CAN WALL STREET'S "GLOBAL RESOLUTION" PREVENT SPINNING? A CRITICAL EVALUATION OF CURRENT ALTERNATIVES

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INTRODUCTION

In December 2002, New York Attorney General Eliot Spitzer announced that the State of New York, the Securities and Exchange Commission, and several other regulatory authorities, had reached a "global settlement" in their investigation into the investment banking practices of ten major Wall Street investment firms.[1] The investigation had focused primarily on analyst conflicts of interest: the tendency of research analysts to supply unduly optimistic forecasts of company performance, under pressure from colleagues in the investment banking department who owe their business to the very same companies the analysts are touting.[2] But when the agreements became public nearly a year later,[3] one of the more

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[1] Press Release, Office of the New York Attorney General Eliot Spitzer, SEC, NY Attorney General, NASD, NASAA, NYSE, and State Regulators Announce Historic Agreement to Reform Investment Practices (Dec. 20, 2002) [hereinafter Global Resolution Press Release], *at* http://www.oag.state.ny.us/press/2002/dec/dec20b_02.html (last visited Feb. 26, 2004).

[2] *See* Press Release, *infra* note 78. The conflict arose as a result of inadequate segregation of research analysts and investment bankers working within the same brokerage house. *See infra* notes 123-33 and accompanying text. Analysts would create hype over a particular company by releasing unduly rosy appraisals of that company's performance. *Id.* In the euphoric investor market of the late 1990s, such hype often translated into high investor demand for the stock of that company. *Id.* Riding this investor groundswell, the company would often increase its demand for investment banking services, which generated lucrative fees for the investment banking arm of the brokerage house. *Id.* Thus, working in conjunction, research analysts and investment bankers were able to generate huge profits for their principals. *Id.* At the same time, investors relying on false or misleading analyst reports often paid exorbitant prices for stock that should have traded at a fraction of its market price at the height of the stock market bubble. *Id.*

[3] *See* Press Release, Securities and Exchange Commission, Federal Court

interesting provisions concerned the allocation of shares in initial public offerings, or IPOs—a topic that might seem, at first blush, to have little bearing on analyst conflicts of interest. Events of the past several years,[4] however, have shown that in an environment of lax regulatory oversight, IPO allocations often degenerate into a practice known as "spinning." Spinning, fraught with conflicts of interest of its own, reinforces analyst conflicts of interest and threatens investor confidence in the overall integrity of financial markets.

The importance of IPO allocations in general and spinning in particular is best illustrated by way of example. Picture a publicly traded security that you, the investor, can buy at 9:30 a.m. for twenty dollars and sell later that same day for upwards of ninety dollars. Imagine that the security seemingly defies the conventional wisdom that with higher yields generally come increased risks.[5] To the contrary, owning this security poses virtually no risk at all, and, in fact, you are practically assured a substantial profit. Naturally, any investor would clamor for the opportunity to purchase such a security, and the effect of this competition would drive up the security's price.[6] But suppose you have the ability to acquire tens of thousands of shares of this security for the guaranteed price of twenty dollars each, free from all competitive market forces. Thus, a single transaction may net you millions of dollars in profits. Now suppose that you can repeatedly profit from such transactions, month after month, year after year. As an added bonus, suppose this was all perfectly legal.

While such securities sound like fantasy to the sober investor in today's equity markets, they were commonplace as little as two years ago.[7] The securities in question are shares in "hot"[8] IPOs. In the

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Approves Global Research Analyst Settlement (Oct. 31, 2003) (appending the individual settlements reached with each firm), *at* http://www.sec.gov/litigation/litreleases/lr18438.htm (last visited Feb. 26, 2004).

[4] *See infra* Part I.

[5] *See* HAL R. VARIAN, INTERMEDIATE MICROECONOMICS 233 (4th ed. 1996) ("[A] risk averse investor would never hold the risky asset if it had a lower expected return than the risk-free asset. It follows that if you choose to devote a higher fraction of your wealth to the risky asset, you will get a higher expected return, but you will also incur higher risk."). This phenomenon is well documented in practice. *See* FRANK K. REILLY & EDGAR A. NORTON, INVESTMENTS 46-47 (4th ed. 1995) (noting that "[a]s expected, the higher returns available from equities come at the cost of higher risk," and providing graphical data).

[6] Rising demand coupled with fixed supply of any given commodity exerts upward pressure on price. *See* VARIAN, *supra* note 5, at 7.

[7] For several years following the dot-com boom, United States financial markets have witnessed a sharp decline in the number of initial public offerings. *See* Aaron Elstein, *Economic Surge Rebuilds Altar of Public Offerings*, CRAIN'S N.Y. BUS., Dec. 15,

hands of skillful financiers, their unique qualities give rise to a host of equally unique legal issues. Foremost among them is the controversial issue of "spinning."

"Spinning" occurs when an IPO underwriter places shares of a hot IPO in the personal account of an individual investor who, in his or her capacity as a director or officer of a corporation, can direct lucrative corporate business back to the underwriter.[9] For several years, controversy has swirled as to whether this practice is legal and within the underwriter's discretion, or whether it amounts to an illegal bribe of a corporate fiduciary.[10] Indeed, policymakers and commentators continue to debate the basic question of whether spinning should be legal.[11] If spinning is legal, questions remain as to whether the fiduciary has a duty to disclose the opportunity to the corporation before reaping the profits.[12]

This Comment examines the controversy surrounding the practice of spinning, as well as recent developments in the regulation of underwriters. Part I provides an overview of the mechanics of IPO share allocation in general and spinning in particular. Additionally, it surveys some of the recent media attention that spinning has garnered, which suggests that popular opinion weighs heavily in favor of a strict prohibition of the practice. In Part II, this Comment discusses the major arguments against spinning, attempting to shed

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2003, at 15. After a peak year in 1999, with 510 IPOs raising more than $60 billion in capital, U.S. markets in 2003 saw fewer than ninety IPOs, raising less than $20 billion in the aggregate. *Id.* (showing a steady decline in the number of IPOs and aggregate capitalization since 1999, and estimating only eighty-four IPOs in 2003 raising approximately $15 billion). But the IPO market appears poised to begin its rebound in 2004. *Id.* (noting that Richard Peterson, Thompson Financial's chief market strategist, estimates there may be up to two hundred IPOs in 2004, thus ending the longest decline in the domestic IPO market since 1975); *see also* Lucas van Grinsven, *Tech IPOs Will Be Back with a Vengeance in 2004*, REUTERS, Dec. 23, 2003 (predicting that 2004 will be a watershed year for European tech company IPOs), *at* http://uk.biz.yahoo.com/031223/80/ehps2.html (last visited Feb. 26, 2004). The prospect for the return of the IPO market in the near future speaks to the pressing concern of some observers that IPOs must be more carefully regulated to prevent abuse. *See infra* Part II.

[8] *See infra* note 47 and accompanying text. The above hypothetical is admittedly sensational but nevertheless is a paradigm example of a "hot" IPO.

[9] *See* sources cited *infra* note 63.

[10] *See infra* notes 91-107 and accompanying text.

[11] *See* Ermanno Pascutto, *Bribery by Another Name: Is IPO Spinning an Immoral Practice That Is Undermining Investor Confidence in the Markets, or Harmless Business That Should Be Left Alone?*, NAT'L POST, Jan. 2, 2003, at FP8 ("In Canada and the United States, there is a debate in the media about whether spinning is illegal, unethical, or just good business practice.").

[12] *See* discussion *infra* Parts IV.B.1, IV.B.2.

light on the reasoning behind recent regulatory interest in this area. Next, Part III analyzes the New York Attorney General's "global resolution," with its putative ban on spinning, and argues that this agreement is an incomplete remedy and should be better viewed as a stepping-stone to more conclusive and preclusive SEC regulation. Finally, Part IV reviews the current alternatives to New York's "global resolution." First, it describes the inherent weaknesses of existing regulations, and suggests a more certain approach for future regulatory efforts. Then, it suggests that aggrieved shareholders should be able to sue corporate fiduciaries for their past spinning activities. To that end, this Comment describes theories of liability involving the corporate opportunity doctrine and principles of agency law. Lastly, this Comment presents an alternative method of IPO underwriting, the Dutch auction method, and argues that broader use of this fledgling technique will obviate many of the inefficiencies that encourage spinning in the first place.

PART I: THE MECHANICS OF SPINNING

An initial public offering ("IPO") is a company's first sale of stock to the public.[13] It is one of the most important means by which corporations raise capital.[14] Corporations that undertake IPOs have substantial discretion in how to use the resulting funds.[15] IPOs also provide initial investors a public market in which to cash out their shares at some future date.[16] Other factors, such as increased publicity[17] and the "first-mover advantage,"[18] may play subsidiary roles

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[13] BLACK'S LAW DICTIONARY 1111 (7th ed. 1999) (defining an initial public offering as "[a] company's first public sale of stock").

