

THE LAW AND ECONOMICS OF IPO FAVORITISM AND REGULATORY SPIN

Ely R. Levy*

TABLE OF CONTENTS

I. INTRODUCTION.....	186
II. THE ONGOING REGULATORY ACTIVITY	191
A. <i>The Investigations</i>	191
1. Illegal Profit Sharing.....	192
2. “Hot” IPO Allocations	193
3. Tie-in Arrangements	194
4. Allocations to Executives.....	195
5. “Friends and Family” Allocations.....	196
B. <i>The Common Bond</i>	196
C. <i>The “Global” Settlement</i>	197
III. OF EXISTING LAWS AND PROPOSED RULES.....	198
IV. THE ECONOMICS OF IPO FAVORITISM.....	201
V. THE ECONOMIC PLAUSIBILITY OF NONDISCRIMINATORY ALLOCATION	207
VI. ECONOMIC THEORY AND LAWS CONSTRAINING IPO ALLOCATION	209
A. <i>The Prospect of Government Intervention</i>	209
B. <i>Law, Economics and Managerial Value Diversion</i>	212
C. <i>Market Forces and Regulation</i>	214
VII. CONCLUSION	216

“[Y]ou bring your underwriting to us, but we will give you . . . IPO

* J.D., Hofstra University School of Law, 2003; B.A., New York University, 2000. The Author is an associate in the New York office of King & Spalding LLP, specializing in corporate and securities law. He would like to thank Professor J. Scott Colesanti for his valuable suggestions and enduring friendship. He also gratefully acknowledges Professor Julian Ku and Deric Behar for their thoughtful insights.

*allocations to the tune of a few million bucks.' Is that Legal? I'm not going to answer the question, yet. But I don't think so. Maybe. Anyway, the point is you had this incestuous ring from analyst to investment banker to CEO. Now who is left out in this? Who's left out is the shareholder — folks like you and I. . . . The game is over.*¹

—New York Attorney General, Eliot Spitzer

I. INTRODUCTION

While investors may have come a long way from the euphoric tulip bulb bubble,² the popular delusion of our time is purchase access to the coveted and mighty initial public offering (“IPO”). In what has been described as the “gold rush” of the 1990s,³ access to IPOs has been a pipe dream for retail investors.⁴ Only the crème de la crème — top executives, venture capitalists, and institutional or sophisticated investors — are able to purchase shares of IPO stock.⁵ The allocation of IPO shares by underwriters is arguably the most active area of current empirical research.⁶

1. Honorable Eliot Spitzer, *Keynote Address*, 76 ST. JOHN'S L. REV. 801, 812 (2002).

2. The reference is to the “tulipomania” crises that swept through Holland in the mid-seventeenth century. CHARLES MACKAY, MEMOIRS OF EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF THE CROWDS 85-86 (London, Office of the National Illustrated Library 1852). Rare tulip breeds caused a sensation as aristocrats flaunted the exotic flowers as symbols of prestige and power. *See id.* A single tulip bulb of the viceroy species sold for “four tons of wheat, eight tons of rye, . . . four oxen, . . . two casks of wine, . . . two tons of butter, 1000 pounds of cheese, . . .” Ric Edelman, *Inside Personal Finance* (Jan. 1999), available at <http://www.ricedelman.com/planning/investing/tulipbulbs.asp>. This account was present in a seventeenth century bill of sale as described in a famous historical account on popular manias. *See* CHARLES MACKAY at preface (documenting the tulip-bulb craze and other manias and ultimately concluding that “whole communities suddenly fix their minds upon one object, and go mad in its pursuit; that millions of people become simultaneously impressed with one delusion, and run after it, till their attention is caught by some new folly more captivating than the first.”); *see also* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 34 (W.W. Norton & Co. 1995) (arguing that while the “castle-in-the-air theory can well explain speculative binges, outguessing the reactions of a fickle crowd is a most dangerous game”); *see generally* EDWARD CHANCELLOR, DEVIL TAKE THE HINDMOST: A HISTORY OF FINANCIAL SPECULATION (Farrar Straus & Giroux 2002) (discussing the adverse effects the tulip crisis had on the Dutch and English economies); PETER M. GARBER, FAMOUS FIRST BUBBLES: THE FUNDAMENTALS OF EARLY MANIAS (MIT Press 2000) (providing a more modern analysis of the tulip-bulb mania).

3. *See* CNNfn, *As Market Sizzles for Public Offerings, Ordinary Investors Seek a Way in* (June 30, 1999), available at http://www.money.cnn.com/1999/06/30/fortune/fortune_ipos/.

4. *See, e.g.*, Michael Siconolfi, *The Spin Desk: Underwriters Set Aside IPO Stock for Officials of Potential Customers*, WALL ST. J., Nov. 12, 1997, at A1.

5. *See, e.g.*, Randall Smith et al., *Something Ventured and Something Gained?*, WALL ST. J., Oct. 17, 2002, at C1; Randall Smith, *Goldman Gave Hot IPO Shares to Top Executives of Its Clients*, WALL ST. J., Oct. 3, 2002, at A1.

6. *See* Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795, 1822-23 (2002) (concluding that research into share allocation issues is the most

These empirical studies have been limited due to the fact that the investment banks have not publicized data on IPO share allocations.⁷ This Article addresses empirical economic studies with respect to IPO allocation, as well as neoclassical economic theory in light of the recent regulatory activities and calls for reform.⁸

After the recent market collapse, securities regulators robotically sought to reassess the industry's practices. Perp-walks became commonplace,⁹ criminal charges were aggressively filed,¹⁰ the plaintiff's bar commenced litigations,¹¹ congressional investigations were launched,¹²

promising area of research in IPOs at the moment).

7. See generally *id.*; see also Tim Jenkinson & Howard Jones, *Bids and Allocations in European IPO Bookbuilding*, at <http://ideas.repec.org/p/cpr/ceprdp/3644.html> (Nov. 2002).

8. One such call for reform has come from the House of Representatives Financial Services Committee. See *Statement of the Honorable John J. LaFalce, Ranking Member House Financial Services Committee on Citigroup's Release of IPO Information* (Aug. 27, 2002), http://www.house.gov/banking_democrats/pr_082702.htm. The congressman stated:

The information provided by Citigroup on allocation of IPO shares to executives of WorldCom raises broader public policy questions concerning the manner in which IPO shares are allocated by all investment banks. These issues are not limited to a single firm, but extend across the entire investment banking industry. These practices may have been widespread in the past, and may or may not have been legal, but the potential conflicts of interest created by giving IPO allocations to executives of investment banking clients raises important policy issues that Congress and the regulators must investigate further.

Id.

9. A "perp walk" is colloquial terminology describing when a criminal defendant who has just been arrested "is 'walked' in front of reporters and photographers, showcasing the Police Department's crime-fighting skills, and satiating the media's demand for a glimpse of the criminal." *Judge Condemns Policy of Parading Suspects Past Cameras*, N.Y. TIMES, Feb. 26, 1999, at B1. Apparently, the perp-walk has been a police tradition dating back more than a hundred years in the United States. See, e.g., *Lauro v. New York*, 39 F. Supp. 2d 351, 365 (S.D.N.Y. 1999) (holding the New York Police Department liable in damages for violating a criminal defendant's Fourth Amendment right to be free from unreasonable seizures). For a discussion of this tradition and its interplay with the news media, see generally Alan Vinegrad, *Media and Law Enforcement: Law Enforcement and The Media: Cooperative Co-Existence*, 1999 ANN. SURV. AM. L. 237 (arguing that there are laws, rules, and policies that encourage the cooperative co-existence between the media and law enforcement and this co-existence maintains the independence of each, and provides a check on the potential excesses of both).

10. See Richard B. Schmitt & Jerry Markon, *Wall Street Enforcers Uphold Giuliani Model*, WALL ST. J., Oct. 23, 2002, at C1.

11. See Kara Scannell, *Bid to Dismiss IPO-Market Suits Is Denied by Judge*, WALL ST. J., Feb. 20, 2003, at C5; Charles Gasparino, *N.Y. Sues Telecom Executives Over Stock Profits*, WALL ST. J., Oct. 1, 2002, at A1. For a comprehensive source of information on securities class action lawsuits, see Stanford Law School's Securities Class Action Clearinghouse, available at <http://securities.stanford.edu/index.html> (last visited Sept. 11, 2003).

12. See, e.g., Amy Borrus & Mike McNamee, *Commentary: How Bankers and Brokers Could Get Bruised*, BUS. WK. ONLINE (Oct. 7, 2002), available at http://www.businessweek.com/magazine/content/02_40/b3802051.htm; Tom Hamburger et al., *Salomon IPO Deals Provoke Congress*, WALL ST. J., Aug. 29, 2002, at C1; Charles Gasparino et al., *Salomon Faces Questions on IPO*, WALL ST. J., July 10, 2002, at C1.

Self-Regulatory Organizations¹³ (“SROs”) proposed new rules,¹⁴ the Securities and Exchange Commission’s (“SEC”) commissioner was replaced,¹⁵ and the New York Attorney General was consequently convinced first, that “the game is over” and second, that “folks like you and I” missed the party.¹⁶

Is the “game” really over? This Article discusses the current regulatory flurry to empirically assess whether Wall Street practices, particularly with respect to IPO allocations, have been reformed. By focusing on what the regulators have actually done, a clear and simple premise is formulated, namely, that despite what the media reports, regulators have not addressed the public’s core concerns surrounding IPO allocation practices. Relatedly, this Article examines the economics underlying the IPO allocation processes to assess whether the system is in need of the reforms so many have called for and whether such reforms would be economically sound and optimal.

Along these lines, this Article explores the chorus of disapproval attacking the current allocation system and calling for equal distribution of IPOs to retail investors, (what Attorney General Spitzer refers to as “folks like you and I”).¹⁷ Regulators, academics, investors and the media have

13. Self Regulatory Organizations (“SROs”) are private regulatory entities that exercise more rigorous rules and regulations over their members. *See generally* Sam S. Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 WASH. & LEE L. REV. 853 (1985) (analyzing whether SROs are effective entities and whether they are adequate alternatives to direct SEC or governmental scrutiny). Membership in a SRO requires complex registration procedures, more stringent than those required by the SEC. *See, e.g.*, NASD Conduct Rule 1021, NASD Manual (CCH) at 3171 (May 2003); New York Stock Exchange Guide (CCH) at 3038 (2003); American Stock Exchange Guide (CCH) at 2133 (2000). On the regulatory authority of SROs, *see generally* Sloan v. New York Stock Exchange, Inc., 489 F.2d 1, 4 (2d Cir. 1973) (noting that Congress clearly intended in the Exchange Act that stock exchanges function as self-regulatory bodies). It should be noted that SROs are subject to SEC regulations as they must register with the SEC, and the SEC reviews SRO rule proposals and actions by and against them. *See* 15 U.S.C. § 78s(g)(1) (2000). For more on SRO rulemaking and proceedings, *see generally* Karessa Cain, *New Efforts to Strengthen Corporate Governance: Why Use SRO Listing Standards?*, 2003 COLUM. BUS. L. REV. 619; Dale A. Oesterle, *Comments on the SEC’s Market 2000 Report: On, Among Other Things, Deference to SROs, the Mirage of Price Improvement, the Arrogation of Property Rights in Order Flow, and SEC Incrementalism*, 19 IOWA J. CORP. L. 483 (1994); Ralph C. Ferrara & J. Triplett Mackintosh, *Legal Representation In The International Securities Market: Representing A Party or Witness in an SEC or SRO Proceeding*, 14 DEL. J. CORP. L. 893 (1989).

