seems a pretty high threshold, given that an investment firm could have a multi-million dollar position in a large company without triggering disclosure requirements.

Perhaps the financial services community was willing to allow regulation of research analysts, but not so willing to completely overhaul lucrative IPO underwriting practices, given the speed with which Rule 2711 was passed as compared to lengthy approval processes for Rules 2790 and 2712. The industry may have realized that increased analyst regulation was inevitable given the aggressive SEC investigation that culminated in the Global Settlement of Analyst Conflict of Interest. Whether industry acquiescence to Rule 2711 reflects the use of research analysts as sacrificial lambs by investment banks or merely reveals the investment banks choosing wisely among different battles, Rule 2711 should have a large and positive impact on the independence of research reports.

\textsuperscript{403} See Rule 2711(h)(A) (including as a "financial interest" options, rights, warrants, futures, and long and short positions).
\textsuperscript{404} See Rule 2711(h)(1)(B) (calculating a firm's interest as of the end of the month before the publication of the report or the public appearance).
\textsuperscript{405} See Rule 2711(h)(2).
In one of the most publicized legal actions arising out of the bursting of the technology bubble, the SEC named in a lawsuit ten major New York investment banks and two prominent investment analysts, Jack Grubman and Henry Blodget. Although allegations of improper IPO allocation practices were included both in the lawsuit and in the settlement against two of the defendants, this lawsuit focused mainly on the conflicts of interest that arose between investment analysts, who were issuing research reports on issuer's stocks with buy and sell recommendations, and the investment banking firms that employed them. The lawsuits alleged that the investment banks were routinely authorizing and possibly requiring analysts such as Grubman and Blodget to give favorable ratings to clients when those ratings were not warranted. This practice was so pervasive that during 2000, analysts were giving "buy" recommendations for issuers whose businesses were plummeting into bankruptcy. All of the defendants entered into the Global Settlement of Analyst Conflict of Interest on April 28, 2003, pursuant to which each defendant signed a Letter of Acceptance, Waiver and Consent under NASD rules without admitting or denying the allegations or findings. Under the Global Settlement, which was negotiated by the SEC, the New York Attorney General's office, and NASD and NYSE officials, the defendants agreed to pay $1.4 billion dollars, with $387.5 million of that sum to go to a fund to reimburse aggrieved investors. Grubman and Blodget were both barred from the securities industry by the SEC, NASD, and NYSE and ordered to pay fines of $15 million and $4 million, respectively.
The settlement also requires the firms to take positive steps to insulate the research departments of their firms from the investment banking activities. Analyst compensation must not be connected in any way to investment banking business, and investment banking personnel may not supervise or evaluate analysts. In addition, analysts no longer can have a role in recruiting investment banking clients or in touting offerings in road shows. Although analysts and investment banks are not prohibited from owning shares in the companies that the analysts cover, analysts must disclose the possibility of any conflict in research reports. The settlement also funds independent research for five years. During this period, the firms must purchase independent, third-party research from at least three independent research firms and make this research available to its customers.

Because of the timing of the Global Settlement, the structural reforms included in the settlement incorporate the requirements of Regulation AC and NASD Rule 2711 and anticipate the July 2003 amendments to Rule 2711. Accordingly, the structural reforms of the Global Settlement currently do no more than require investment banking firms to comply with existing SEC and NASD rules. However, in one highly publicized snafu, at least one firm is finding compliance with the settlement problematic. In addition, some commentators have noted that U.S. firms have not changed their practices in the European market to conform to the settlement.

B. Voluntary Initiative Regarding IPO Allocations

In April 2003, the ten investment banks that were parties to the Global Settlement also entered into a Voluntary Initiative Regarding Allocations of Securities in “Hot” Initial Public Offerings to Corporate Executives and Directors. This initiative states that it will be available at http://www.nasdr.com/news/pr2003/release_03_017.html.