[14] *See* Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795, 1795 (2002) (noting that between 1980 and 2001, United States markets averaged more than one IPO per day, raising a total of $488 billion, or $78 million per deal on average).

[15] Bruce E. Crocker, *The Initial Public Offering Process*, 955 PLI/CORP. 385, 387 (1996).

[16] Ritter & Welch, *supra* note 14, at 1796.

[17] Professors Ritter and Welch suggest that the publicity factor is a minor consideration, as entrepreneurs are generally reluctant to engage in complex public finance mechanisms. *Id.* at 1796, 1798. But Professors Ritter and Welsh may underestimate corporate desire for the favorable analyst coverage that often accompanies a successful IPO. *See* Rajesh K. Aggarwal et al., *Strategic IPO Underpricing, Information Momentum, and Lockup Expiration Selling*, 66 J. FIN. ECON. 105, 106 (2002) (discussing the role of analyst coverage on IPO share price in the aftermarket).

[18] A corporation may realize additional value from being the first corporation within an industry group to go public. Ritter & Welch, *supra* note 14, at 1798 (noting that commentators often cite Netscape as the archetype).

in a corporation's decision to go public.

Once the directors of the company going public (the "issuer") decide to pursue an IPO, they typically select a lead underwriter to manage the public offering.[19] In a typical IPO, the lead underwriter is a large broker-dealer, such as Salomon Smith Barney or Goldman Sachs, whose guiding function is to make an orderly and bona fide distribution of the issuer's IPO shares to investors.[20] Underwriter selection may be a highly competitive process[21] in which the issuer's board evaluates a number of competing underwriters[22] on the basis of such factors as experience, the amount of research analyst coverage that the underwriter can provide, the strength of the underwriter's sales and trading departments, the underwriter's credibility with investors, and the underwriter's commitment to a long-term relationship with the issuer.[23] Often, however, the issuer's board will make an informal selection based upon reputation or prior dealings with a particular firm or executive.[24]

After the issuer's board settles on a lead underwriter, the underwriter will execute a "letter of intent."[25] Though non-binding,[26] the letter of intent outlines the terms of the services that the underwriter expects to provide[27] and forms the blueprint of the subsequent binding underwriting agreement between the issuer and

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[19] *See* 3A HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 8:1 (2d ed. 2002). The lead underwriter, in turn, typically assembles a syndicate of secondary underwriters to assist in the transaction. 3A *id.* Note, however, that there is no requirement under either state or federal securities law that the issuer conduct its offering through a broker-dealer. 1 WILLIAM M. PRIFTI, SECURITIES: PUBLIC AND PRIVATE OFFERINGS § 5:01 (2d ed. 2001).

[20] 1 PRIFTI, *supra* note 19, § 5.01.

[21] Crocker, *supra* note 15, at 393 ("During the final selection process for managing underwriters, which is typically conducted by the company's top executives and board of directors, investment banks will compete intensely and can be aggressive in promoting their qualifications.").

[22] *See* Therese H. Maynard, *Spinning In a Hot IPO—Breach of Fiduciary Duty or Business as Usual?*, 43 WM. & MARY L. REV. 2023, 2060 (2002) (stating that it is standard practice for a board to interview at least three prospective underwriters).

[23] Crocker, *supra* note 15, at 393-94; *see* 1 PRIFTI, *supra* note 19, § 5.05 (listing fourteen factors that a board might consider).

[24] *See* 1 PRIFTI, *supra* note 19, § 5.01 ("At present, obtaining an underwriter is a matter of who you know."); *see also* 1 *id.* § 5.05 (noting that there is no firm regimen for selecting an underwriter, and boards will often base their decision on informal contacts "such as the accountant, venture capitalist, friends, or perhaps the broker with whom you already made a general securities account"). Frequently, the board may select a particular underwriter upon the suggestion of the CEO. Maynard, *supra* note 22, at 2060.

[25] 1 PRIFTI, *supra* note 19, § 4.01.

[26] 3A BLOOMENTHAL & WOLFF, *supra* note 19, § 8:6.

[27] 1 PRIFTI, *supra* note 19, § 4.01.

underwriter.[28] Often, the underwriter's services will include a commitment to purchase all of the issuer's IPO shares at the offer price, minus the underwriter's fee, or discount.[29] Just before the IPO, the underwriter will then re-sell the shares to select investors at the offer price.[30] This so-called "firm commitment" method of underwriting thus places the burden of selling the shares on the underwriters, and is by far the most common method of underwriting in the United States today.[31] The letter of intent may also include preliminary estimates for the number of shares to be sold and their offering price, but the underwriter will not finalize these critical terms until it has had a chance to gauge investor demand for the issuer's securities.[32]

The most important job of the newly selected lead underwriter is to estimate investor demand for the issuer's IPO shares over a range of potential offer prices.[33] Since the 1960s, "roadshows" have been an important vehicle in this process.[34] Roadshow is the term used to describe the promotional campaign that brings together the issuer's management and investors who are potentially interested in investing

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[28] 1 *id.* (stating that the letter of intent "is the document between the underwriter and the issuer from which the underwriting agreement is written").

[29] Raymond P.H. Fishe, *How Stock Flippers Affect IPO Pricing and Stabilization*, 37 J. FIN. & QUANTITATIVE ANALYSIS 319, 322 (2002) (describing this arrangement as a "firm-commitment contract"); *see* 3A BLOOMENTHAL & WOLFF, *supra* note 19, § 8:5; 1 PRIFTI, *supra* note 19, § 4.04 (providing an example of a formal letter of intent in which the underwriter commits to purchase the issuer's offering).

The National Association of Securities Dealers ("NASD") regulates the size of the underwriters' discount, which will vary with the size of the offering. 1 *id.* § 5.01. Typically, a $10 million IPO will generate an underwriters' discount of 10.65%; a $20 million IPO will generate a 7.42% discount; IPOs above $40 million will generate discounts around 7.0% or less; and for IPOs of $50 million or more, the discount will be no more than 6.89%. 1 *id.*

[30] *See* Crocker, *supra* note 15, at 397 (noting that share allocations are finalized before public trading commences). These privileged investors will thus own IPO shares when public trading of the IPO shares begins, and are generally free to sell them to clamoring individual investors anytime thereafter. *See* John C. Coffee, Jr., *The IPO Allocation Probe: Who Is the Victim?*, N.Y. L.J., Jan. 18, 2001, at 5 (noting that "institutional investors regularly [resell] the shares they buy in IPOs within days or weeks of the offering").

[31] 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 327 (3d ed. 1998) (noting that "firm commitment" underwriting is the most prevalent method); *see* Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced*, 41 UCLA L. REV. 17, 68 n.190 (1993) (stating that firm commitment IPOs comprise over ninety-five percent of all IPOs).

[32] 1 PRIFTI, *supra* note 19, § 4.02.

[33] Fishe, *supra* note 29, at 322 ("[T]he underwriter estimates market demand for the issue . . . as a function of offer price . . . .").

[34] Linda J. Yi, Note, *Road Shows On the Internet: Taking Individual Investors for a Ride on the Information Highway*, 52 DUKE L.J. 243, 247 (2002).

in the IPO.[35] An IPO roadshow typically consists of a series of presentations and face-to-face meetings, spanning the country, and open only to select institutional investors such as pension funds and mutual funds.[36] Investor feedback from these meetings allows the underwriter to "build a book" of probable investors.[37] Through this bookbuilding process, the underwriter assembles a group of investors who will then have the opportunity to purchase IPO allotments from the underwriter at the offer price during the critical period just before public trading begins.[38] Investor interest during the roadshow also provides the underwriter with a sense of the aggregate market demand for the IPO, which allows the underwriter to hone the offer price.[39]

In theory, the underwriter should arrive at an offer price that will maximize the issuer's returns from the IPO by exploiting the full extent of aggregate investor demand.[40] Between 1980 and 2001, however, IPO share price at the close of the first day of public trading on United States equities markets averaged 18.8 percent above the offer price, suggesting a pattern of systematic underpricing.[41] Theorists have advanced a number of possible reasons for this phenomenon,[42] but most concede that the underwriter, who must

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[35] *Id.*

[36] *Id.* at 247-48 (noting that allowing individual investors to participate in roadshows would likely violate § 5(b)(1) of the Securities Act of 1933, which prohibits general advertising to investors); *see also* 15 U.S.C. § 77e(b)(1) (2002). For a flavor of the roadshow experience, see generally Mike Mills, *A Digital Age Rite: The IPO Roadshow; A Former Post Reporter Chronicles His New Company's Successful Pitch to Underwriters, Regulators, and Investors*, WASH. POST, Nov. 28, 1999, at H1.