14. *See, e.g.*, NASD Proposed Rule 2790, http://www.nasdr.com/filings/rf99_60.asp.

15. Former SEC Chairman Harvey Pitt resigned after his initial selection to head the Public Company Accounting Oversight Board, William Webster, was linked with a company that faced accounting fraud charges. David S. Hilzenrath, *Embattled Pitt Resigns as SEC Chief; Latest Controversy Cost Him White House Support*, WASH. POST, Nov. 6, 2002, at A1.

16. *See* Spitzer, *supra* note 1, at 812.

17. *See id.*

collectively amplified the equal access notion.¹⁸ By delving into the economics of the IPO allocation paradigm, this Article demonstrates that even if shares were allocated in pro rata fashion, retail investors would not be better off. In essence, high IPO returns are akin to a castle in the sky; economically unobtainable even if retail investors were granted equal access to them by operation of law. Additionally, this Article draws on economic theory addressing value diversion by corporate management to determine whether it is economically desirable to institute a law regulating the allocation of IPOs.

Part II discusses the recent investigations undertaken by the regulators and demonstrates that in regards to IPO allocations, the capital markets have not experienced much, if any, reform. A common theme that becomes apparent from the plethora of investigations is that what is being targeted is IPO allocations in the presence of garden-variety fraud — activity that was traditionally prohibited by SEC or National Association of Securities Dealers (“NASD”) rules.¹⁹ What is not being targeted is what this Article will call, “pure allocation.” Pure allocation is the allocation of shares in an IPO to select clientele — usually sophisticated and institutional investors — and the inability of retail investors to gain access to these shares.²⁰ Part II further argues that the regulators are not (and should not) attempting to regulate this behavior because of the seemingly unassailable economics the IPO allocation paradigm is founded on.

Part III articulates the legal framework that existed prior to the recent regulatory onslaught. This discussion suggests that existing legal rules and doctrines, such as the NASD Conduct Rules²¹ and the corporate opportunity doctrine,²² can collectively be employed to target the IPO allocation abuses

18. See, e.g., Charles Gasparino, *The SEC and Spitzer Might Outlaw ‘Spinning’ of IPOs*, WALL ST. J., Nov. 5, 2002, at C1; Raymond Hennessey, *IPO Supply Stages a Comeback, Giving Confidence to Bankers*, WALL ST. J., Nov. 11, 2002, at C5; Mike McNamee, *IPOs: Getting the Price Right*, BUS. WK., Sept. 9, 2002, at 126; Susan Pulliam & Randal Smith, *SEC May Punish Some Executives Who Snared IPOs*, WALL ST. J., Sept. 27, 2002, at C1; John C. Coffee, Jr., *The IPO Investigations: Who’s the Victim? What’s the Harm?*, at <http://www.pbs.org/wgbh/pages/frontline/shows/dotcon/crying/coffeeipos.html> (last visited Sept. 11, 2003); Alex Frew McMillan, *The World of ‘Everyman IPOs’*, CNN Money (Nov. 24, 1999), available at http://money.cnn.com/1999/11/24/investing/q_iposforall.

19. See, e.g., IM-2310-2, NASD Manual, *supra* note 13, at 4261.

20. See, e.g., *CNBC Business Center: Profile: Surge and Decline of Initial Public Offerings* (NBC television broadcast, Oct. 9, 2002) (transcript on file with Westlaw).

21. The NASD Conduct Rules, 2110, 2120, and 2710 are broad catch-all rules that require the observance of high standards of commercial honor and just and equitable principles of trade. See NASD Conduct Rules 2110, 2120, 2710; NASD Manual, *supra* note 13, at 4111, 4128, 4501.

22. The corporate opportunity doctrine comes into play when corporate management diverts value from the corporation.

If an officer or director of a corporation, in violation of his duty as such, acquires gain or

that are currently being investigated. Accordingly, the rule-making efforts of the regulatory apparatus have been essentially superfluous.

Part IV discusses the economics of the IPO process and practice of what this Article calls “bookbuilding.” Bookbuilding is a method used by investment bankers in marketing IPOs and bringing new firms to market.²³ The bookbuilding procedure allows for the underwriting syndicate to price the offering based on “indications of interests” from institutional or sophisticated investors.²⁴ Part IV addresses the notion that IPO share allocation is akin to free money. After assessing the role of sophisticated and institutional investors in the bookbuilding process, this Article argues that share allocation is not necessarily free, as these select investors provide valuable information to underwriters for the purpose of formulating a demand curve in the pricing of the offering. Moreover, institutional and sophisticated investors are compensated with “hot” IPO share allocations for their participation in poor or “cold” offerings.²⁵

Part V discusses the economic plausibility of nondiscriminatory allocation relative to pro-rata distribution — an auction-type allocation mechanism. It economically compares the predominant bookbuilding method with a pro-rata auction allocation scheme, and argues that a random auction system or an equal access rule, would substitute sound economics for unattainable egalitarian concerns.²⁶ Further, Part V suggests that, even

advantage for himself, the law charges the interest so acquired with a trust for the benefit of the corporation, at its election, while it denies to the betrayer all benefit and profit. The rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation.

Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939). For a more recent elaboration on the doctrine, *see Broz v. Cellular Info. Sys.*, 673 A.2d 148, 155 (Del. 1996) (noting that a director or officer cannot take a business opportunity that “(1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation’s line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation.”).

23. *See* Richard A. Booth, *Discounts and Other Mysteries of Corporate Finance*, 79 CAL. L. REV. 1055 (1991).

24. *See id.* at 1094.

25. IPOs are said to be “hot” when there is a substantial market demand in them. For a discussion of the market consequences of hot IPOs, *see id.* at 1090-94.

26. Interestingly, Law and Economics scholars argue that the persistent regulation of insider trading similarly substitutes plausible economic theory for egalitarian notions of fairness. Henry G. Manne, *The Case For Insider Trading*, WALL ST. J., Mar. 17, 2003, at A14 [hereinafter “*Case For Insider Trading*”] (“[T]here is no evidence that publicity about insider trading ever caused a significant reduction in aggregate stock market activity. It is merely one of the many scare arguments that the SEC and others have used over the years as a substitute for sound economics”). For further development of this line of argumentation, *see generally* HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (Free Press 1966); Dennis W. Carlton & Daniel R. Fischel,

if equitable allocation were legally mandated, for economic reasons, retail investors would not be able to realize optimal IPO gains.²⁷

Drawing on neoclassical economic theory, Part VI explores whether adopting legal rules to regulate the current IPO allocation model currently in place is desirable. It extends on existing economic literature that discusses the effectiveness and utility of formulating and instituting legal rules that constrain value diversion by corporate fiduciaries. In applying economic theory to the allocation problem, this Article argues that it is economically unsound to impose legal rules on allocation practices. Rather, private contractual arrangements and company-specific policies addressing IPO allocations would be a more efficient alternative than legal rules banning allocation to corporate executives all together.

Part VII ultimately concludes that the current IPO allocation model should not be altered in an attempt to produce an equal access scheme, as this would obstruct the underlying purposes of IPOs and undermine the economics of the IPO allocation process. Regulators should not attempt to address the pure allocation issue because of the sound economic underpinning of the bookbuilding process. Any alternative scheme to provide individual investors with access to IPO shares will not achieve that desired purpose. In light of the bookbuilding method's success as a source of financing in corporate America, the current IPO share allocation process should not be disturbed or threatened by legal rules that will not achieve their desired purpose.

II. THE ONGOING REGULATORY ACTIVITY

A. *The Investigations*

In addressing the recent regulatory missions and corporate malfeasance, SEC Commissioner, William Donaldson stated: "These cases reflect a sad chapter in the history of American business — a chapter in which those who reaped enormous benefits from the trust of investors profoundly betrayed that trust."²⁸ A daily perusal of the *Wall Street Journal*

The Regulation of Insider Trading, 35 STANFORD L. REV. 857 (1983); Henry G. Manne, *Insider Trading and the Law Professors*, 23 VANDERBILT L. REV. 547, 567 (1970) [hereinafter "*Insider Trading and the Law Professors*"]. *But cf.* Therese H. Maynard, *Spinning in a Hot IPO- Breach of Fiduciary Duty or Business as Usual?*, 43 WM. & MARY L. REV. 2023 (2002) (rejecting Law and Economics rationales that the market will correct IPO spinning to corporate management).

27. *See infra* Part V.

28. *See* Randall Smith & Susan Craig, *Spitzer Views Notes for Salomon Meeting As Crucial in Probe*, WALL ST. J., Apr. 29, 2003, at C1.

or watching any business news network would certainly lead one to think — with reasonableness — that the ongoing regulatory activity has been successful in curbing Wall Street abuses and has further addressed the Street's problem areas. SEC and SRO IPO investigations and proposed rules, coupled with investigations and criminal charges filed by the United States Attorney's office and the New York Attorney General's office have certainly been prevalent in media.²⁹

Have the regulators, however, addressed the pure allocation problem itself? This Part suggests that after clearing away the fog (that results from robust media reporting and regulator press conferences), the regulators have failed to address the critical issue that has troubled investors and academics for quite some time, the issue of pure allocation.³⁰

1. Illegal Profit Sharing

The SEC investigated and subsequently filed a civil action against Robertson Stephens in connection with 'hot' IPOs and profit sharing.³¹ Specifically, the investigation found that the brokerage firm allocated IPOs in return for excessive commissions and markdowns made by customers, practices outlawed by both SEC and NASD rules.³² Ultimately, the firm agreed to pay \$33 million in fines without admitting or denying any wrongdoing.³³ Following the investigation, a failed buyout attempt led to the winding down of the firm.³⁴

Similarly, the NASD charged Invemed with improperly sharing customer profits on hot IPOs.³⁵ Langone, a "power broker," was accused of

29. See generally *id.*

30. The IPO allocation dilemma was prevalent in the mid-1990s and then disappeared until the 2000 Internet bust. See, e.g., Michael Siconolfi, *The Spin Desk: Underwriters Set Aside IPO stock for Officials of Potential Customers*, WALL ST. J., Nov. 12, 1997, at A1; Michael Siconolfi, *SEC Broadens 'Spinning' Probe to Corporations*, WALL ST. J., Dec. 24, 1997, at C1.