413 See Donaldson Testimony, supra note 76, at 8 (outlining structural reforms).
414 See id. at 8-9. However, firms will only have to state that the firm “does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report.” Id.
415 See id. at 9.
417 See Silvia Ascarelli, Europe’s IPO: Analysts’ Game is the Same, WALL ST. J., June 18, 2003, at C1 (noting that weeks after the Global Settlement, Goldman Sachs, CSFB, and J.P. Morgan took analysts to pitch investment banking services to a potential European IPO client, Bank Austria Creditanstalt); Erik Portanger, Banned in U.S., but Alright Overseas?, WALL ST. J., June 6, 2003, at C1 (reporting that days after the Global Settlement, Citigroup and UBS Warburg used analysts to woo potential IPO client Tussaud’s Group in London).
418 See Voluntary Initiative Regarding Allocations of Securities in “Hot” Public Offerings to
effective until the earlier of a date five years from its execution or the effective date of any new rule "that would place restrictions on the ability of investment banking firms to allocate securities in 'hot' IPOs to executive officers and directors of public companies."\textsuperscript{419} Presumably, this initiative has been superseded by the SEC's approval of NASD Rule 2790.

Under the initiative the investment banking firms agreed not to allocate securities in a "hot" IPO to any executive officer or director of a publicly traded U.S. company, not to allocate securities in any IPO for the purpose of rewarding or enticing investment banking business, and not to allow investment banking personnel other than the firm's equity capital markets group to make IPO allocations.\textsuperscript{420} Although the initiative would still allow IPO allocations to institutional investors and to regular customers, its terms are stricter than the final provisions of Rule 2790. Even proposed Rule 2712, which would prohibit underwriters from allocating IPO shares to customers in consideration for future or current investment banking business, does not extend to prohibiting any allocations to officers and directors of publicly traded companies.\textsuperscript{421}

C. Civil Lawsuits Involving IPO Allocations

Private investors have filed thousands of lawsuits in federal court against investment banks and issuers that accuse the two groups of manipulating the market and inflating stock prices by, among other things, allocating IPO shares to customers in return for promises to buy more shares of the stock in the aftermarket at pre-arranged prices. Many of these lawsuits were consolidated into two class actions, \textit{In re Initial Public Offering Securities Litigation},\textsuperscript{422} which alleged that through a complex scheme of laddering agreements, undisclosed compensation, and biased analyst reports, the investment banks and the issuers violated federal securities laws by artificially increasing the price of IPO stock to the detriment of the retail investor, and \textit{In re Initial

\textsuperscript{419} Id.

\textsuperscript{420} See id. at (1), (3), (4).

\textsuperscript{421} See discussion supra Section IV.A.

\textsuperscript{422} \textit{In re Initial Pub. Offering Sec. Litig.}, 277 F. Supp. 2d 1375 (J.P.M.L. 2003) (transferring 1,100 actions to ongoing case in Southern District of New York involving over 1,000 actions alleging that issuer and underwriter defendants manipulated the IPO process by tie-in arrangements, misleading analyst reports, and nondisclosures of excess commissions). The first of these claims was appropriately filed near the beginning of the new millennium. Makaron v. VA Linux Sys., Inc., No. 01 Civ. 242 (filed Jan. 11, 2001).
Public Offering Antitrust Litigation, which alleged that these same practices violated federal antitrust laws. The second case was dismissed on the theory that the federal securities laws effectively repeal federal antitrust laws under the doctrine of implied immunity.

The Master Allegations document in In re IPO Securities Litigation depicts a vast conspiracy of investment banks and issuers joining together to artificially raise IPO shares prices in 309 issues long enough to extract profits from retail investors. The claims allege violations of § 11, 15, 10(b), and 20 of the 1934 Act. In addition, the plaintiffs claim that the investment banks engaged in market manipulation in violation of § 10(b), controlling and artificially affecting the price of a security. The plaintiffs in In re IPO Securities Litigation argue that the issuers had motivation to see the stock price increase, and therefore the necessary fraudulent intent, because with that high stock price issuers could then engage in other activities to raise capital, including secondary offerings and mergers and acquisitions. Plaintiffs also argued that individuals at an issuing corporation, who necessarily make decisions for the corporation, also stood to gain from increasing continued demand for the stock because they then could sell individual stock holdings or exercise stock options and reap enormous gains.