[37] *See* Lawrence M. Benveniste & Walid Y. Busaba, *Bookbuilding vs. Fixed Price: An Analysis of Competing Strategies for Marketing IPOs*, 32 J. FIN. & QUANTITATIVE ANALYSIS 383 (1997); Mills, *supra* note 36 (describing "the delicate act of balancing 'the book'").

[38] *See* Mills, *supra* note 36, at H1 (describing the strategy of creating an investor syndicate during the roadshow).

[39] *See* Benveniste & Busaba, *supra* note 37, at 390 ("The gathered indications [from prospective investors] provide an assessment of the demand for the issue that allows the underwriter to set an offer price that better reflects aggregate, or market, valuation.").

[40] Fishe, *supra* note 29, at 324; *see* Laurie Krigman et al., *The Persistence of IPO Mispricing and the Predictive Power of Flipping*, 54 J. FIN. 1015, 1015 (1999) (describing the theory as "balancing supply and demand").

[41] Ritter & Welch, *supra* note 14, at 1795; *see* Aggarwal et al., *supra* note 17, at 106; Krigman et al., *supra* note 40, at 1015. Professors Benveniste and Busaba report a 19.61% average rate of underpricing between 1975 and 1982. Benveniste & Busaba, *supra* note 37, at 394. This phenomenon is not unique to United States markets; an underpricing rate of approximately fifteen percent is observed across all developed countries. Aggarwal et al., *supra* note 17, at 106.

[42] One of the most likely is that the underwriter's reputation may suffer harm if

purchase the issuer's IPO shares at the offer price, has an incentive to underprice.[43] Firm commitment underwriting requires the underwriter to maintain the share price after public trading of the IPO shares has begun.[44] If newly issued IPO shares begin to trade down, i.e., the trading price drops below the offer price (indicating excess supply relative to demand), the firm commitment underwriter may have to purchase the excess shares for its own account.[45] Rather than face this risk of loss, the underwriter may instead underprice the IPO, thus effectively shifting the financial burden to the issuer in the form of foregone capitalization from the IPO.[46] But whether deliberate or not, pricing IPO shares well below market demand transforms ordinary IPO shares into so-called "hot issues."[47] Traders covet shares of "hot" IPOs because they can "flip" the shares—resell

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an overpriced IPO yields negative first-day returns. *See* Fishe, *supra* note 29, at 324-25. Another theory is that underwriters underprice IPOs as insurance against lawsuits alleging violation of federal securities laws. *See* Alexander, *supra* note 31, at 19 ("Damages in suits brought under the Securities Act of 1933 . . . are based on the difference between the offering price and the stock price at the time of suit. The lower the offering price, the lower the potential damages.") (footnote omitted).

[43] *See, e.g.*, James Bohn & Stephen Choi, *Fraud in the New Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 954 n.162 (1996) (noting that "several commentators have written on the possible incentive of underwriters to underprice an IPO"); Note, *Auctioning New Issues of Corporate Securities*, 71 VA. L. REV. 1381, 1390 (1985) [hereinafter *Auctioning New Issues*] ("In a firm commitment offering, the underwriter bears the risk that investors may not buy the securities. Underpricing the issue, however, reduces this risk.").

One may legitimately ask why an issuer would acquiesce in the underwriter's underpricing of an IPO. Assuming that the issuer does not independently perform its own pre-IPO valuation—a safe assumption, as this would defeat in large part the very purpose of retaining an underwriter—the issuer will not know that its IPO has been undervalued until *after* the offering, when the shares begin trading at levels in excess of the offer price. By then, the damage is done, and the issuer may have little, if any, recourse. But there is considerable evidence that issuers are not troubled by IPO underpricing, if indeed they are even conscious of its existence. For one, a massive increase in price on the first day of trading may attract valuable media and research analyst coverage. *See infra* note 356 and accompanying text. It may also cement the issuer's relationship with the underwriter, a consideration particularly important where the issuer expects to draw upon the underwriter's services in the future. And underwriters may mollify the issuer's key management by selling them options in the IPO or in future hot IPOs. *See infra* notes 117-18 and accompanying text.

[44] Alexander, *supra* note 31, at 68.

[45] *Id.*

[46] *See id.* at 68-69 (discussing the underwriter's financial and reputational incentives to underprice); *see also infra* notes 114-18 and accompanying text (discussing the effect of forgone capitalization).

[47] *See* SEC Approves Amendments to Free-Riding and Withholding Interpretation, NASD Notice to Members 98-48 (Aug. 17, 1998) ("Hot issue securities are defined by the Interpretation as securities of a public offering that trade at a premium in the secondary market whenever such trading commences.").

them in the highly competitive aftermarket[48]—for a substantial profit.[49]

One might suppose that the underwriter could simply retain the hot IPO shares until trading commences and then flip them in the aftermarket for a profit. This practice is known as "withholding," and as one might expect, the National Association of Securities Dealers ("NASD") has promulgated regulations that prohibit it.[50] The Free-Riding and Withholding Rules require the underwriter "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."[51] Traditionally, this rule has meant that an underwriter has discretion to place IPO shares with investors of its choosing, so long as they are not employees, officers, directors, partners, or agents of the underwriter.[52] Thus, by requiring the underwriter to sell its IPO shares to investors at the offering price—the same price the underwriter paid the issuer minus the discount—the Free-Riding and Withholding Rules limit the underwriter's direct profit to the discount paid by the issuer.[53]

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[48] The aftermarket, i.e., the secondary market, is "the securities market in which previously issued securities are traded among investors." BLACK'S LAW DICTIONARY 984 (7th ed. 1999).

[49] Meredith B. Cross & Christine Sarudy Roberts, *Recent Developments in Underwriting of IPOs: "Spinning" and Syndicate Penalty Bids*, 1084 PLI/CORP. 595, 597 (1998).

[50] *See* NASD Manual, IM-2110-1(b)(1) (1998), *available at* http://www.nasdr.com/pdf-text/9848ntm.txt (last visited Feb. 26, 2004); *see also* Royce de R. Barondes, *Adequacy of Disclosure of Restrictions on Flipping IPO Securities*, 74 TUL. L. REV. 883, 894 & n.65 (2000) (defining withholding); Susan Pulliam & Randall Smith, *Two at CSFB Put on Leave Amid IPO Probe*, WALL ST. J., Apr. 20, 2001, at C1 (stating that the NASD rule forbids underwriters from retaining an equity interest in the issuer). NASD Rule 2110 further states:

> 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 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.

NASD Manual, *supra*, at IM-2110-1(a)(1).

[51] NASD Manual, *supra* note 50, at IM-2110-1(a)(1); *see supra* note 20 and accompanying text.

[52] NASD Manual, *supra* note 50, at IM-2110-1(b)(2); *see* Maynard, *supra* note 22, at 2039.

[53] *See* 3A BLOOMENTHAL & WOLFF, *supra* note 19, § 8:2 ("[M]embers of the underwriting group are compensated by the per-share difference between the offering price and the price to be paid by the underwriter to the issuer . . . ."); Crocker, *supra* note 15, at 392 ("The underwriters purchase the shares from the

Nevertheless, there is at least one significant method by which an underwriter may benefit beyond just the discount. Because Securities and Exchange Commission ("SEC") and NASD regulations allow the underwriter broad discretion to allocate IPO shares to non-affiliated investors of its choosing, the underwriter has the ability to confer substantial financial benefits upon specific investors through the allocation of hot issues.[54] These select investors, in turn, are free to flip the IPO shares in the aftermarket for a quick, virtually guaranteed profit, courtesy of the underwriter.[55] Obviously, such allocation practices tend to generate a tremendous amount of investor goodwill toward underwriters in times of hot IPO markets, and underwriters have exercised their discretion strategically.[56]

As a group, institutional investors represent the single largest constituency in U.S. equities markets.[57] Perhaps not coincidentally, they have also received the lion's share of hot IPO allocations.[58] Nevertheless, beginning in the 1980s and increasing through the

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company at an agreed upon discount to the offering price called the 'gross spread,' which serves as their compensation.").

[54] *See* Fishe, *supra* note 29, at 319 ("When the 'order book' is built for an IPO, the underwriter tries to determine who will flip, who will hold shares, and the total demand with and without flippers."); *see also* Mills, *supra* note 36, at H1 (describing the strategy underwriters employ in building an order book of IPO subscribers).

[55] Mills, *supra* note 36, at H1 ("[Y]ou want some flippers—investors who quickly sell their shares—otherwise, on the first day of trading nothing would happen."). Of course, the investor need not flip the shares immediately to enjoy the benefit of receiving an underpriced security. As some of the more spectacular IPOs of the late 1990s have demonstrated, however, holding hot IPO shares over long periods of time may introduce long-term risk, and may even cause the investor to sustain a loss. *See infra* notes 357-58 and accompanying text.

[56] Mills, *supra* note 36, at HI; *see* Coffee, *supra* note 30, at 5 ("Clearly, IPO allotments are not distributed under any equal opportunity or 'first-come-first served' rule, but instead go to favored customers. This should not surprise, as most merchants in times of scarce supply will favor long-standing or major customers over the first-time customer.").