31. See SEC Press Release, *SEC Sues Robertson Stephens Inc. for Profit Sharing in Connection with Hot IPOs* (Jan. 9, 2003), <http://www.sec.gov/news/press/2003-3.htm>.

32. See *id.* (alleging that Robertson Stephens engaged in illegal profit sharing and violated Section 15(c) of the Securities and Exchange Act of 1934 and Rule 15c1-2(b) and NASD rule 2110 mandating securities industry firms to use "just and equitable principles of trade"); Randall Smith & John Hechinger, *Former Unit of FleetBoston Receives Fines*, WALL ST. J., Jan. 10, 2003, at C1. To enumerate precisely what the Commission has targeted in this case, this Article focuses on the SEC's Order Instituting Administrative Proceedings Pursuant to Section 15(b)(4) of the Securities and Exchange Act of 1934, Release No. 47144 (Jan. 9, 2003).

33. See Smith & Hechinger, *supra* note 32; see also NASD News Release, *NASD Charges Robertson Stephens with Sharing in Millions of Dollars of Customers' Profits in Exchange for "Hot" IPO Shares* (Jan. 9, 2003), http://www.nasdr.com/news/pr2003/release_03_001.html.

34. See Keith Ragen, *Robertson Stephens Follows Dot Coms to Demise*, E-COMMERCE TIMES (July 15, 2002), available at <http://www.ecommercetimes.com/perl/story/18585.html>.

35. See Randall Smith, *NASD Charges Langone Broke Rules on IPOs*, WALL ST. J., Apr. 16,

having his clients pay exorbitant commissions in exchange for hot IPO allocations.³⁶ Unlike other investigated entities, Langone refuses to admit that he or his firm violated any NASD rules and further he rather aggressively stated that he “welcome[s] the fight.”³⁷

2. “Hot” IPO Allocations

Similar to the Robertson Stephens’ infractions, CSFB received excessive commissions in return for IPO share allocation.³⁸ CSFB inflated “tens of millions of dollars from customers in inflated commissions that amounted to a ‘profit sharing’ arrangement for allocation of ‘hot’ IPOs.”³⁹ As part of a settlement with regulators to not pursue a securities fraud claim, CSFB agreed to pay \$100 million and to revise its allocation policies and procedures.⁴⁰

Additionally, after selecting CSFB as their investment bank, clients were entitled to open a “Friends of Frank” account, though there has been no concrete evidence suggesting the existence of a quid pro quo — IPO share allocations for investment banking business.⁴¹

The NASD Department of Enforcement filed a complaint against investment banker Frank Quattrone alleging that he illegally spun shares in violation of NASD rule 3060 that prohibits members from giving “gratuities in excess of \$100 to anyone in relation to the business of the employer of the recipient.”⁴² Additionally, Quattrone was accused of failure to supervise under NASD rule 3010⁴³ and he was charged criminally with obstruction of justice for tampering with key witnesses and

2003, at C1.

36. *See id.*

37. *Id.*

38. *See* Randall Smith & Susan Pulliam, *How CSFB’s Allocation Settlement Changes the Rules of the IPO Game*, WALL ST. J., Jan. 22, 2002, at C1.

39. *See* NASD News Release, *NASD Fines Two CSFB Execs for Failing to Prevent IPO Profit Sharing Kickbacks* (Aug. 15, 2002), http://www.nasdr.com/news/pr2002/release_02_039.html (quoting NASD News Release, *NASD Regulation Charges Credit Suisse First Boston with Tens of Millions of Dollars of Customers’ Profits in Exchange for “Hot” IPO Shares* (Jan. 22, 2002), http://www.nasdr.com/news/pr2002/release_02_005.html).

40. *See* Smith & Pulliam, *supra* note 38.

41. *See* Randall Smith & Susan Pulliam, *How a Star Banker Pressed for IPOs*, WALL ST. J., Sept. 5, 2002, at C1 [hereinafter “*How a Star Banker Pressed for IPOs*”].

42. *See* Complaint for Dep’t of Enforcement at ¶¶ 11-24, *Dep’t of Enforcement v. Quattrone* (No. CAF030007), <http://news.findlaw.com/hdocs/docs/csfb/nasdquatt30603spincmp.pdf> [hereinafter “*Dep’t of Enforcement Complaint*”].

43. *See id.* at ¶¶ 29-40.

participating in the destruction of IPO documents.⁴⁴ Interestingly, when asked about IPO allocations to corporate executives in 1997, Quattrone responded, “an IPO is priced Wednesday. Thursday morning you call 25 venture capitalists and say ‘By the way, XYZ just went public at 15; it’s now trading at 30. You just sold the allocation at 29 ½. I hope you’re happy.’ That to me is smarmy.”⁴⁵

The Quattrone investigation has withered into a sole obstruction of justice charge that has resulted in a mistrial.⁴⁶ The charge centered on an e-mail message sent from Quattrone to his colleagues advising them to “clean up” their files after Quattrone allegedly learned of a federal grand jury subpoena seeking information about his IPO allocation practices.⁴⁷ Ironically, Quattrone was not charged with any offense in the investigation that he allegedly obstructed.⁴⁸ The media has appositely criticized the investigation of Quattrone as “an alleged cover up, but nothing criminal underneath” and further noted that “[t]o put a man in jail there must be a clear line crossed . . . [T]he government searched for lines, found muck and indicted anyway.”⁴⁹

3. Tie-in Arrangements

The SEC investigated the two financial services behemoths for allegedly forming “tie-in” arrangements, what the media calls “laddering.”⁵⁰ Laddering is the steering of hot IPOs to big investors who signaled plans to buy additional shares in the aftermarket.⁵¹ Such tie-in agreements could potentially have the effect of creating artificial demand for a stock which in turn causes a first day price gain that harms investors who purchase the IPO stock in the aftermarket.⁵²

44. See Randall Smith & Kara Scannell, *U.S. Charges Quattrone with Obstruction*, WALL ST. J., Apr. 24, 2003, at C1.

45. See Siconolfi, *supra* note 30.

46. See, e.g., Kara Scannell & Randall Smith, *Quattrone Mistrial May Give Prosecutors Reasons to Hesitate*, WALL ST. J., Oct. 27, 2003, at C1.

47. See Randall Smith & Kara Scannell, *Quattrone Case Won't Be a Layup*, WALL ST. J., May 1, 2003, at C1.

48. See Scannell & Smith, *supra* note 46; see also Dan Ackman, *A Raw Deal*, WALL ST. J., Apr. 29, 2003, at A16 (comparing the Quattrone investigation to the indictment and conviction of Arthur Anderson for its participation in the Enron debacle).

49. See Ackman, *supra* note 48.

50. Randal Smith, *IPO Laddering Case Expanded*, WALL ST. J., Feb. 26, 2003, at C1; see Division of Market Regulation, *Staff Bulletin No. 10: Prohibited Solicitations and “Tie-in” Agreements for Aftermarket Purchases* (Aug. 25, 2000), <http://www.sec.gov/interp/legal/slmb10.htm>.

51. *Id.* (describes the scope of the investigation and the alleged illegalities).

52. See *id.* (quoting Professor John C. Coffee, Jr.).

The SEC has always prohibited this practice.⁵³ Indeed, a 2000 SEC bulletin reminded securities firms of the prohibition on soliciting aftermarket orders during the IPO, or making any arrangements that would be a condition to favorable IPO share allocation.⁵⁴ Goldman was also investigated for IPO spinning.⁵⁵

4. Allocations to Executives

Members of the House of Representatives Financial Services Committee commenced an investigation seeking to learn who at WorldCom received IPO share allocations.⁵⁶ The congressmen were curious to know why Salomon analyst Jack Grubman surreptitiously touted the WorldCom stock as it abruptly declined, while officials at WorldCom received IPO share allocations.⁵⁷ Bernard Ebbers, WorldCom's former CEO, profited to the tune of \$ 11 million from IPO trading and it was suggested that he allegedly returned the favor to Salomon by spinning WorldCom's investment banking business to them.⁵⁸

While no action was brought against Salomon, New York Attorney General Eliot Spitzer sued Ebbers and several other WorldCom executives pursuant to the Martin Act, an archaic New York securities fraud statute that allows broad pre-trial discovery.⁵⁹ Recently, one such lawsuit filed against Philip Anschutz, the former chairman of Qwest Communications International, settled.⁶⁰ Anschutz agreed to contribute the \$4.4 million in IPO profits obtained on stock he allegedly improperly received from investment banks to several New York area law schools and other nonprofit organizations.⁶¹ This settlement is significant in that it marks the first time an executive has returned profits gained from IPO spinning.

53. See Securities Exchange Act, Release No. 6536 (April 24, 1961). The Commission also has held that tie-ins are fraudulent devices that violate Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and Rule 10b-5 under the Exchange Act, because they facilitate material omissions in connection with the offer or sale of securities. *Id.*

54. See Division of Market Regulation, *supra* note 50.

55. See Smith et al., *supra* note 5.

56. Gasparino et al., *supra* note 12.

57. See *id.* (Connecticut Republican Christopher Shays and Pennsylvania Democrat Paul Kanjorski initiated the investigation).

58. Pulliam & Smith, *supra* note 18.

59. See Gasparino, *supra* note 11.

60. State v. Anschutz, No. 02/403855, *stipulation filed* (S.D.N.Y. May 13, 2003); see Randall Smith, *Anschutz Settles IPO 'Spinning' Case with Donation Pact*, WALL ST. J., May 14, 2003, at C1 [hereinafter "*Anschutz Settles IPO 'Spinning' Case*"].

61. See State v. Anschutz, No. 02/403855, *stipulation filed* (S.D.N.Y. May 13, 2003); *Anschutz Settles IPO 'Spinning' Case*, *supra* note 60.

Notwithstanding the settlement, there has been no admission or denial of liability on the part of Anschutz.⁶²

5. "Friends and Family" Allocations

The SEC and prosecutors from the Department of Justice ("DOJ") commenced investigations into the purchases, by former Qwest executives, of low cost shares prior to their initial public offering from telecom suppliers to Qwest.⁶³ These so called, "friends and family" distributions have never before been targets of any federal probe. The government's legal theory that supports this investigation is still unknown, and legal commentators have expressed skepticism over the merits of this investigation.⁶⁴ Some have suggested that the SEC may file civil charges and allege that Qwest executives have accepted bribes to steer business toward equipment manufacturers that offered them pre-IPO shares.⁶⁵ While such *quid pro quo* cases are difficult to prove without documents or testimony establishing such, this ongoing investigation may have a significant impact on IPO allocation.

B. *The Common Bond*

What is strikingly common to all these major investigations is that they all involve IPO allocation intertwined with elements of garden-variety fraud.⁶⁶ The regulators have not addressed the pure allocation problem. Most of the investigations are subject to existing SEC and NASD rules prohibiting the said IPO activities.⁶⁷ Thus, what the regulators have done is precisely what they were supposed to be doing all along — policing the capital markets for fraudulent activity that undermines the integrity of the marketplace.