After the plaintiffs in IPO Securities Litigation survived a Motion to Dismiss in February 2003, the 300 issuer defendants, but not the underwriter defendants, entered into a $1 billion settlement. Under the terms of the settlement, if the plaintiffs eventually recover more than $1 billion from the remaining investment bank defendants, then the issuers will pay nothing to the plaintiffs. In addition, the issuers assigned the rights to any causes of action that they might have against

423 In re Initial Pub. Offering Antitrust Litig., No. 01-2014 (S.D.N.Y. 2002) (alleging that the syndicate bookbuilding system violated the Sherman Act and that agreements between underwriters and customers not to flip IPO shares violated the Robinson-Patman Act).
426 Id. at 368-69.
427 Id. at 366 (alleging individual profits ranging from $220,000 to $40 million).
428 Note that Judge Shira Scheindlin did grant the motion to dismiss as it related to issuer defendants who did not engage in later capital-raising transactions such as secondary offerings or mergers and acquisitions. The Judge reasoned that in those cases, under the PSLRA, the plaintiffs did not adequately plead facts that tended to show intent on the parts of those issuers. In addition, Judge Scheindlin dismissed some claims under Section 11 brought by plaintiffs who sold stock above the offering price but who nevertheless felt they were defrauded by the IPO allocation scheme. Regarding this issue of first impression, the Judge held that these plaintiffs had no damages as a matter of law. In re Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d at 347.
429 Internet Boom Companies Agree to Pay $1 Billion to Settle IPO Dispute, 10 No. 6 ANDREWS CLASS ACTION LITIG. REP. 23 (July 2003) (calling the settlement the “largest recovery attributable to Wall Street’s unethical condition between January 1998 and December 2000”).
the investment banks to the plaintiffs.\textsuperscript{430} The remaining underwriting defendants renewed motions to dismiss following a ruling by the Second Circuit that "loss causation" could be sustained by a showing of "market manipulation" in certain circumstances.\textsuperscript{431} In December 2003, the District Court once again denied the Motion to Dismiss, reiterating that loss causation incurred in the sale of a security may be adequately pled by merely alleging facts that, if true, prove that the underwriters manipulated the market.\textsuperscript{432} In October 2004, Judge Scheindlin ruled on plaintiffs' motion to certify certain classes of plaintiff, certifying Exchange Act claims for six focus cases.\textsuperscript{433}

IX. RE-INVENTING THE WHEEL OF FORTUNE

With economic recovery upon us\textsuperscript{434} and a resurgence occurring in the IPO market,\textsuperscript{435} now is the time to overhaul the IPO process. Current indications suggest the end of the 1999-2000 Boom was not the end of the retail investor and growth in this segment of the investor population will continue.\textsuperscript{436} Although the SEC and the NASD approved broad-