[57] Eric W. Orts, 1998 Survey of Books Relating to the Law, *The Future of Enterprise Organization*, 96 MICH. L. REV. 1947, 1963 (1998) (noting that institutional investors collectively own most publicly traded stock in United States markets); *see* Thomas A. Stewart, *The King Is Dead. (Stockholders Are Gaining Power over Chief Executives)*, FORTUNE, Jan. 11, 1993, at 34 ("[I]nstitutional investors—pension funds, mutual funds, insurance companies— . . . hold 50.3% of all the stock of all the corporations in America.").

[58] Michael Siconolfi, *The Spin Desk: Underwriters Set Aside IPO Stock for Officials of Potential Customers*, WALL ST. J., Nov. 12, 1997, at A1 ("It is no news that underwriters make most of the shares in hot IPOs available not to the little-guy investor but to institutions, such as mutual-fund companies and pension funds, that provide a lot of trading commissions and other business."); *see* Terzah Ewing & Joshua Harris Prager, *Many Are Finding IPOs Still Out of Reach*, WALL ST. J., Feb. 28, 2000, at C21 ("Small investors receive less than a quarter of the shares in the average IPO . . . .").

rampant bull market of the 1990s,[59] some influential individual investors began to demand a larger piece of the IPO pie.[60] Consequently, many underwriters began to seek a method by which they could continue to entice high-volume customers while simultaneously satiating individual investors' demand for shares of hot IPOs.[61] As it turned out, "spinning" became the strategy of choice.[62]

Spinning, in Wall Street parlance, refers to the underwriter's practice of allocating hot IPO shares to the personal trading accounts of individual investors who, in their capacity as directors or senior officers of a corporation, are in a position to direct future corporate business to the underwriter.[63] Before the start of open trading, the underwriter sells IPO shares into the investor's trading account at the offer price.[64] If the IPO stock is trading substantially higher by the end of the first trading day (i.e., the IPO is "hot"), the investor, or perhaps the underwriter,[65] may then flip the stock (i.e., sell it in the aftermarket), and the investor will realize a substantial profit. The underwriter's purpose in performing this service is to foster goodwill among corporate decision-makers who might later direct corporate business back to the underwriter.[66] Critics argue that spinning, in its essence, is a quid pro quo.[67]

How pervasive is spinning? In 1997, the Wall Street Journal first

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[59] *See, e.g.*, George R. Monahan & Grace Toto, *Monthly Statistical Review*, SEC. INDUSTRY ASS'N RES. REP., Feb. 16, 2000, at 9 (noting that eight of the securities industry's ten best profit years occurred in the 1990s), *available at* http://www.sia.com/research/pdf/marginVol1-1.pdf (last visited Feb. 26, 2004).

[60] Maynard, *supra* note 22, at 2029-30; *see* Siconolfi, *supra* note 58, at A1 (noting that spinning began in the 1980s).

[61] *See generally* Ewing & Prager, *supra* note 58 (describing efforts to bring individual investors into the IPO market).

[62] Siconolfi, *supra* note 58, at A1 (describing the practice of spinning as "rampant").

[63] Maynard, *supra* note 22, at 2027; Cross & Roberts, *supra* note 49, at 597; Siconolfi, *supra* note 58, at A1.

[64] Siconolfi, *supra* note 58, at A1.

[65] As a service to clients, some underwriters will allocate hot IPO shares to a client's discretionary trading account and later flip the shares for a profit, thus eliminating the need for client participation. *Id.* A discretionary account is "[a]n account that allows a broker access to a customer's funds to purchase and sell securities or commodities for the customer based on the broker's judgment and without first having to obtain the customer's consent to the purchase or sale." BLACK'S LAW DICTIONARY 479 (7th ed. 1999).

[66] Siconolfi, *supra* note 58, at A1 (quoting Hambrecht & Quist's managing director of investment banking as candidly admitting to "trying to solicit business" through the practice).

[67] *See, e.g.*, Maynard, *supra* note 22, at 2027-28.

reported on the practice, quoting an executive officer of a technology company as saying, "It's as common as water."[68] The article recounted how Joseph Cayre, the CEO of GT Interactive Software Corp., had realized a $2 million one-day profit on hot IPO shares in Pixar Animation Studios that he had purchased from his broker, Robertson Stephens.[69] Several weeks later, GT Interactive selected Robertson Stephens to underwrite its own IPO, a transaction that ultimately generated over $5 million in fees for the broker.[70] In response to this story, the SEC opened an investigation into spinning practices on Wall Street, but closed the investigation in 2001 without taking any formal action.[71]

Meanwhile, amidst the fallout of recent corporate scandals,[72] new tales of even more dramatic proportions have emerged. In July 2002, in court papers filed in connection with his wrongful termination suit, a former Salomon Smith Barney ("SSB") broker alleged widescale spinning at the Citigroup unit.[73] The allegation prompted the House Financial Services Committee to subpoena SSB records as part of a legislative inquiry into fraud in the financial services industry.[74] Documents that SSB subsequently turned over to the Committee suggest that throughout the late 1990s, SSB favored a select group of individual investors with large and repeated allocations of hot IPO shares.[75] WorldCom is illustrative of what many commentators regard as the abuses inherent in IPO spinning:

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[68] Siconolfi, *supra* note 58, at A1.

[69] *Id.* Pixar's IPO stock closed up seventy-seven percent on its first trading day; Mr. Cayre held 100,000 shares at the time. *Id.*

[70] *Id.*

[71] *See* Susanne Craig & Charles Gasparino, *Salomon Used IPOs as Lure, Broker Says*, WALL ST. J., July 18, 2002, at C1.

[72] An excellent article that captures the flavor and magnitude of corporate scandals of late is Mark Gimein, *You Bought. They Sold.*, FORTUNE, Sept. 2, 2002, at 64. The author documents an economy-wide trend of executive cashing-in since 1999 amounting to $66 billion dollars in executive profits. *Id.* at 66. At the same time these executives were profiting by selling off stock holdings at the peak of the market, their corporations were shedding at least seventy-five percent of their market capitalization. *Id.* at 65 (limiting the study to executive selling at corporations with a peak market capitalization of $400 million and a subsequent decline in value of at least seventy-five percent).

[73] *See* Dan Ackman, *A Harmonic Convergence of Sleaze*, Forbes.com (July 18, 2002), *at* http://www.forbes.com/2002/07/18/0718topnews_print.html (last visited Feb. 26, 2004). David Chacon's amended pleading alleged that he was fired for complaining about SSB's spinning practices with respect to a number of telecommunications executives. *Id.*

[74] *See* Craig & Gasparino, *supra* note 71, at C1.

[75] The House Financial Services Committee has made these documents available to the public at http://financialservices.house.gov/media/pdf/citiresp2_001.pdf.

WorldCom directors Walter Scott, Jr., Stiles Kellett, Jr., and James Q. Crowe personally realized $2.4 million, $202,047, and $3.5 million, respectively, on allocations of hot IPO shares from SSB;[76] CEO Bernard Ebbers earned more than $11 million.[77] WorldCom repaid this largess in kind, awarding SSB more than $107 million in corporate business between 1998 and 2002,[78] just before filing the largest Chapter 11 bankruptcy in United States history in July 2002.[79]

Such practices, however, extend far beyond SSB and WorldCom. Recent *Wall Street Journal* articles have chronicled spinning by Credit Suisse First Boston[80] and Goldman Sachs,[81] as well. Directors and officers of Qwest Communications,[82] McLeodUSA,[83] and Metromedia Fiber Networks,[84] may also be among the many executives who profited from spun shares in oversubscribed[85] IPOs in the late 1990s. While their officers were profiting from hot IPO shares, each of these corporations supplied the underwriter, SSB, with millions of dollars of investment banking business.[86] Perhaps even more disturbing are reports that underwriters may have spun IPO shares to prominent members of Congress.[87]

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[76] *See* Susanne Craig, *Offerings Were Easy Money for Ebbers*, WALL ST. J., Sept. 3, 2002, at C1.

[77] *Id.*

[78] Press Release, Office of the New York State Attorney General Eliot Spitzer, State Suit Seeks Repayment of IPO and Stock Option Profits of Corporate Executives (Sept. 30, 2002) [hereinafter State Suit Seeks Repayment], *available at* http://www.oag.state.ny.us/press/2002/sep/sep30c_02.html (last visited Feb. 26, 2004).

[79] Shawn Young et al., *Leading the News: WorldCom Files for Bankruptcy*, WALL ST. J., July 22, 2002, at A3.

[80] Randall Smith & Susan Pulliam, *Buddy System: How a Technology-Banking Star Doled Out Shares of Hot IPOs*, WALL ST. J., Sept. 23, 2002, at A1.