The media has fueled these investigations with headlines that would make one believe that the securities industry's practices have been

62. See *State v. Anschutz*, No. 02/403855, *stipulation filed* (S.D.N.Y. May 13, 2003); *Anschutz Settles IPO 'Spinning' Case*, *supra* note 60. It should be noted that the other suits filed against the other four executives are still pending as of the publication of this Article.

63. See Dennis K. Berman & Scott Thurm, *SEC May Charge Qwest Ex-Staff: Civil Investigations Focuses On Purchase of Shares By Executives, Sales Pacts*, WALL ST. J., May 1, 2003, at A3. Qwest had been previously under fire in a major investigation alleging that their sales teams circumvented accounting standards to facilitate the appearance of augmented revenue. *Id.*

64. See *id.*

65. See *id.* at A15.

66. See *supra* Part II.A.

67. See *id.*

fundamentally altered. In essence, however, IPO practices at many major financial service companies remains the same with little, if any, change. The pivotal egalitarian concern regarding the broad discretion of investment bankers to dole out IPOs to specific clients has not been challenged and remains prevalent in the industry. Thus, what is apparent from the investigations and reactionary regulatory activity is that the regulators have not conducted meaningful reforms with respect to IPO allocation, but rather, they have awoken to prevalent fraud abuses that have always been traditionally prohibited.

C. The “Global” Settlement

The recent “global settlement” pioneered by Attorney General Spitzer and the behemoth Wall Street banks seem to indicate that progress has been made in curbing Wall Street abuses.⁶⁸ While Attorney General Spitzer has certainly asserted himself as an important regulatory force, his ultimate goal of restoring integrity to the capital markets and ensuring a level playing field for “folks like you and I” has been short-lived.⁶⁹ One commentator described the settlement as “more punishment to brokerage firms than benefit to investors,”⁷⁰ while another likened the settlement to “chicken feed for investors.”⁷¹ Notwithstanding monetary fines, what genuine changes in the IPO context have been mandated by this so-called “global” settlement? How “global” and “historic” is the settlement? Moreover, did the settlement “permanently change the way Wall Street operates?”⁷²

One thing is clear from the global settlement: IPO allocation to

68. See, e.g., Jerry Markon & Charles Gasparino, *For Corporate-Crime Fighters, No Law is Old*, WALL ST. J., Oct. 2, 2002, at C1 (referencing Spitzer’s use of the Martin Act to combat securities fraud); Holman W. Jenkins, Jr., *A ‘Bubble’ is Not a Crime*, WALL ST. J., Oct. 9, 2002, at A19; Schmitt & Markon, *supra* note 10; Charles Gasparino, *N.Y.’s Spitzer Sues 5 Telecom Chiefs Over Stock Profits*, WALL ST. J., Oct. 1, 2002, at A1; Randall Smith & Charles Gasparino, *Research Pact: All-in-One Deal?*, WALL ST. J., Nov. 4, 2002, at C1; Ben White, *N.Y. to Make Executives Return IPO Profits*, WASH. POST., Sept. 26, 2002, at E1; Complaint for Spitzer, Spitzer v. Anschutz (Sept. 30, 2002), <http://news.findlaw.com/hdocs/docs/worldcom/nyanschultz93002cmp.pdf> [hereinafter “Spitzer Complaint”]; Office of the New York State Attorney General Press Release, *SEC, NYAG, NASD, NYSE, Announce Historic Agreement to Reform Investment Practices* (Dec. 20, 2002), http://www.oag.state.ny.us.press/2002/dec/dec20b_02.html.

69. See Spitzer, *supra* note 1, at 812.

70. See Jeff D. Opdyke & Ruth Simon, *How You Come Out in Wall Street’s Deal*, WALL ST. J., Apr. 29, 2003, at D1 (quoting finance professor Kent Womack of Dartmouth College).

71. Gregory Zuckerman & Susanne Craig, *Settlement Establishes \$387.5 Million Fund, But Check Isn’t in Mail*, WALL ST. J., Apr. 29, 2003, at C1 (quoting Samuel Hayes, professor of investment banking at Harvard Business School).

72. See Office of the New York State Attorney General Press Release, *supra* note 68.

corporate executives and board members has been abolished as a way to lure investment-banking business.⁷³ This reform alone, however, does not democratize the IPO allocation scheme currently in place. Institutional and other sophisticated investors will still have prime access to the IPO market, while share allocation to retail investors is nowhere in sight.⁷⁴ “If the market expects an IPO to be hot, shares that otherwise would have gone to corporate honchos probably will be grabbed by institutional investors that spend big dollars with brokerage firms.”⁷⁵

Moreover, the settlement’s ban on IPO spinning is not “global” in any sense of the word. Many firms were not privy to the settlement and therefore do not have to comply with it.⁷⁶ Smaller firms, particularly those that have modest investment banking departments, are not required to cease allocating IPO stock to corporate executives.⁷⁷ Thus, while the Wall Street settlement has been an important focus of media and reformers, in the context of IPO allocations, it does not address the pure allocation issue and does not meaningfully reform the IPO distributive scheme.

III. OF EXISTING LAWS AND PROPOSED RULES

In conjunction with recent regulatory efforts the NASD issued a notice to its members proposing rules purporting to curb IPO spinning practices.⁷⁸ Rule 2712, “IPO Allocation and Distribution,” and Amendment to Rule 2710, target the allocation practices of all NASD firms.⁷⁹ The proposed regulations contain several prohibitions.⁸⁰ First, offering or threatening to withhold IPO share allocations as consideration for receipt of compensation that is excessive in relation to the NASD member’s services will be

73. Opdyke & Simon, *supra* note 70.

74. *See id.* at D2. “The provision banning firms from distributing IPO shares to corporate executives won’t do much to help individual investors.” *Id.*

75. *Id.* The settlement also creates a \$387.5 million restitution fund to repay lost funds by small investors as a result of fraudulent research. *Id.* at D1. Additionally, investor education programs will be established and independent research programs purportedly mitigating the problem of biased stock market analysis will be provided. *See id.*

76. *See id.* at D1. A highly controversial part of the settlement requires broker-dealers to disclose their analysts stock-picking and disclosing the information gleaned by the attorney general to the public who will utilize it in pursuing legal action against the firms. *See id.*

77. *See, e.g.,* Susanne Craig, *One Small Firm Battles Internal, External Discord*, WALL ST. J., Apr. 28, 2003, at C1.

78. *See* National Association of Securities Dealers, Inc., *Notice to Members 02-055, Regulation of IPO Allocations and Distributions* (proposed Aug. 21, 2002), available at <http://www.nasdr.com/pdf-text/0255ntm.pdf> (The regulation will be codified as NASD Rule 2712 and as an amendment to rule 2710) [hereinafter “NASD, Proposed Rule 2712”].

79. *See id.*

80. *See id.*

prohibited.⁸¹ Additionally, NASD members will be prohibited from requesting that a customer purchase shares in the aftermarket as a condition to IPO share allocation, colloquially referred to as tie-ins.⁸² Lastly, these rules prohibited IPO share allocation to corporate management as an inducement for future investment banking business, or as compensation for past business.⁸³ In the same respect, any IPO allocation made to corporate management must be reported to the NASD within 180 days before the distribution under review.⁸⁴ Interestingly, the NASD specifically stated that Rule 2712 would not prohibit an NASD member from allocating IPO shares to a client because that client has separately retained the member for other services.⁸⁵

Much like the regulatory activity discussed prior, the prohibitions in these proposed rules do not address the pure allocation problem.⁸⁶ Indeed, other NASD and SEC rules, as well as state law fiduciary duty constraints prohibit the activity the NASD is seeking to regulate.⁸⁷ As was discussed

81. *See id.*

82. *See id.*

83. *See id.* It remains to be seen, and is the subject of much debate in the literature, whether regulating such behavior is socially and/or economically optimal. Several Law and Economics scholars have challenged the social and economic utility of regulating self-dealing transactions, corporate opportunities such as spinning and the like. In this regard, the distinguished Chicagoans focus on how the fruits of insider trading and other corporate opportunities in the hands of corporate management would not harm shareholders, but rather, such benefits would be offset by reductions in compensation. *See, e.g.,* Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L. J. 698, 707, 734-35 (1982); David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 N.WEST. U. L. REV. 1449, 1461-62 (1987); Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 805 (1980); *see generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (Harvard Univ. Press 1991); HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (Free Press 1966); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970). *But cf.* Maynard, *supra* note 26 (rejecting any and all Law and Economics rationales that the market will correct IPO spinning to corporate management); Lucian Arye Bebchuk & Christine Jolls, *Managerial Value Diversion and Shareholder Wealth*, 15 J. L. ECON. & ORG. 487 (1999), available at <http://www.nber.org/papers/w6919> (arguing that the costs of managerial value diversion can conceivably outweigh the benefit to shareholders); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985) (arguing against the aforementioned free market models and asserting that it is implausible to assume that the level of managerial pay is set by a disinterested agent seeking to maximize share value).

84. *See* NASD, Proposed Rule 2712, *supra* note 78. Ancillary to these proposed rules is the requirement that each NASD member adopt and implement procedures designed to ensure compliance. *See id.*

85. *See id.*

86. *See supra* notes 83-84 and accompanying text.

87. Letter from Kenneth L. Josselyn, Chair of the Capital Markets Committee of the Securities Industry Association ("SIA"), to Barbara Z. Sweeny, Corporate Secretary of the NASD,

supra part II.A.3., tie-in arrangements between NASD members and clients are prohibited per se by SEC Regulation M.⁸⁸

Additionally, allocations to corporate executives are subject to the NASD Conduct Rules.⁸⁹ These rules, and specifically Rule 2110, require the observance of high standards of commercial honor and just and equitable principles of trade.⁹⁰ They have been broadly applied in many different contexts. The IPO activity the proposed rule seeks to address can be addressed by these rules. For instance, these rules served as the legal basis in the recent civil complaint filed by the NASD against Frank Quattrone.⁹¹ Moreover, NASD Interpretive Memorandum 2110-1 contemplates the rule's usage in the IPO share allocation context.⁹² The targeted behavior in the proposed rules, much like in the regulatory activity discussed above, is also subject to Rule 10b-5 and section 17 of the Securities Act of 1933.⁹³

Along the same lines, the NASD Gratuities Rule 3060 prohibits members from giving "gratuities in excess of \$100 to anyone in relation to the business of the employer of the recipient."⁹⁴ This "in relation to" requirement would necessarily require evidence contemplating a quid pro quo — IPO allocation for future or past business.

Lastly, at the state law level, the corporate opportunity doctrine can also be applied to restrict corporate management's ability to "usurp" IPO

regarding Notice to Members 02-55 and IPO allocations (Sept. 24, 2002) (on file with author) [hereinafter "SIA Letter"] ("The federal securities laws (i.e., rules 10b-5 and Regulation M) and existing NASD rules (i.e., Rule 2110 2710 2330 3010 and 3060) already prohibit IPO allocation abuses."). For a discussion of fiduciary duty law as a potential restriction on spinning, *see generally* Maynard, *supra* note 26 (arguing for a strengthening of fiduciary duty law in the context of the taking of corporate opportunities by corporate management).