\begin{itemize}
\item\textsuperscript{430} Id.
\item\textsuperscript{431} Emergent Cap. Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189 (2d Cir. 2003). The \textit{Emergent} court explains that although plaintiffs must prove that the price drop that created their losses was caused by defendant's actions, not just the artificial price inflation, because plaintiffs allege a market manipulation in a "pump and dump" scheme, loss causation is adequately pled. \textit{Id.} at 197. In a securities fraud case based solely on material misstatements, plaintiffs must prove that the eventual price decline was caused by a correction of the misstatement or other defendant action. \textit{Id.} at 198.
\item\textsuperscript{432} \textit{In re Initial Pub. Offering Sec. Litig.}, 297 F. Supp. 2d 668 (S.D.N.Y. 2003) (reasoning that plaintiffs' claims adequately pled loss causation because a market manipulation claim does not require pleading of separate defendant action that causes price to eventually drop because "[i]n market manipulation cases . . . it may be permissible to infer that the artificial inflation will inevitably dissipate ".)
\item\textsuperscript{434} See E.S. Browning, \textit{Another Saga of the Running of the Bulls}, \textit{WALL ST. J.}, Jan. 2, 2004, at R1 (noting the Dow Jones Industrial Average finished 2003 up 43.5 percent from its low on October 9, 2002 and the NASDAQ Composite Index was up 80 percent from its low on the same day).
\item\textsuperscript{435} See Ben Elgin, Robert D. Hof & Emily Thornton, \textit{Initial Public Momentum}, \textit{BUS. WEEK}, Nov. 17, 2003, at 48 (predicting that 150-200 companies will go public in 2004); Hennessey, \textit{Revived, supra} note 299, at C5 (reporting the IPO share prices of China Life Insurance Co. and Universal Technology Institute, Inc. gained 27 percent and 29 percent, respectively, on their first days of trading, although Orbitz Inc. ended its first day of trading down almost $1).
\item\textsuperscript{436} See John Hechinger & Jeff D. Opdyke, \textit{Day Trading Makes a Comeback and Brokers Vie for the Business}, \textit{WALL ST. J.}, Sept. 30, 2003, at A1 (reporting that online brokerages saw "active trading" increase by 15-30 percent in September 2003); see also Browning, \textit{supra} note 434, at R1 (quoting an investment strategist as saying: "Investors did not learn a lesson over 2000-2002. We continue to see an unhealthy addiction to technology stocks, as well as a revival of the margin debt problem.").
\end{itemize}
based reforms aimed at making research analysts more independent, that issue was merely part of a much larger problem. However, dismantling the IPO profit machine will not be easy, and the financial industry will not be willing participants in the reforms that would be required to create a truly transparent, democratic IPO offering process. Perhaps just as tax professionals have an investment in the current Internal Revenue Code, the industry players are too invested in the “crazy quilt” of existing SEC and NASD IPO rulemaking to welcome a complete overhaul of the process.

A. Eliminate the Bookbuilding Method

As discussed, the bookbuilding method, with its concomitant characteristic of allowing the underwriter unfettered discretion in allocation of IPO shares, creates a system open to underpricing and allocation abuses. If the bookbuilding approach is eliminated, all of the abuses of that system will be eliminated as well. The underwriter would have no ability to underprice and no ability to handpick beneficiaries of built-in profit. Without the incentive to sustain artificially high share prices to benefit privileged recipients, the underwriter will have no incentive to collude with investors in laddering agreements, anti-flipping agreements or lock-in agreements. The underwriter will also have no need to collude with research analysts to maintain artificial prices for the benefit of share recipients and insiders.

437 Earlier efforts to reform underwriting practices in the IPO process have failed miserably. See SEC Release 26182, supra note 378 (withdrawing after fourteen years proposed SEC Rule 10b-20 that sought to explicitly prohibit laddering and tie-in agreements that “may artificially stimulate higher public demand for such shares” and “unjustly [deprive] many members of the public the opportunity to purchase such hot issue shares at their original offering prices”); see also Certain Manipulative Practices in Public Offerings, Exchange Act Release No. 74-11328, 40 Fed. Reg. 16,090 (April 2, 1974).

438 See Lane, supra note 6, at *2 (noting that his ambitious IPO reforms in SEC Release 7606A (dubbed the “aircraft carrier”) garnered 190 comments and that the most vigorous opponents were “the securities industry” and “corporate lawyers”).

439 See Sheldon D. Pollack, Tax Complexity, Reform, and the Illusion of Tax Simplification, 2 GEO. MASON INDEP. L. REV. 319, 320, 347-48 (1994) (conceptualizing the U.S. tax code as rules of a game in which the players invest substantial time and effort in learning how best to maximize outcomes under these rules and therefore may be “reluctant to acknowledge that there is even a ‘problem’”).

440 See Lane, supra note 6, at *2 (reporting unhappily that his efforts to substantially overhaul aspects of securities regulation were not met with industry enthusiasm for a “new strategic model”).