[81] *See* Michael Erman & Per Jebsen, *Top Executives Risk Lawsuits over Goldman IPO List*, REUTERS, Oct. 3, 2002 (on file with author).

[82] *See* Press Release, Office of the New York State Attorney General Eliot Spitzer, Investment Banking Deals and Corporate Executive Profits (Sept. 30, 2002) [hereinafter Chart] (attributing $4.8 million in IPO profits to Chairman Philip Anschutz and $1 million in profits to CEO Joseph Nacchio), *available at* http://www.oag.state.ny.us/press/2002/sep/sep30c_02_chart.html (last visited Feb. 26, 2004).

[83] *Id.* (attributing $9.4 million in IPO profits to CEO Clark McLeod).

[84] *Id.* (attributing $1.5 million in IPO profits to Chairman Stephen Garofalo).

[85] *See Auctioning New Issues*, *supra* note 43, at 1383 n.13 ("An issue [i.e., an IPO] is oversubscribed when more orders are placed for the issue than can be satisfied by the issuer.").

[86] *See* Chart, *supra* note 82 (citing $37 million in fees from Qwest, $49 million in fees from McLeodUSA, and $47 million in fees from Metromedia).

[87] *See* Christine B. Whelan & Tom Hamburger, *IPO Largess Flowed to Capitol Hill*, WALL ST. J., Sept. 6, 2002, at A4. This Comment, however, will focus only on

PART II: THE CASE AGAINST SPINNING

Most Wall Street observers first became acquainted with the practice of spinning as a result of the November 1997 *Wall Street Journal* exposé.[88] But in the exuberant bull market of the late 1990s, public outcry was short-lived, and the issue of spinning did not again attract broad public scrutiny until the summer of 2002.[89] Now, in the fallout of recent scandals, reform is underway.[90]

Probably the most frequently voiced criticism of spinning is that it is nothing more than a thinly veiled form of corporate bribery.[91] But the term "bribe" often connotes images of brown paper bags filled with cash changing hands behind closed doors.[92] In a spinning transaction, by contrast, the flow of cash is necessarily much less obvious.[93] Defenders of the practice often argue that IPO shares are an investment like any other, and are simply not the equivalent of a cash gift.[94] They note that inherent in any publicly traded security is risk, and this risk—this chance for loss—is what sets IPO allocations apart from bribery.[95] Surely directors and officers are allowed to participate in equity markets like any other retail investor?

But a CEO is *not* like any other retail investor, as is obvious to anyone who sought in vain to purchase into a hot IPO in the 1990s.[96]

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spinning in the corporate context.

[88] *See* Siconolfi, *supra* note 58.

[89] See, for example, Craig & Gasparino, *supra* note 71, as the first in a series of spinning stories that the *Wall Street Journal* ran in the wake of spinning allegations at SSB.

[90] *See infra* notes 134-37 and accompanying text.

[91] *See, e.g.*, Maynard, *supra* note 22, at 2036; *see also* Pascutto, *supra* note 11 (stating that spinning is a form of bribery and noting that in Hong Kong markets, spinning is an arrestable offence under the Prevention of Bribery Ordinance); Michael Siconolfi, *SEC Broadens 'Spinning' Probe to Corporations*, WALL ST. J., Dec. 24, 1997, at C1 (quoting former SEC commissioner Steven Wallman as saying, "It's a black-and-white corporate bribery issue"); Michael Siconolfi, *'Spinning' of Hot IPOs Is Probed*, WALL ST. J., Apr. 16, 1998, at C1 (quoting former SEC commissioner Edward Fleischman as saying spinning "sure smells like whatever commercial bribery is"); Siconolfi, *supra* note 58 (quoting Robert Messih, managing director at Salomon Inc., as affirmatively stating, "It's a bribe, no question about it").

[92] *See, e.g.*, Pascutto, *supra* note 11.

[93] *Id.*

[94] *See* George Bragues, *Why Single Out CEOs?*, NAT'L POST, Jan. 2, 2003, at 8.

[95] *See id.* ("While it's common for shares to trade at a premium to the offer price on the first day, it's not guaranteed."); *see also* Mark D. Seltzer, *'Spinning' Hot Stocks: Is It a Crime?*, BUS. CRIMES BULL.: COMPLIANCE & LITIG., Sept. 1998, at 7 ("The best defense against charges of fiduciary fraud or bribery in the spinning context may be that IPO shares remain market instruments that involve a substantial risk of loss.").

[96] *See* Pascutto, *supra* note 11 ("If a retail investor called the investment bank to purchase some of the IPO, the chances of getting any shares are slim to none.").

Corporate decision-makers have a powerful advantage during the IPO allocation process that enables them to take a share of the offering while other individual investors are shut out.[97] Further, consider that in 1999 and 2000, at the peak of the IPO market, the *average* IPO closed up sixty-five percent on its first day of public trading.[98] Under such market conditions, recipients of IPO share allocations were virtually assured of a substantial and instantaneous profit with little or no risk.[99] If there were any question whether the IPO shares would trade up on their first day of public trading, some unscrupulous underwriters deftly eliminated this uncertainty by allocating the shares to the director's or officer's discretionary trading account only after trading had commenced and the price had begun to rise.[100] Hence, at the moment of allocation, the recipient was already "in the money."

Bribery implies a quid pro quo,[101] however, and it is here that prosecutors and potential litigants have faced the greatest difficulty in making their case for corporate bribery.[102] Parties to a spinning transaction typically will deny the existence of a quid pro quo.[103] Thus, critics of spinning have long argued that when an underwriter spins shares of a hot IPO to a corporate officer or director, the quid pro quo is implied.[104] The underwriter allocates hot IPO shares (the "quid," as it were) to a corporate director or officer in return for a "quo" of corporate investment banking business at some future time. But the problem with this approach is that it suffers from the fallacy

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[97] *Id.*

[98] Mike McNamee, *Getting the Price Right*, BUS. WK., Sept. 9, 2002, at 126.

[99] *See* Siconolfi, *supra* note 58.

[100] *See* Seltzer, *supra* note 95. This practice, known as "withholding," is a technical violation of the NASD Free-Riding and Withholding Rule. *See supra* note 50 and accompanying text.

[101] *See* Coffee, *supra* note 30, at 5 ("[A] bribe typically requires a specific quid pro quo exchange."); Seltzer, *supra* note 95 (examining New York and Massachusetts commercial bribery statutes, as well as bribery under the Federal Travel Act).

[102] *See* Seltzer, *supra* note 95 ("The government would confront substantial obstacles . . . in proving the required quid pro quo . . . .").

[103] *See, e.g.*, Siconolfi, *supra* note 58 (recounting how Joseph Cayre and underwriter Robertson Stephens denied the existence of a quid pro quo on an allocation of Pixar IPO shares). *But see* Mills, *supra* note 36, at H1 (candidly admitting that institutional investors who tell the underwriter during the roadshow that they intend to flip the shares "are given shares as a kind of favor, to get them to continue doing more business with Merrill [Lynch]").

[104] *See* John C. Coffee, Jr., *'Spinning' for Dollars: IPOs and Allocation of Hot Issues*, N.Y. L.J., Mar. 26, 1998, at 5 (observing that the underwriter will generally know when an offering is oversubscribed, and arguing that spinning in such instances amounts to a "tacit commercial bribe").

of *post hoc, ergo propter hoc*;[105] the mere fact that an investment banking contract follows a spinning transaction does not necessarily imply a causal relation.[106] Further difficulties arise when a corporate director or officer receives IPO stock placements from multiple underwriters—a common occurrence—but only supplies corporate business to one underwriter in return.[107]

Even if spinning does not rise to the level of corporate bribery, it does create corporate conflicts of interest, as the NASD itself has conceded.[108] In August 2002, the association issued a Notice to Members in which it wrote:

> "Spinning" or awarding IPO shares to the executive officers and directors of the company divides the loyalty of the agents of the company (i.e., the executive officers and directors) from the principal (i.e., the company) on whose behalf they must act. This practice is inconsistent with just and equitable principles of trade.[109]

Indeed, several commentators have expanded on this idea by arguing that spinning is a violation of the corporate opportunity doctrine.[110]

Spinning creates an added incentive for underwriters to underprice IPOs.[111] Pricing IPO shares below market demand creates securities that have an inflated value that the underwriter may then exploit to its own advantage when making the distribution.[112] For example, the underwriter may use these hot IPO shares as a kind of currency to buy favors from individual investors who are also

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[105] This phrase refers to the false assumption that simply because B happened after A, B happened as a result of A.

[106] *See* Seltzer, *supra* note 95 (noting that "[t]he mere coincidence of timing between IPO allocation and prospective underwriting work may not be sufficient" to satisfy state commercial bribery statutes).

[107] *Id.*

[108] Regulation of IPO Allocations and Distributions, NASD Notice to Members 02-55 (Aug. 2002).