88. *See supra* Part II.A.3.

89. *See supra* notes 83-84 and accompanying text.

90. *See* NASD Conduct Rule 2110, NASD Manual, *supra* note 13, at 4111.

91. *See* Dep't of Enforcement Complaint, *supra* note 42, at ¶¶ 11-24.

92. *See* IM-2110-1, NASD Manual, *supra* note 13, at 4112. The Interpretive Memorandum expressly states,

[Rule 2110] is based upon the premise that members have an obligation to make a bona fide public distribution at the public offering price of securities of a public offering which trade at a premium in the secondary market whenever such secondary market begins (a hot issue) . . . the failure to make a bona fide public distribution when there is a demand for an issue can be a factor in artificially raising the price. Thus, the failure to do so, especially when the member may have information relating to the demand for the securities or other factors not generally known to the public, is inconsistent with the high standards of commercial honor and just and equitable principles of trade and leads to an impairment of public confidence in the fairness of the investment banking and securities business. Such conduct is, therefore, in violation of Rule 2110.

Id. at IM 2110-1(a)(1).

93. These sections are codified at 17 C.F.R. § 240.10b-5 (2002); 15 U.S.C. § 77q (2000) respectively.

94. NASD Conduct Rule 3060, NASD Manual, *supra* note 13, at 4862.

allocations to their personal accounts by virtue of their position as a director or officer. The doctrine precludes corporate management from taking corporate opportunities unless they “disclose any prior spinning activity to the board before it finalizes its selection of the lead underwriter for the company’s IPO.”⁹⁵ Similarly, state securities laws containing broad prohibitions on fraud, such as the Martin Act in New York, can be dusted off to target IPO allocation abuses.⁹⁶

Thus, the proposed rules purporting to target “IPO allocation and distribution” are for the most part superfluous as pre-existing laws and doctrines can be applied to regulate the prevalent IPO abuses. Again, the SROs have refrained from addressing the pure allocation element of the IPO process. It remains to be seen whether they have done so in light of the potential superiority bookbuilding maintains over the public offer auction method of raising capital.

IV. THE ECONOMICS OF IPO FAVORITISM

An integral participant in the process of bringing a firm to market through an IPO is arguably the underwriter.⁹⁷ Among the underwriter’s functions in the IPO process is the marketing of the IPO shares.⁹⁸ The underwriters and their brokerage houses maintain complete IPO allocation discretion.⁹⁹ The process of identifying potential buyers of IPO shares and marketing such shares is known as bookbuilding.¹⁰⁰ The underwriter will attempt to learn as much information as possible with respect to the investor demand for the new issue and the likelihood of investor buying and selling once the stock begins trading.¹⁰¹ The actual “book” is comprised of bid information, i.e., each bid submitted, the number of shares requested, and a

95. See Maynard, *supra* note 26, at 2061. The law and economics response to this is to rely on the reputation market for managers and directors to compel this type of disclosure rather than creating regulations that mandate disclosure.

96. See generally N.Y. GEN. BUS. LAW § 352 (1999). For one of the Act’s first applications, see, e.g., *People v. Federated Radio Corp.*, 154 N.E. 655, 657 (N.Y. 1926) (identifying the purpose of the Martin Act, namely, to prevent all kinds of fraud in connection with the sale or purchase of securities and to defeat schemes that fraudulently exploit the public).

97. See SIA Issue Bulletin 105, *IPO Primer*, at http://www.sia.com/key_issues/pdf/IPO.pdf (Nov. 2002). While the investment banks almost always have the discretion to allocate as they deem fit, several issuers choose to go public by way of public auction. In this format the IPO shares are issued randomly. See *supra* notes 138-42 and accompanying text.

98. See SIA Issue Bulletin 105, *IPO Primer 2*, at http://www.sia.com/key_issues/pdf/IPO.pdf (Nov. 2002).

99. See generally *id.*

100. See *id.* at 2.

101. *Id.*

limit price.¹⁰²

The economics of the bookbuilding practice are of great relevance to the IPO allocation process. Through the process of bookbuilding the investment bank uses the information obtained from the investors to formulate a demand curve.¹⁰³ The information gleaned from the investors is absolutely essential in this respect. Based on the investment banker's interpretation of the indications of interests a price will be formulated.¹⁰⁴ The investment banker generally sets the price at a level where the demand exceeds the supply, and then allocates the shares to these investors at his discretion.¹⁰⁵

This act of share allocation to investors has been perceived by many as the investment bank giving its clients "free money."¹⁰⁶ The reference to free money is because most IPOs experience a first day price spike.¹⁰⁷ As the demand for the stock exceeds the supply, the value of the stock generally increases on the first day of trading.¹⁰⁸ Notably, the bids by investors are merely indications of interests and not legally binding offers to purchase. As a result, the underwriter persistently will oversubscribe offerings.¹⁰⁹ These bids are legally revocable until the SEC declares the

102. The book may contain several types of bids. The two most common are the "limit bid" (which states the maximum price that the bidder will pay for the shares) and the "strike bid" (which is a request of shares with a price range but regardless of what the issue price will be). See Francesca Cornelli & David Goldreich, *Bookbuilding and Strategic Allocation*, 56 J. OF FIN. 2337, 2340 (2001).

103. See *id.* at 2337.

104. See *id.*

105. See *id.* It is important to note that the investors' bids are not a commitment but merely an indication of interest.

106. See *In re Monetta Financial Services, Inc.*, Exchange Act Release No. ID-162, Fed. Sec. L. Rep. (CCH) Vol. 72, No. 1, at 82, 91 (Mar. 27, 2000) [hereinafter "*In re Monetta*"] (finding a breach of fiduciary duty in corporate management's failure to disclose IPO allocation and further characterizing IPO shares as free money); see also Spitzer, *supra* note 1, at 811 (likening IPO share allocation to commercial bribery).

107. Coffee, *supra* note 18. As Professor Coffee explained,

During 1999 and early 2000, the average IPO rose roughly 100 percent from its initial offering price to the close of trading on the first day. By definition, price spikes occur because the offering is oversubscribed — that is, the underwriters have solicited 'indications of interest' from potential buyers amounting to many times the number of shares that the issuer . . . wishes to sell.

Id.

108. See Coffee, *supra* note 18. At times there are IPOs where the price decreases on the first day as well. For examples of IPOs that have been unsuccessful in the 2002 fiscal year, see, e.g., Kate Kelly & Raymond Hennessey, *Finally, an IPO! But It Surely Isn't a Mania*, WALL ST. J., Feb. 13, 2003, at C1; Jay R. Ritter, *Some Factoids About the 2002 IPO Market*, at http://bear.cba.ufl.edu/ritter/work_papers/IPOs2002.pdf (Jan. 13, 2003); Kate Kelly, *Only the Strong Survived Darwinian IPO Sector: Number of Offerings Hits Two-Decade Low, but Rise in Stock Price Offers Hope*, WALL ST. J., Jan. 2, 2003, at R6.

109. See Coffee, *supra* note 18, at 2. Oversubscription can be defined as the sum of all bids

issuer's registration statement effective.¹¹⁰ These legal hoops encourage the oversubscription of IPO stock, as the possibility of the investors revoking their bids is always present.¹¹¹ Thus, in a rational response to protect against "a sudden shrinkage in demand" the underwriter must oversubscribe an offering.¹¹²

The issue is whether the institutional or sophisticated investor is really receiving "free money" or "commercial bribery."¹¹³ The argument underlying the free money theory posits that the clients of the investment bank who receive these shares are top executives of public corporations who, after receiving the shares, explicitly or implicitly agree to give the allocating party future investment banking business — "spinning."¹¹⁴ The view that IPO allocations are free money because recipients of shares at the offering price garner "instant" first day profits has been articulated in *In re Monetta Financial Services, Inc.*¹¹⁵

In re Monetta involved decisions that were made in the mutual fund context as to how to allocate hot IPO shares that had been received in fifty-one IPOs over an eight month period in 1993.¹¹⁶ IPO shares were allocated to the personal accounts of several fund directors and sold in first day of trading for profits.¹¹⁷ SEC Chief Administrative Law Judge Brenda P. Murray held that an advisor, portfolio manager, mutual fund director and mutual fund trustee committed fraud when the portfolio manager allocated IPO shares to the director's and trustee's personal accounts without making proper disclosures.¹¹⁸ While *Monetta* "can be read . . . to find violations of law not in the allocations, or the acceptances, but in the failure to disclose them" the ruling is important because of the discussion and treatment of the principles underlying IPO share allocation and the free money theory.¹¹⁹

With respect to IPO stock as free money the court began its analysis by

divided by the sum of all shares allocated. See Cornelli & Goldreich, *supra* note 102, at figure 1.

110. Coffee, *supra* note 18, at 2.

111. See *id.*

112. See *id.*

113. See Spitzer, *supra* note 1, at 811.

114. Spinning is a term of art created by the media to describe IPO share allocation to corporate executives personally who, in turn, allegedly 'spin' their future corporate underwriting business to these allocating banks. For a discussion on spinning, see generally Maynard, *supra* note 26.

115. See *In re Monetta*, *supra* note 106, at 82, 91.

116. See *id.*

117. See *id.*

118. See *id.*

119. Dixie L. Johnson et al., *Hot IPOs: The Dangers of Both Giving and Receiving*, in ADVANCED SEC. LAW WORKSHOP 509, 511 (2000).

stating that “IPO allocations are highly sought after.”¹²⁰ This factor, coupled with the expert testimony findings that the average first day performance of IPOs was “significantly positive,” led the court to conclude that free money was funneled to the mutual fund directors.¹²¹ While there is no denying the positive performance of IPOs on the first day of trading, there are economic grounds to contest the notion that they are free money.