441 See Corbus, supra note 295 (noting that generally in an IPO auction, no “pops” occur and no flipping occurs).

442 Elimination of the bookbuilding method would not eliminate conflicts between analysts and their investment banking employers in connection with pleasing current issuer clients or attracting potential issuer clients. However, Rule 2711 does provide a framework for eliminating
arising out of the relationship between the issuer and the underwriter will be substantially reduced, as will agency costs inherent in the relationship between the founders and the underwriters, merely by eliminating the ability of these two groups to underprice IPO shares to reap the benefits of built-in profits.

To accomplish this goal, a new paradigm for the issuer-underwriter relationship must be created. The U.S. underwriting market is clearly entrenched in using the bookbuilding method. Even the IPO Advisory Committee members stated their preference that “[t]he market, and not regulators, should determine whether bookbuilding, a Dutch auction or another method is desirable for a particular IPO.” However, the NASD’s NTM 03-72 issued this year does ask for comments on “requiring underwriters to . . . use an auction or other system to collect indications of interest to help establish the final IPO price.” If the NASD does not restrict the use of the bookbuilding method, then powerful issuers such as Google can help force the market for underwriting IPOs adapt to a more issuer-friendly system. Online auctions may continue to draw clientele in the next hot market if founders of start-up companies can be persuaded that auctions promise the cheapest method of obtaining the most capital for the issuer. Unfortunately, without regulatory intervention or substantial price competition from online IPO auction firms, bookbuilding will probably be the dominant method of distributing IPOs for the foreseeable future.

B. Restrict the Ability of the Underwriter to Make Discretionary Allocations

Within the framework of the bookbuilding distribution system, the NASD should go further to create a more democratic distribution process. The easiest way to do this is to decrease the underwriter’s discretion in allocating an offering. As proposed in Section V.A., the underwriter’s ability to pre-allocate original IPO shares should be limited to twenty-five percent of the offering or less, and any friends and family program should be limited to five percent or less, in keeping with recommendations of the IPO Advisory Committee. As the number of shares available for underwriter allocation diminishes, the incentive

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443 NTM 03-72, supra note 334, at 772.
444 See Gardner & Gardner, supra note 66 (interviewing Patrick Byrne, CEO of Overstock.com, who responded to underwriters who threatened not to give his IPO any coverage if he chose to go with Hambrecht’s OpenIPO system with the statement, “I don’t negotiate with terrorists.”).
to underprice also decreases and the ability to manipulate supply in the aftermarket to maintain an artificial price becomes severely limited. Much of the ability of the underwriter to manipulate aftermarket prices stems from the small number of shares in the public float. Demand is created for the full offering as reported in the registration statement, but then buyers are unknowingly competing on price for as little as ten percent of that volume. Potential investors who have entered "market" orders with retail brokerage firms may be buying shares at a much higher price. As the public float begins to approach the actual size of the public offering, the actions of market participants making free choices to buy and sell will be able to determine the share price. For the same reasons, I would propose prohibiting flipping restrictions and lock-up agreements imposed by the underwriter. If the issuer wants to restrict shares owned by insiders for other purposes, then the regulation would not affect internal issuer policy. In addition, restricting the size of friends and family programs will reduce some opportunism of the founders to underprice and extract wealth for themselves and their associates.

CONCLUSION

In conclusion, the IPO process is broken, and it has been for a long time. Like any type of machine with an inherent design defect, the problems caused by this defect are more pronounced during times when the machine is overburdened. Accordingly, during IPO boom periods, the abuses that are endemic to the IPO process have severe effects. Unfortunately, once the boom is over, attention usually moves away from this problem to a more timely concern, just as I forget, during the summer months, about the funny noise that the furnace makes. However, another IPO boom is certain to appear, and retail investors will again fall prey to the abuses inherent in the IPO process. To prevent these abuses from recurring in yet another IPO boom, regulators should consider either eliminating the bookbuilding process altogether or at least reforming it substantially thereby eliminating the agency problems that are created by the opportunism endemic in the discretionary allocation system.