[109] *Id.* at 525. NASD rules explicitly require members to adhere to "high standards of commercial honor and just and equitable principles of trade." NASD Manual, *supra* note 50, at IM-2110-1(a)(1).

[110] *See* William H. Donaldson, *Testimony Concerning Global Research Analyst Settlement, Statement Before the Senate Committee on Banking, Housing and Urban Affairs* (May 7, 2003) [hereinafter Donaldson, *Testimony*] (noting that spinning "raises serious questions about whether the corporate insiders who take hot IPO shares in exchange for their firms' investment banking business are breaching their fiduciary duties to their shareholders"), *at* http://www.sec.gov/news/testimony/ts050703whd.htm (last visited Feb. 26, 2004); *see also* Maynard, *supra* note 22, at 2085. For a discussion of the corporate opportunity doctrine, see *infra* Part IV.B.1.

[111] *See supra* note 43 and accompanying text.

[112] *See* McNamee, *supra* note 98, at 126 ("[Underpricing] turned IPO shares into a currency that some underwriters abused.").

corporate decision makers.[113] This, in turn, creates negative effects on several levels. Most immediately, misjudging market demand deprives the issuer of capitalization that it could have realized in the offering.[114] Consider that in 1999 and 2000, IPO underpricing caused the *average* IPO issuer to miss out on $79 million in capitalization from the offering.[115] This money, which should have gone to the issuing corporation to fund research, pay salaries, and distribute dividends, instead went largely to a few fortunate investors, including corporate directors and officers, whose influence bought them a share of the distribution.[116] One might expect the management of an issuer to demand better service from the underwriter, but often, underwriters were able to mollify management by granting them options in the IPO or spinning future hot IPO shares to their personal accounts.[117] Thus, IPO underpricing may generate further conflicts of interest by swaying directors and officers to act (or fail to act) in subversion of their primary duty to the corporation and its shareholders.[118]

Another consideration falls under the general rubric of "fairness." Many critics decry as unfair the inability of most small investors to participate in any IPO allocations[119] while select individual

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[113] This is the essence of spinning. *See supra* note 63 and accompanying text.

[114] *See* McNamee, *supra* note 98.

[115] *Id.* (providing data showing that in 1999 and 2000, the average IPO priced at $5 or more traded up sixty-five percent on its first day of trading, causing the average issuer to lose out on $79 million in capitalization (measured in year 2000 dollars)). Thompson Financial data show 510 IPOs in 1999 and 385 IPOs in 2000. *See* Elstein, *supra* note 7. The foregoing figures thus suggest an aggregate of approximately $70 billion in forgone capitalization in just those two years. *See id.*; McNamee, *supra* note 98.

[116] McNamee, *supra* note 98.

[117] *See* Coffee, *supra* note 104 (offering an excellent description of how an executive of the issuer can profit even when the issuer itself fails to realize capital due to IPO underpricing).

[118] *Id.* (discussing fiduciary duty issues inherent in spinning).

[119] *See, e.g.*, Coffee, *supra* note 30 (noting that media coverage has tended to characterize small investors who are shut out of the IPO process as victims); Susanne Craig, *IPO Allotments: A Guide to the Game*, WALL ST. J., Aug. 29, 2002, at C1 (attributing the current interest in spinning to the fact that "it doesn't seem fair that some wealthy investors got favored treatment"); Craig, *supra* note 76 (quoting Congressman Michael Oxley as saying that Bernard Ebbers's spinning profits "raise[] questions about the fairness of the process that brings new listings to the markets"); Press Release, United States House of Representatives, Congressmen Kanjorski and Shays Release Salomon Smith Barney's Initial Response on IPO Allocations to WorldCom Executives (July 12, 2002) ("As we examine the lessons of the Internet bubble, I hope that all investment banks will reevaluate their policies to improve fairness in the allocation of IPO shares in the future."), *at* http://www.house.gov/kanjorski/02_07_12WorldComKanjorskiShaysCitigroup.htm

investors participate in dozens of offerings.[120] Others have argued that many investment banks owe much of their business capital to mutual funds and pension plans, comprised of contributions from countless individual small investors.[121] Hence, the argument goes, fairness dictates that when a bank underwrites an IPO, it should allocate the shares to the funds and not to the executives of influential clients.[122]

Recently, New York State Attorney General Eliot Spitzer suggested a new basis for concern: the synergies that arise between hot IPO spinning and phony analyst stock ratings.[123] In September 2002, Spitzer brought suit against five corporate executives under New York's Martin Act,[124] seeking to disgorge their profits from trading in hot IPO allocations.[125] The complaint alleged a tri-fold scheme whereby the underwriter, in this case SSB, spun hot IPO shares to the personal accounts of defendant executives in return for corporate investment banking business from their respective corporations.[126] Once SSB secured this investment banking business, Spitzer alleged, SSB would then hand the reins to its chief telecommunications analyst Jack Grubman, who would follow through by providing unduly optimistic and often false stock ratings.[127] In this manner, SSB secured lucrative investment banking

(last visited Feb. 26, 2004).

[120] *See* Donaldson, *Testimony*, *supra* note 110 (stating that "[s]pinning increases the public perception that IPO allocations are an insiders' game"); *see also* State Suit Seeks Repayment, *supra* note 78 (stating that Qwest executives participated in fifty-seven IPO offerings between September 1998 and February 2002).

[121] *See supra* note 57 and accompanying text (describing the dominant role that institutional investors play in modern equities markets).

[122] *See* Letters to the Editor, *The 'Little Guy' Gets Stiffed Again*, WALL ST. J., Dec. 3, 1997, at A23 [hereinafter Letters to the Editor]. But note that institutional investors remain the largest participant in IPO allocations. *See supra* note 58 and accompanying text.

[123] *See* State Suit Seeks Repayment, *supra* note 78. The press release noted that the suit "grew out of a broad conflict of interest investigation into Wall Street brokerage firms." *Id.*

[124] Martin Act, N.Y. GEN. BUS. LAW §§ 352, 352(c), 353, 353-a, 359(g) (McKinney 2002). The Martin Act is New York's 1921 state securities law, and commentators widely regard it as the toughest in the nation. *See* Jerry Markon & Charles Gasparino, *For Corporate-Crime Fighters, 1921 Martin Act Isn't Too Old*, WALL ST. J. ONLINE (Oct. 2, 2002), *at* http://www.litigation-results.com/popupwallst10_2.htm (last visited Feb. 26, 2004). It grants the state Attorney General broad powers to prosecute the fraudulent sale of securities and does not require proof of a quid pro quo. *Id.*

[125] *See* Complaint, State v. Anschutz, *available at* http://www.oag.state.ny.us/press/2002/sep/sep30c_02_complaint.pdf (last visited Feb. 26, 2004).

[126] *Id.* ¶ 1.

[127] *Id.* For instance, Grubman still had a buy rating on Metromedia Fiber

business,[128] and the defendant executives profited twice: first, on the sale of spun IPO shares,[129] and again on the sale of the artificially inflated stock that they held in their corporations.[130] The cost of these schemes, Spitzer concluded, fell squarely on those investors who relied on Grubman's phony stock ratings and who held stock while these schemes fell apart.[131] Spitzer summed up the relationship between spinning and analyst conflicts of interest thus:

> The spinning of hot IPO shares was not a harmless corporate perk. Instead, it was an integral part of a fraudulent scheme to win new investment banking business. And, once again, we see enormous pressure being placed upon research analysts to issue misleading stock ratings in order to secure that business.[132]

As Attorney General Spitzer recognized, spinning often occurs in conjunction with, and reinforces, other conflicts of interest involving research analysts and investment bankers.[133]

Networks, even after its stock fell from $40 in June 2000 to just $4 in June 2001. *Id.* ¶ 55. Similarly, WorldCom still had a buy rating after it fell from $46 in June 2000 to $7 in March 2002. *Id.* ¶ 71. At around the same time, Grubman allegedly wrote an e-mail to a colleague in which he stated, "most of our banking clients are going to zero and you know I wanted to downgrade them months ago but got a huge pushback from banking [i.e., SSB's investment banking division]." *Id.* ¶ 54.

[128] Spitzer's research indicates that between 1996 and 2002, these fees totaled $37 million from Qwest Communications, $47 million from Metromedia Fiber Networks, $49 million from McLeodUSA, and $107 million from WorldCom. Chart, *supra* note 82.

[129] These profits totaled over $28 million for the five named defendants. *See supra* notes 82-84.

[130] Just prior to the crash in stock price of their respective companies, four of the five named defendants sold off their stock holdings. Clark McLeod (McLeodUSA) made $16 million on his sale of McLeodUSA stock; Bernard Ebbers (WorldCom) made $23 million on his sale of WorldCom stock; Joseph Naccio (Qwest) made $226 million on his sale of Qwest stock; and Philip Anschutz (Qwest) made an astonishing $1.4 billion on his sale of Qwest stock. *See* Chart, *supra* note 82.