Several empirical economic studies provocatively suggest that the investors are not receiving *free* money. The reason why the IPO stock is not free is due to the fact that these investors serve a core function in the bookbuilding process. In essence, these investors are being compensated for revealing critically important information that facilitates the underwriter’s pricing functions.¹²² Moreover, such institutional investor participation has been argued to increase the issuer’s value¹²³ and is necessary and indispensable for an IPO to be successful.¹²⁴

120. See *In re Monetta*, *supra* note 106, at 82, 91.

121. See *id.* Indeed the directors participated in what has come to be called “flipping.” See, e.g., Michael Siconolfi, *On-Line Firms Move to Quash IPO Flipping*, WALL ST. J., Aug. 13, 1998, at C1; Michael Siconolfi & Patrick McGeehan, *Wall Street Boosts Penalty on IPO Flips*, WALL ST. J., July 31, 1998, at C1; Michael Siconolfi & Patrick McGeehan, *Flip Side: Wall Street Brokers Press Investors to Hold IPO Shares*, WALL ST. J., June 26, 1998, at A1 (describing penalties imposed by broker-dealers on primarily individual customers who promptly sell their IPO allocations). “Investors who sell their shares in the first few days after trading begins are referred to as flippers and investment banks have implemented schemes to discourage flipping because this activity puts downward pressure on the stock price.” Reena Aggarwal, *Allocation of Initial Public Offerings and Flipping Activity*, 68 J. OF FIN. ECON. 111, 112 (2003), available at <http://www.msb.georgetown.edu/faculty/agggarwal/jfeflipping.pdf>. Aggarwal empirically demonstrates that there is a general misperception that the large trading volume in IPOs is mostly due to flippers. By examining a broad sample of IPO aftermarket activity, she documents that only nineteen percent of trading volume and fifteen percent of shares offered during the first two days of trading accounts for flipping activity. *Id.* at 113. For an interesting discussion relating to the legality of flipping, see Royce de R. Barondes, *Adequacy of Disclosure of Restrictions on Flipping IPO Securities*, 74 TUL. L. REV. 883 (2000) (analyzing disclosure issues arising out of the recent practice of underwriting firms imposing penalties on buyers who promptly flipped their IPO allocations). On the inefficiency that flipping creates, see Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 VAND. L. REV. 965, 976 (1995).

122. See generally Lawrence M. Benveniste & Paul A. Spindt, *How Investment Bankers Determine the Offer Price and Allocation of New Issues*, 24 J. FIN. ECON. 343 (1989); Lawrence M. Benveniste & William J. Wilhelm, *A Comparative Analysis of IPO Proceeds Under Alternative Regulatory Environments*, 28 J. FIN. ECON. 173 (1990); Lawrence M. Benveniste & William J. Wilhelm, *Initial Public Offerings: Going by the Book*, 10 J. APPLIED CORP. FIN. 98 (1997) [hereinafter “Benveniste & Wilhelm, *Initial Public Offerings*”].

123. Neal M. Stoughton & Josef Zechner, *IPO Mechanisms, Monitoring, and Ownership Structure*, 49 J. FIN. ECON. 45, 48 (1998). *But cf.* Michael Brennan & Julian Franks, *Underpricing, Ownership, and Control in Initial Public Offerings of Equity Securities in the UK*, 45 J. FIN. ECON. 391 (1997) (arguing that IPO allocation is driven by the issuer’s desirability for a dispersed ownership structure).

124. Reena Aggarwal & Dahiya Sandeep, *Capital Formation and the Internet*, 11 J. APPLIED

The book is consequently restricted to sophisticated and institutional investors because underwriters must provide an incentive to these parties to collect costly information and base their bid on such.¹²⁵ This has been referred to in the economics literature as “giving some rents for truthful revelation.”¹²⁶ The bids provided by the investors supply specific information about the “elasticity of demand” which in turn presents the underwriter with a financial framework to price the offering.¹²⁷ While the investment banker may already have produced somewhat detailed forecasts of the issuing company’s future cash flows, the information obtained via the bookbuilding process is invaluable in demonstrating the market’s beliefs.

Moreover, institutional and sophisticated investors play an additional function central to the allocation process in providing a kind of ‘insurance’ to the banker. These investors are compensated for this ‘insurance’ which takes the form of valuable pricing information these regular investors provide in both badly received and well-received issues.¹²⁸ Since the investment banker’s broad discretion enables him to discriminate in the allocation of shares based on investors’ participation in past offerings, the investment banker will consequently favor these regular investors who participated in many offerings and provided him with such pricing information in the past.¹²⁹ These institutional and sophisticated investors, however, despite their favorable treatment in the allocation process, would still not earn higher returns than other investors, given the fact that they are essentially being compensated for buying less successful issues.¹³⁰

CORP. FIN. 108, 113 (2000), available at <http://msb.georgetown.edu/faculty/sd/JACFPaper.pdf>.

125. See Cornelli & Goldreich, *supra* note 102.

126. See *id.* at 2346-47.

127. See *id.* at 2346. While the underwriters may indeed have broad and relatively unregulated discretion in the allocation procedure, issuing companies may have preferences over the ownership and distribution of shares. For instance, some issuers wish to avoid having a single investor or its affiliates from acquiring a large block of stock. Further, the issuer may require the investment bank to broadly allocate the stock so as to spread ownership for the purpose of increasing liquidity. *Id.* at 2347. For a more detailed articulation of these theories, see generally Brennan & Franks, *supra* note 123, at 395.

128. See Benveniste & Wilhelm, *Initial Public Offerings*, *supra* note 122. Note that the information is gathered at an event that is arranged by the underwriter called the “roadshow.” At the roadshow, the issuer’s corporate management makes presentations to institutional and sophisticated investors. It is at the roadshow where the investment banker begins to “build the book” and create a demand curve and a price range. For a more plenary discussion of the roadshow, see Reena Aggarwal, *Allocation of Initial Public Offerings and Flipping Activity*, 68 J. OF FIN. ECON. 111 (2003), available at <http://www.msb.georgetown.edu/faculty/aggarwal/jfeflipping.pdf>. On the lawyers role in the roadshow and underwriting scheme, see generally Samuel N. Allen, *A Lawyer’s Guide to the Operation of Underwriting Syndicates*, 26 NEW ENGL. L. REV. 319, 340-49 (1991).

129. See Benveniste & Wilhelm, *Initial Public Offerings*, *supra* note 122.

130. See *id.* Accordingly, the investment banker usually will attempt to encourage early

This conceptualization is connected to the 'retail investor' issue. Because many have called for reform in the way IPO shares are allocated to the general public,¹³¹ the empirical question of whether this objective would be economically sound must not be ignored. Economist Ivo Welch recently addressed this question, examining whether a rule mandating pro-rata distributions of IPO shares would afford retail investors the opportunity to participate in the "game."¹³²

At the outset, several economic observations are apparent. If a pro-rata distribution scheme was established, the incentive for investment bankers to underprice IPOs would be greatly diminished, thereby undoubtedly harming the full-service brokerage industry.¹³³ The reasoning underlying Professor Welch's belief that pro-rata distribution is not a viable economic option is best illustrated in a hypothetical:

See, you have to submit to get shares before you know if you are going to receive an allocation. If the offering is widely desirable, chances are that it is oversubscribed (and perhaps ten times so). If the offering is undesirable (and likely to trade below its offer price in the after-market), you are still likely to receive the full allocation you asked for. So, among offerings likely to quadruple, your invested dollar is expected to give you a profit of \$3, but you only get an allocation of one-tenth (or, equivalently, only one-tenth of the number of shares you asked for). Thus, you expect to make only 30¢. The one poor offering may drop to half its offer price, and your invested dollar loses you 50¢. On average, the newspaper quotes that the two IPOs offered a return of

$$1/2 \times 300\% + 1/2 \times (-50\%) = 125\%$$

and you still lost 30¢ on your dollar!¹³⁴

In essence, Professor Welch's hypothetical describes the inability of retail investors to gain high returns even if they had pro-rata access to IPO

demand for shares from the informed investors, consistent with the investment banker's marketing function. While the actual book is kept confidential, the investment banker will facilitate the formation of an informational cascade. By hinting to investors that the demand for shares is high, the investment banker has the ability to better market the stock as information collection will occur earlier in the process. Investors who supply early demand and pricing information will be rewarded with larger allocations.

131. See *infra* notes 8-15 and accompanying text.

132. Ivo Welch, *Investing in IPOs for Small Retail Investors*, at <http://www.iporesources.org/ipoinvesting.htm> (Apr. 1, 1999).

133. See *id.*

134. *Id.*; see also Raymond Hennessey, *For Every IPO Winner, Now There Are at Least Two Losers*, WALL ST. J., Dec. 4, 2000, at C1 ("By ratio of more than 2:1, IPO losers are outpacing gainers in 2000."), available at <http://www.infopoint.com/articles/IPOMarket.html>; Ivo Welch, *Amateurs Beware: IPOs not for the Faint-Hearted*, at <http://www.iporesources.org/press1.html> (Dec. 12, 1997).

stock.¹³⁵ In the same respect, empirical studies have found that profits that accrue to IPO investors are not higher than those captured by other investors, particularly in light of the theory that these institutional and sophisticated investors provide insurance by taking their share in poor offerings.¹³⁶ Thus, the institutional and sophisticated investors are not being allocated IPO shares based solely on their ‘friend of the investment bank’ status, but, rather, because this extra allocation is necessary in order to compensate them for the poor offerings they participate in.

Given the economics of the IPO process, regulators should be hesitant to undermine the bookbuilding methodology and mandate a pro-rata distribution scheme. It is highly questionable that such a scheme would accomplish its intended purpose. Moreover, the notion that the investment bankers are rewarding clients by doling out free money is yet to be proven as an empirical matter, and indeed how *free* the IPO shares really are is a matter that can be contested with sound economic evidence. The economic plausibility of share allocation via a nondiscriminatory auction, one that provides equal access to all investors, is discussed in the following Part.

V. THE ECONOMIC PLAUSIBILITY OF NONDISCRIMINATORY ALLOCATION

Proponents of an egalitarian distribution system, which would contemplate the allocation of IPOs to all investors equally, often suggest that a bidder style auction should govern the process.¹³⁷ The most common auction type following this model is the public offer auction.¹³⁸ In a public offer auction the issue price is set first and then offers are taken from investors who generally pay in advance for the shares that were ordered.¹³⁹

135. Cf. Alex Frew McMillan, *The World of Everyman IPOs*, CNN Money (Nov. 24, 1999), available at http://money.cnn.com/1999/11/24/investing/q_iposforall (Nov. 24, 1999).

136. See Cornelli & Goldreich, *supra* note 102.

137. See, e.g., Andres Rueda, *The Hot IPO Phenomenon and the Great Internet Bust*, 7 FORDHAM J. CORP. FIN. 21, 29 (2001), WL 7 FDMJCFL 21, 29 (arguing that the “NASD or SEC should eliminate favoritism in the IPO allocation process by mandating the use of equitable mechanisms to conduct distributions”); John C. Coffee, Jr., *IPO Underpricing and Dutch Auctions*, N.Y.L.J., Sept. 16, 1999, at 5-6; Bill Hambrecht, *Fixing the IPO Process*, available at http://www.wrhambrecht.com/ind/strategy/bill_pov/200209/report.pdf (Sept. 2002).

138. The public offer auction is also known as a fixed price auction, open offer auction, or universal offer auction. See Ann E. Sherman, *Global Trends in IPO Methods: Book Building vs. Auctions*, NPER Working Paper 5 (March 2002), at <http://www.gsb.stanford.edu/cebc/pdfs/Global2.pdf> (last visited Oct. 6, 2003).

139. See *id.* Wit Capital, WR Hambrecht, DLJdirect, and Epoch Capital distribute share allocations to retail investors in this manner. See Matthew Goldstein, *IPOs to Go*, at <http://www.smartmoney.com/stockwatch/index.cfm?story=200002022> (Feb. 2, 2000); Mark Calvey, *Bank Hopes to Herald New Epoch for Individual Members*, S.F. Bus. Times (Nov. 6, 2000), available at <http://www.bizjournals.com/sanfrancisco/stories/2000/11/06/story7.html>. For

The critical difference between the public offer auction and the bookbuilding method is that in the public auction there is no prospect of discriminatory allocation.¹⁴⁰ Consequently, auctions require allocations to be founded on present bids without regard to prior institutional relationships.¹⁴¹ Moreover, auctions are open to all investors, institutional and retail alike. Allocation discrimination in auctions is severely restricted by “fairness rules.”¹⁴²

While an underwriter does have the ability to conduct roadshows and solicit indications of interest, without the allocation discretion that is present in bookbuilding, in a public offer auction “there is no way for the underwriters to give investors the incentive to accurately report their information.”¹⁴³ In this regard, public offer auctions lead to greater underpricing relative to the bookbuilding method.¹⁴⁴ Bookbuilding offers less risk for issuers and investors, which leads to less underpricing.¹⁴⁵ Auctions are inherently more uncertain and risky because each investor must decide whether or not to enter and how much information to purchase without knowing whether or not he will receive the shares.¹⁴⁶ Additionally, the auction system also adversely affects issuers. While bookbuilding affords the underwriter the ability to tailor underpricing to the preferences of each individual issuer, auctions give little choice.¹⁴⁷ In auctions “you simply offer up the shares and hope for the best.”¹⁴⁸

Thus, the economics underlying public auction IPOs yield concrete economic disadvantages to both issuers and investors alike. Indeed, as one economic empirical study suggested,

the ‘Open IPO’ internet approach of getting ‘everyone’ involved in every IPO may be asking for trouble. If there is cost to information, and particularly if an issuer is small, risky and generally hard to evaluate, then lowering entry costs and opening up the process discourages investors

a discussion of the variations of auction systems, *see* Rueda, *supra* note 137, at 90-93.

140. *See* Sherman, *supra* note 138, at 5.

141. *See id.* at 5, 10-11; *see also* Ann E. Sherman, *IPOs and Long-Term Relationships: An Advantage of Bookbuilding*, 13 REV. FIN. STUDIES 697, 714 (2000) (arguing that a key feature of book building is that the underwriter has total discretion in allocating shares, allowing allocations to be based on long-term relationships between underwriters and investors, and further, the underwriter’s ability to lower underpricing depends largely on its ability to favor regular uninformed investors), *available at* <http://ideas.repec.org/a/oup/rfinst/v13y2000i3p697-714.html>.

142. *See* Sherman, *supra* note 138, at 5.

143. *See id.* at 6.

144. *See id.* at 23.

145. *See id.*

146. *See id.* at 22.

147. *See id.* 23.

148. *See* Sherman, *supra* note 138, at 23.

from doing serious evaluation.¹⁴⁹

Therefore, in auctions, the greater chance of undersubscription coupled with the fact that auctions lead to little if any evaluation of the offering, suggests that the bookbuilding methodology remains economically superior for issuers and investors alike. This, coupled with the aforementioned economic fallacies inherent in pro-rata distribution schemes, should lead to the conclusion that the IPO share allocation system currently in place should remain intact.¹⁵⁰ Indeed, perhaps these economic theories explain why the regulators have not enacted any meaningful reforms in this context.

VI. ECONOMIC THEORY AND LAWS CONSTRAINING IPO ALLOCATION

This Part discusses the economic desirability and utility of fashioning legal rules to constrain the IPO allocation process, particularly in the context of allocations to corporate executives. This Part argues that regulatory forces should not attempt to regulate the IPO allocation scheme because of the myriad of economic issues that transcend the equal access allocation models suggested by academics and investors.¹⁵¹ Moreover, several sound economic theories that have been advanced in other securities regulation contexts indicate that legal rules would be unnecessary and sub-optimal from economic perspectives.

A. *The Potential for Government Intervention*

Section 19(c) of the Securities Exchange Act of 1934, allows the SEC, on its own initiative, to amend the rules of an SRO, as it deems necessary or appropriate.¹⁵² The SEC is permitted to do so to facilitate the fair administration of SROs, and to conform its rules to requirements of the Exchange Act and the rules and regulations thereunder applicable to SROs.¹⁵³ Additionally, as a catchall, the SEC has broad authority to amend SRO rules in furtherance of the purposes of the Exchange Act.¹⁵⁴

149. *Id.* at 25. Indeed, if a small obscure issuer goes public via an auction, it might be “trying to avoid giving investors too much incentive to thoroughly scrutinize the stock.” *Id.*

150. *See supra* notes 133-36 and accompanying text.

151. It should be noted, that this Article steadfastly opposes the conditioning of IPO allocations on the receipt of excessive compensation for other services, in exchange for future investment-banking business or agreements to purchase in the aftermarket. Instead, this Article argues that the allocation of IPOs to corporate executives personally or to institutional investors (for reasons other than these illegitimate and/or illegal purposes) is a business decision that should be upheld without regulatory intervention.

152. 15 U.S.C. § 78s(c) (2000).

153. *See id.*

154. *See, e.g.,* Business Roundtable v. SEC, 905 F.2d 406 (1990).

While the SEC has always had this authority, the SEC has generally refrained from meddling in the SRO sphere. If the problem of IPO allocation is so egregiously troubling and inimical to the broad purposes underlying the Exchange Act, the SEC is empowered under its expansive congressional mandate, to either amend SRO rules to introduce a new allocation model or introduce an SEC rule as it so often does.¹⁵⁵ With respect to IPO distribution, the SEC's traditional position, as evidenced by several SEC publications released in 2001¹⁵⁶ and 1999,¹⁵⁷ has been to question the suitability of IPO investments for retail investors. The Commission has expressly stated that it "does not regulate the business decision of how IPO shares are allocated."¹⁵⁸ The fact that the SEC has thus far stalled its tinkering in the capital formation arena in the context of IPO distribution is encouraging. There have been, however, recent recommendations to do precisely just that.¹⁵⁹

At the direction of the SEC, the NYSE and the NASD formed an IPO Advisory Committee ("IPO Committee") to investigate potential reforms in the IPO process.¹⁶⁰ The IPO Committee proposed several steps to enhance the public's confidence in the integrity of the IPO process.¹⁶¹ Among the

155. Pursuant to the 1934 Act, Congress empowered the SEC to enforce the provisions of the 1934 Act. 15 U.S.C. § 78w(a). Most importantly, Congress granted the SEC rule-making authority. *Id.* Section 23(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78w(a) et seq., grants broad authority to the SEC to adopt rules and regulations "as may be necessary or appropriate," to implement the 1934 Act. *Id.* Section 23(a) of the Securities Exchange Act of 1934 provides in relevant part:

The Commission . . . shall have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this title for which they are responsible and may for such purposes classify persons, securities, transactions, statements, applications, reports and other matters and prescribe greater, lesser, or different requirements for different classes thereof.

Id.

156. See SEC, *Initial Public Offerings: Eligibility to Get Shares at Broker Dealers*, at <http://www.sec.gov/answers/ipolig.htm> (Mar. 2, 2001) (explaining that a broker-dealer firm may not sell IPO shares to individual investors unless the investment is suitable for them).

157. See SEC, *Initial Public Offerings: Why Individuals Have Difficulty Getting Shares*, at <http://www.sec.gov/answers/ipodiff.htm> (Dec. 24, 1999).

158. See *id.*

159. See, e.g., Randall Smith & Kate Kelly, *More Disclosure On Distribution of IPOs Looms*, WALL ST. J., May 12, 2003, at C1; see also NYSE/NASD IPO ADVISORY COMMITTEE, *Report and Recommendations of a Committee Convened by the NYSE and NASD at the Request of the U.S. Securities and Exchange Commission 2* (May 2003), available at http://www.nasdr.com/pdf-text/ipo_report.pdf.

160. See Randall Smith, *Controlling IPOs: New Steps Would Limit Big 'Pops'*, WALL ST. J., May 30, 2003, at C1.

161. The themes followed in formulating IPO Committee recommendations include:

The IPO process must promote transparency in pricing and avoid aftermarket distortions; Abusive allocation practices must be eliminated; Regulators must improve the flow of, and access to, information regarding IPOs; Regulators must encourage underwriters to maintain

most significant of its recommendations, the Committee has suggested that underwriters be obligated to provide their corporate clients with the complete pre-IPO price indications received from investors as well as full disclosure to the issuers the identities of those investors that received an allocation.¹⁶² Additionally, the IPO Commission recommended that issuers appoint a committee of directors to assess and monitor the pricing of IPOs.¹⁶³ These recommendations, coupled with newly suggested limits on how much an IPO price could vary from the last disclosed price range will presumably create a disincentive to engage in underwriter underpricing activity.¹⁶⁴ This, in effect, arguably prevents a reduction in the issuer's finance proceeds and deters quick profits to underwriters and their clients.

Relatedly, one of the committee's themes was to terminate "abusive allocation practices."¹⁶⁵ The IPO Committee recommended limiting the size of so-called "friends and family" programs¹⁶⁶ which they felt "compromises" the IPO allocation process.¹⁶⁷ Additionally, the recommendations advocate for publicly traded corporations to have a code of conduct addressing receipt of IPO stock,¹⁶⁸ and IPO Committee endorsed the ban on spinning adopted by the Wall Street firms in the global settlement. Also, the IPO Committee implemented a ban on "market orders" on the first day of trading after an IPO is launched.¹⁶⁹ The purpose of these particular recommendations is to protect investors from purchasing the stock at prices that exceed their expectations.¹⁷⁰

Notwithstanding these recommendations, several of the IPO Committee's members criticized the recommendations because of their

the highest possible standards, establish issuer education programs regarding the IPO process and promote investor education about the advantages and risks of IPO investing.
NYSE/NASD IPO ADVISORY COMMITTEE, *supra* note 159, at 3.

162. *See id.* at 16.

163. *See id.* at 4. For more on the pricing of IPOs, see *supra* notes 103-08 and accompanying text.

164. *See id.*

165. *See id.* at 3.

166. Friends and family programs generally allocate a portion of the IPO's stock to employees, customers and others specifically designated by the issuer.

167. The committee believes "friends and family" programs should be limited to no more than five percent of the IPO. *See* NYSE/NASD IPO ADVISORY COMMITTEE, *Report and Recommendations of a Committee Convened by the NYSE and NASD at the Request of the U.S. Securities and Exchange Commission* 13 (May 2003), available at www.nasdr.com/pdf-text/ipo_report.pdf.

168. *See id.* at 11.

169. *Id.* at 10-11.