[131] *See* State Suit Seeks Repayment, *supra* note 78 ("Uninformed shareholders, meanwhile, lost millions of dollars when the stocks in the defendants' companies crashed.").

[132] *Id.* Recently, the NASD brought similar suits against Frank Quattrone, who oversaw CSFB's underwriting business in the late 1990s. The suits accused Mr. Quattrone of nourishing analyst conflicts of interest through the use of spinning. *See* Charles Gasparino & Randall Smith, *Quattrone Faces Civil Charges on 'Spinning'*, WALL ST. J., Mar. 7, 2003, at C1. These suits represent the first time the NASD has charged an investment banker with spinning. *Id.* Mr. Quattrone's first trial ended in a hung jury in October 2003; as of February 2004, a retrial was pending. *Executives on Trial: Quattrone Retrial Is Postponed*, WALL ST. J., Feb. 9, 2004, at C5.

[133] New York's Martin Act action has already proved effective in inducing several of the defendants to relinquish some, though not all, of their spinning profits. Phillip Anschutz disgorged $4.4 million in spinning profits. Press Release, Office of the New York Attorney General Eliot Spitzer, Telecom Executive Agrees to Give Up IPO Profits (May 13, 2003) (noting that this is "the first time an executive has given

PART III: THE GLOBAL RESOLUTION AND ITS LIKELY EFFECTS

Within three months after filing the Martin Act complaint, Eliot Spitzer announced that the New York Office of the Attorney General, the SEC and other regulatory authorities had reached a global resolution with ten major brokerage houses to settle the government's broader conflicts of interest probe.[134] According to the initial press release, one of the central provisions of the agreement is "a complete ban on the spinning of Initial Public Offerings (IPOs). Brokerage firms will not allocate lucrative IPO shares to corporate executives and directors who are in the position to greatly influence investment banking decisions."[135] The ten participating firms also agreed to pay a total of $1.435 billion, to consist of approximately $900 million in fines and disgorgment, $450 million for independent research over five years, and $85 million spent on investor education.[136]

On October 31, 2003, Judge William H. Pauley III of the Southern District of New York approved the global resolution, at which time the SEC released the language of the final judgments to the public.[137] Despite anticipatory fanfare of a "complete ban" on spinning, the final judgments of eight of the ten corporate defendants make no mention whatsoever of IPOs.[138] Indeed,

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up profits linked to the controversial Wall Street practice known as 'IPO spinning'"), *at* http://www.oag.state.ny.us/press/2003/may/may13b_03.html (last visited Feb. 26, 2004). Joseph P. Nacchio agreed to disgorge $400,000 of his spinning profits. Press Release, Office of the New York Attorney General Eliot Spitzer, Telecom Executive Agrees to Give Up IPO Profits (Oct. 9, 2003), *at* http://www.oag.state.ny.us/press/2003/oct/oct09a_03.html (last visited Feb. 26, 2004). Stephen Garofalo, former CEO of Metromedia Fiber Network, has agreed to disgorge $1.5 million of his spinning profits. Press Release, Office of the New York Attorney General Eliot Spitzer, Former Telecom Executive Agrees to Turn Over IPO Profits (Dec. 4, 2003), *at* http://www.oag.state.ny.us/press/2003/dec/dec04b_03.html (last visited Feb. 26, 2004). As of December 2003, no settlements had yet been reached in the suits against Bernard Ebbers or Clark McLeod. *Id.*

[134] Global Resolution Press Release, *supra* note 1.

[135] *Id.*

[136] *See* Randall Smith, *Will Investors Benefit from Wall Street's Split?*, WALL ST. J., Dec. 23, 2002, at C1. *But see* Gregory Zuckerman, *The Stock-Research Pact: Wall Street's Settlement Will Be Less Taxing*, WALL ST. J., Feb. 13, 2003, at C1 (suggesting that the fines portion will only amount to $450 million, with the balance consisting of tax-deductible restitution, education, and independent research payments). The SEC reports the following breakdown under the terms of the final judgments: $497 million in penalties; $397 million in disgorgment; $432.5 million to fund independent research; and $80 million for investor education. *See* Federal Court Approves Global Research Analyst Settlement, *supra* note 3.

[137] *See* Federal Court Approves Global Research Analyst Settlement, *supra* note 3.

[138] There is no mention of initial public offerings in the final judgments or

examination of SEC press releases exposes the reason for this apparent omission: "the firms have collectively entered into a *voluntary* agreement restricting allocations of securities in 'hot' IPOs."[139] Thus, only the two corporate defendants who were specifically charged with spinning—SSB and Credit Suisse First Boston ("CSFB")—received judgments placing restrictions on their future allocation of IPO shares.[140] But assuming all the defendants' good faith in adhering to the voluntary ban, SSB's final judgment, which does address IPOs, is emblematic of the type of restrictions that the defendants will face.[141] It contains two provisions specifically related to spinning. First, the judgment states that SSB[142] shall be

> permanently restrained and enjoined from violating Rule 2110 of the Conduct Rules of NASD, Inc. . . . and Rules 401 and 476 of the New York Stock Exchange, Inc. ["NYSE"] . . . by . . . giving preferential allocations of shares in initial public offerings to directors, officers, or executives of existing or potential investment banking clients.[143]

This provision is the crux of the global resolution's putative prohibition on spinning, striking at the very conduct that amounts to a spinning transaction. The second provision is essentially a monitoring guideline; it provides that SSB shall be

> permanently restrained and enjoined from violating NASD Rule 3010 and NYSE Rule 342 by failing to maintain appropriate supervisory procedures regarding or controls over the following

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addenda of the following eight corporate defendants: Bear Stearns; J.P. Morgan Securities; Lehman Brothers; Merrill Lynch; U.S. Bancorp Piper Jaffray; U.B.S. Warburg; Goldman Sachs; and Morgan Stanley. Links to each of the final judgments are available at http://sec.gov/litigation/litreleases/lr18438.htm.

[139] Donaldson, *Testimony*, *supra* note 110 (emphasis added).

[140] Close examination of SEC statements exposes the reason for this apparent omission: the putative ban on spinning is "voluntary." Donaldson, *Testimony*, *supra* note 110 (noting that "the firms have collectively entered into a voluntary agreement restricting allocations of securities in 'hot' IPOs").

[141] CSFB's final judgment contains wording identical to that of SSB with respect to IPOs. *See* Final Judgment as to Defendant Credit Suisse First Boston LLC, f/k/a Credit Suisse First Boston Corporation at 2-4 (S.D.N.Y. Oct. 31, 2003), *available at* http://sec.gov/litigation/litreleases/judg18110.pdf (last visited Feb. 26, 2004); Final Judgment as to Defendant Citigroup Global Markets Inc., f/k/a Salomon Smith Barney Inc. at 3-4 (S.D.N.Y. Oct. 31, 2003) [hereinafter SSB Final Judgment], *available at* http://www.sec.gov/litigation/litreleases/judge18111.pdf (last visited Feb. 26, 2004). Thus, this Comment's treatment of the SSB settlement applies equally to that of CSFB.

[142] Or rather, "[SSB], [SSB's] officers, agents, servants, employees, attorneys, and all persons in active concert or participation with them who receive actual notice of this Final Judgment by personal service or otherwise." SSB Final Judgment, *supra* note 141, at 3.

[143] *Id.*

> that are reasonably designed to ensure compliance with securities laws and regulations: . . . its [SSB's] business activities relating to allocations of shares of initial public offerings.[144]

Although initial reaction to some of the global resolution's broader structural reforms has been mixed, a number of commentators have openly applauded its putative ban on spinning.[145]

Use of the "putative" qualifier is necessary because the question remains: Does the global resolution truly ban spinning? The answer, it seems, is not as clear as many commentators have supposed. Unremarkably, the SSB final judgment enjoins SSB from violating NASD Rule 2110 and NYSE Rules 401 and 476. Yet, none of these rules is new; all were in place at the time SSB was engaged in spinning; and violations of these rules have always been actionable.[146] Thus, it seems that the global resolution has added absolutely nothing by enjoining SSB from violating these rules. What is remarkable about the SSB final judgment's language, however, is its assertion that "giving preferential allocations of shares in initial public offerings to directors, officers, or executives of existing or potential investment banking clients"[147] amounts to a violation of these rules. These rules have not in the past been interpreted to preclude spinning;[148] indeed, when the SEC launched its initial investigation into spinning practices in the late 1990s, it closed its investigation without finding that any of these rules had been violated.[149]

It is also unclear what the New York Attorney General and the SEC meant by prohibiting "*preferential* allocations of shares in initial public offerings"[150] to corporate fiduciaries. Indeed, their deliberate use of the adjective "preferential" strongly suggests that they did not intend to preclude *all* allocations of IPO stock to corporate fiduciaries—only *preferential* allocations. But what exactly is a "preferential allocation"? Common sense and a plain reading of the

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[144] *Id.* at 4.