170. Randall Smith, *More Disclosure on Distribution of IPOs Loans*, WALL ST. J., May 12, 2003, at C9 ("Market orders are purchase orders that do not include price limits. Many securities firms have company specific rules against these types of orders by individual investors.").

failure “to address the systematic problem that creates an incentive for underwriters to underprice, namely preferential allocation.”¹⁷¹ Indeed, as this Article suggests, the pure allocation problem, which one panelist labeled as “the unchecked ability of underwriters to allocate shares to their best clients,” has still not been addressed.¹⁷² While the IPO Committee has advanced several noteworthy and compelling proposals that could potentially benefit the IPO process on the whole (assuming the “recommendations” are adopted as Rules in the future), the Committee did not address the pure allocation problem.¹⁷³

SEC commissioner, William Donaldson, recently labeled the global settlement “a temporary solution to the problem of spinning.”¹⁷⁴ Along those lines, he stated that in the months ahead the SEC “will explore addressing these issues with revised rulemaking.”¹⁷⁵ This Article now addresses the economic ramifications of regulating the current IPO allocation paradigm.

B. *Law, Economics and Managerial Value Diversion*

One area where the SEC has regulated extensively and sought to expand its authority to do so is in the insider trading context.¹⁷⁶ When the SEC first sought to regulate insider trading — “the practice by which a manager or other insider uses material information not yet disclosed to other shareholders or the outside world to make profits by trading in the firm’s stock”¹⁷⁷ — there was a plethora of compelling and oft-cited legal and economic literature questioning the SEC’s crusades.¹⁷⁸ Like the IPO allocation paradigm, insider trading regulations similarly unearth deep-seated questions that center primarily on fairness and economics related concerns.¹⁷⁹ While the core concerns underlying the insider trading debate

171. Randall Smith, *Controlling IPOs: New Steps Would Limit Big ‘Pops,’* WALL ST. J., May 30, 2003, at C16.

172. *See id.*

173. *See id.*

174. Randall Smith, *IPO ‘Spinning’ Comes Under Fire: Regulators Say Exchanges of Business May Be Bribes: Two Firms are Charged,* WALL ST. J., Apr. 29, 2003, at C9.

175. *Id.*

176. *See, e.g.,* United States v. Chestman, 947 F.2d 551, 557 (2d Cir. 1991) (en banc) (holding that Rule 14e-3(a) “creates a duty in those traders who fall within its ambit to abstain or disclose, without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information”); accord SEC v. Peters, 978 F.2d 1162, 1165 (10th Cir. 1992); SEC v. Maio, 51 F.3d 623, 635 (7th Cir. 1995).

177. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 459 (1998).

178. *See Insider Trading and the Law Professors, supra* note 26, at 547.

179. *See id.* at 549-61.

are relatively unique to that realm, several postulations advanced by academics and economists in those discussions have general applicability in the context of government intervention and regulation of IPO allocations to corporate executives.

The two seemingly different contexts raise several comparable practical, theoretical and policy concerns. In essence, both are a form, in one way or another, of managerial value diversion from shareholders to corporate managers. While insider trading is a form of corporate managerial value diversion through the medium of purchasing and selling stock based on confidential information,¹⁸⁰ the receiving of an IPO allocation by an executive is a similar form of value diversion, namely the potential diversion of the IPO investment from the corporation's shareholders.¹⁸¹

Along the same comparative lines, a parallel can be drawn relative to the distributional and fairness concerns underlying both value diversion models. As was discussed previously in this Article, in the IPO allocation model, investors and academics have criticized regulators for their failure to provide retail investors with equal access to these potentially lucrative investments.¹⁸² By allowing a process that systematically excludes certain investors from investments which yield larger profits (at least in the short term), it hinders the underlying policies of the Exchange Act which seek to enhance investor access to the capital markets equally.¹⁸³ The discriminatory allocation model currently in place can thus be perceived as unegalitarian and unfair to retail investors.

In the insider trading context, several more apparent fairness concerns fester. The judicial interpretation of Rule 10b-5 is based on the questionable notion that insider trading is a fraudulent and exploitative business transaction that harms shareholders.¹⁸⁴ Additionally, the "market confidence argument" (also labeled the "scare argument" pejoratively) suggests that "if investors in the stock market know that insider trading is common they will refuse to invest in such an 'unfair' market."¹⁸⁵ Other

180. See J. KELLY STRADER, UNDERSTANDING WHITE COLLAR CRIME 93 (2002).

181. See Schmitt & Markon, *supra* note 10, at 1.

182. See *supra* notes 131-35 and accompanying text.

183. See *id.*

184. See, e.g., *Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969) (describing insider trading as "casting a cloud on the corporation's name, injuring stockholder relations and undermining public regard for the corporation's securities").

185. *Case for Insider Trading*, *supra* note 26, at A14 (criticizing the market confidence advanced by the SEC and other pro-regulation advocates). Manne further stated that,

[t]he most fundamental economic proposition in the whole topic of insider trading is that no shareholder is harmed by a rule of law that allows the exploitation of nonpublicized information about shares of publicly traded corporations. The naive argument in defense of

theorists contend that insider trading amounts to property theft, as information that belongs to the corporate entity is being used without consent.¹⁸⁶ Along the same lines, others argue that notwithstanding economic efficiencies, the potential exploitation of uninformed investors is alarming enough to rationally justify prohibiting insider trading gains.¹⁸⁷

C. *Market Forces and Regulation*

Several theories can be adapted conceptually to the IPO allocation problem from the insider trading debate. The application of these theories, in the IPO context, demonstrate that regulating in this area is not necessary, and not economically desirable. This Part advances those theories, applies them to the IPO allocation context, and argues that there is no genuine need for regulatory intervention as market forces can operate as a check on allocation processes.

Law and Economics scholars have argued that the traditional presumption against managerial value diversion in the insider trading context is misguided.¹⁸⁸ Like insider trading proceeds, IPO allocations, another form of potential value diversion, can be viewed as an alternative form of managerial compensation, a substitute for salaries, bonuses, and other forms of direct managerial pay. Just as with insider trading proceeds, one can make the case that the benefits from diverting IPO allocations will in many circumstances be offset by reductions in direct compensation, leaving total managerial pay and the total wealth enjoyed by shareholders unchanged.

Put another way, the compensation corporate management receives for performing its corporate duties can be adjusted to reflect profits earned from IPO allocation proceeds. In this model, the prospect of receiving IPO

the SEC's position on this subject is that if the shareholder had the information (good news) the insider had, he would not sell his shares.

James A. Dorn & Henry G. Manne, *Insider Trading and Property Rights in New Information*, in *ECONOMIC LIBERTIES AND THE JUDICIARY* 317 (1987). See also *Insider Trading and the Law Professors*, *supra* note 26, at 547; see generally Jie Hu & Thomas H. Noe, *Insider Trading and Managerial Incentives*, 25 *J. BANKING & FIN.* 681 (2001).

186. See, e.g., MICHAEL P. DOOLEY, *THE FUNDAMENTALS OF CORPORATE LAW*, 820-23 (1995). See also Stephen M. Bainbridge, *Insider Trading Under the Restatement of the Law Governing Lawyers*, 19 *J. CORP. L.* 1, 21-23 (1995); see generally Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 *HOFSTRA L. REV.* 9 (1984).

187. For more on the distributional and fairness concerns underlying the insider trading debate, see generally Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne*, 53 *VA. L. REV.* 1425 (1967); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 *TEX. L. REV.* 375 (1999).

188. See *Insider Trading and the Law Professors*, *supra* note 26, at 548.

allocations can be specifically addressed by executive compensation arrangements. Further, any wage contract between the corporation and its manager can be subject to the fiduciary duty of loyalty framework.¹⁸⁹

Relatedly, regulating IPO allocations overlooks the private and cheaper alternatives of limiting this activity through private contracts. Private contracts are potentially easier to enforce than allocation rules as they allow individual companies to evaluate IPO allocations and establish company-specific policies. Like in the insider trading context, in the absence of an express prohibition on IPO allocations to corporate executives, companies would be able to more efficiently elect whether they wish to allow IPO allocations to their executives.¹⁹⁰ If allocations were as harmful to investors and the IPO process as some suggest, the investing public would presumably invest in corporations that expressly and voluntarily adopt restrictions on these practices. This allows IPO allocation policies to be a dimension in which corporations compete for equity investments. Moreover, private contractual arrangements would facilitate a market that would more accurately assess when, how, and to what extent allocations to corporate executives might be detrimental.

Private company policies and contractual arrangements, coupled with the compensation reduction notion adapted from the insider trading context

189. The duty of loyalty contemplates self-dealing or interested transactions. Any personal benefit a corporate fiduciary derives by virtue of his director or officer status would be subject to this duty. Thus, entering into an agreement with the corporation that allows a corporate fiduciary access to IPO allocations would be subject to Delaware's interested transaction statute, which reads as follows:

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:

(1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.

DEL. CODE ANN. § 144 (2001).

190. See MANNE, *INSIDER TRADING AND THE STOCK MARKET*, *supra* note 26, at 421.

are likely more efficient alternatives than legal rules banning IPO allocations all together. The eagerness to displace the relatively regulation free allocation paradigm is ill-founded. These theories coupled with the previously discussed economics underlying the allocation scheme, together make the case for leaving the allocation sphere from legal rules constraining allocation activity.

VII. CONCLUSION

The “game” is far from over. While it may appear as if the regulators have taken concrete steps to curbing Wall Street IPO allocation practices, after clearing away the fog, it is apparent that they have enforced existing laws and have addressed IPO allocation in the presence of garden-variety fraud. Even the SEC has acknowledged the valid economic and regulatory reasons for allowing IPO allocations to be doled out at the discretion of underwriting syndicates.¹⁹¹ In a SEC educational publication, the Commission explains the entire allocation process and concludes that most IPO share allocations are given to institutional and sophisticated investors.¹⁹² The SEC seemingly has no problem with limiting access to IPOs to institutional and sophisticated investors.

This Article has suggested that the regulators have not addressed the pure allocation issue because of the sound economic underpinnings of the bookbuilding methodology. In 2002, underwriters raised \$2.5 trillion for corporate America using the bookbuilding system.¹⁹³ While pro-rata allocation by way of public auction or other mechanisms has been used in other markets, bookbuilding has remained the most successful and popular economic model.¹⁹⁴ At the very least, the economics that the system is founded on have tested remarkably well empirically, and should not be ignored if policy-makers eventually address the pure allocation problem. The economics that form the foundation for discretionary IPO allocation practices should not be ignored or substituted for egalitarian ideals that would not likely accomplish their intended purposes.

191. See SEC, *Initial Public Offerings: Eligibility to Get Shares at Broker Dealers*, at <http://www.sec.gov/answers/ipoelig.htm> (Mar. 2, 2001) (explaining that a broker-dealer firm may not sell IPO shares to individual investors unless the investment is suitable for them).

192. See SEC, *Initial Public Offerings: Why Individuals Have Difficulty Getting Shares* (Dec. 24, 1999), at <http://www.sec.gov/answers/ipodiff.htm>.

193. See SIA Letter, *supra* note 87.

194. See *id.*