[145] *See, e.g.*, Editorial, *The Spitzer-Weill Stock Trade*, WALL ST. J., Dec. 23, 2002 (characterizing the overall agreement as largely ineffectual, but applauding the ban on spinning).

[146] For a list of all amendments to the NYSE rules since 1997, see the NYSE web page at www.nyse.com/regulation/p1020656068597.html?displayPage=%2F1022221392606.html.

[147] SSB Final Judgment, *supra* note 141, at 3.

[148] *See* Craig, *supra* note 119 (noting that neither the SEC nor the NASD had ever brought charges against a party for spinning).

[149] *See supra* notes 68-71 and accompanying text.

[150] SSB Final Judgment, *supra* note 141, at 3 (emphasis added).

text would suggest that it is an IPO allocation to a corporate fiduciary to whom the underwriter has given preference over some other potential recipient. But such could be said of all IPO allocations to a corporate fiduciary,[151] which then begs the question, why was the term "preferential" used at all? Similarly, when the vast majority of IPO allocations fall to institutional investors so that it is virtually impossible for individual investors ever to obtain IPO shares,[152] it would seem that any allocation of hot IPO shares to an individual investor would be by definition preferential. Thus, the true question is, preferential with respect to whom? This is a question that the language of the final judgment does not attempt to answer, and which ultimately may have to be addressed in future SEC regulations or hashed out in litigation.

It is therefore ironic that the New York Attorney General's press releases on the global resolution have spoken in such sanguine tones. They speak unabashedly of "[a] ban on IPO spinning," but in the very same sentence, state, "investment firms will no longer be allowed to allocate to officers or directors of public companies *preferential* access to valuable IPO shares of corporations from which they have sought or obtained investment banking business."[153] If the New York Attorney General's press releases are correct in declaring that the global resolution truly effectuates a ban on spinning, then the "preferential allocation" language of the final judgments should be read broadly to cover *all* IPO allocations to corporate fiduciaries, for anything less would not amount to a ban.[154] But, of course, press

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[151] Indeed, anytime a corporate fiduciary receives an IPO allocation when another investor does not could be seen as a "preferential allocation."

[152] *See supra* notes 57-58 and accompanying text; *supra* notes 96-97 and accompanying text.

[153] Press Release, Office of the New York Attorney General Eliot Spitzer, Statement by Attorney General Eliot Spitzer Regarding the "Global Resolution" of Wall Street Investigations (Apr. 28, 2003) (emphasis added), *at* http://www.oag.state.ny.us/press/statements/global_resolution.html (last visited Feb. 26, 2004).

[154] Some might argue that the final judgments do not seek to ban those IPO allocations to corporate fiduciaries in which the underwriter has no expectation of reciprocal investment banking business from the fiduciary's beneficiary. *See, e.g.*, *supra* notes 94-95, 103-07 and accompanying text. But this interpretation of the final judgments would simply recreate the spinning problem. Where an underwriter allocates shares of a hot IPO to a corporate officer, and that officer's corporation later decides to hire the underwriter for investment banking business, how is a court to determine whether there was a quid pro quo, or whether the transactions were merely coincidental? The parties, it is safe to say, will deny the existence of a quid pro quo. *See supra* note 103 and accompanying text. This, as will be seen, is the very problem that prevented successful prosecution of spinning under existing laws and regulations. *See infra* Parts IV.A, IV.B.

release language is not binding on a court's interpretation of a final judgement, and it is far more likely that the global resolution's true effect on the practice of spinning remains open to debate (or litigation).

Even assuming, *arguendo*, that the global settlement effectively forecloses the practice of spinning, it nevertheless binds only ten investment banks.[155] While it is true that these banks are some of the largest and most widely-recognized names in the business,[156] more than a few prominent banks have not signed on.[157] What is more, regional banks remain unaffected, causing some commentators to foresee a new "two-tier industry in which the regional firms that do not sign 'have a clear advantage' . . . ."[158] In addition, the global resolution would not bind newly-established underwriters who were not parties to it, and it remains to be seen whether the global resolution would reach spin-offs from existing banks who are parties to it.

PART IV: EXISTING ALTERNATIVES TO THE GLOBAL RESOLUTION

In light of these concerns over the global resolution's long-term efficacy, it is imperative that securities regulators have in place rules that will sustain an industry-wide ban on spinning. Indeed, many observers foresee this as the SEC's next step.[159] If these rules are truly to curtail spinning in the future, however, rule makers must consider

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[155] *See* Smith, *supra* note 136.

[156] The signatories are Bear Stearns & Co., Credit Suisse First Boston, U.S. Bancorp Piper Jaffray, Goldman Sachs, J.P. Morgan Chase & Co., Lehman Brothers, Merrill Lynch, Morgan Stanley, Salomon Smith Barney, and UBS Warburg. *See* Press Release, *supra* note 3.

[157] These include Legg Mason Inc., A.G. Edwards & Sons Inc., Raymond James Financial Inc., and a division of Mony Inc. Robert Julavits, *Will Street-Spitzer Deal Give Regionals an Edge?*, AM. BANKER, Dec. 30, 2002, at 7; *see* Elstein, *supra* note 7 (listing "prominent" IPOs anticipated for December 2003, and listing Banc of America and BB&T—both non-signatories to the global resolution—as among the underwriters).

[158] Julavits, *supra* note 157 (quoting Richard X. Bove, analyst with Hoefer & Arnett Inc.).

[159] *Id.* (quoting Richard Bove as saying, "It's now incumbent upon the Securities and Exchange Commission to straighten [concerns of a two-tier industry] out"). The same article reported that securities law professor Adam Pritchard believes the SEC's focus is now on implementing industry-wide regulations. *Id.* Law Professor David Ruder agreed that such regulatory action is necessary to prevent non-signatory banks from gaining an unfair advantage on signatories. *Id.* The SEC, for its part, has been more circumspect. *See* Donaldson, *Testimony*, *supra* note 110 (stating that "[t]he Commission intends to evaluate the need for specific rulemaking in this area, in light of these and other recent Commission enforcement actions that indicate abuses in the IPO allocation process").

how spinning escaped notice in the past. This Part examines existing regulations that have proven ineffective to prevent spinning in the past and suggests a model for drafting new regulations to ban spinning. It further examines common-law options for aggrieved shareholders and suggests that for such claims truly to be effective against spinning, courts must adopt a more aggressive stance with respect to finding the necessary quid pro quo. Finally, this Part examines an alternative to firm commitment underwriting, the Dutch auction, and explains how this fledgling offering technique obviates many of the inefficiencies that make spinning possible under firm commitment underwriting.

A. SEC, NASD, AND NYSE REGULATIONS

Prior to an IPO, the issuer must make certain disclosures pursuant to Regulation S-K, Item 508.[160] Item 508(a), in particular, requires that the issuer disclose the existence of any "material relationship" between the issuer and the underwriter and, further, to "state the nature of that relationship."[161] Given the Supreme Court's broad definition of materiality in *TSC Indus. v. Northway, Inc.*,[162] one might suppose that past allocations of hot IPO shares by the underwriter to the issuer's CEO would qualify as a material relationship. Commentators generally agree, however, that absent a specific quid pro quo arrangement between an underwriter and a corporate fiduciary, spinning does not create an Item 508(a) "material relationship."[163] Hence, Item 508(a), like commercial bribery statutes, fails for want of an explicit quid pro quo.[164]

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[160] Cross & Roberts, *supra* note 49, at 599; *see* 17 C.F.R. § 229.508a (2003).

[161] 17 C.F.R. § 229.508a (2003).

[162] 426 U.S. 438 (1976) (holding that for purposes of Rule 14a-9 liability, "an omitted fact is material if there is substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote" his or her proxy); *see* Dan Childers, *Securities Regulation—Sanders v. John Nuveen & Co., Inc.—Underwriter Liability Under Section 12(2) of the Securities Act of 1933*, 7 J. CORP. L. 157, 158 (1981) ("The language of *TSC Industries, Inc. v. Northway, Inc.*, stating that a fact is material if there is a 'substantial likelihood' that a reasonable person would think it important, is broad enough to allow courts a great deal of freedom in determining what facts are likely to affect a reasonable person.") (internal citation and footnote omitted).

[163] Cross & Roberts, *supra* note 49, at 599; *see* Maynard, *supra* note 22, at 2033.

[164] *See supra* notes 101-07 and accompanying text (discussing commercial bribery). Similarly, with respect to offerings made "through the selling efforts of brokers or dealers," Item 508(c)(2) requires disclosure of "the terms of any agreement, arrangement, or understanding" that the issuer or underwriter enters into with the brokers or dealers prior to the distribution. *See* 17 C.F.R. § 229.508(c)(2) (2003). Once again, the lack of an explicit quid pro quo generally means that the underwriter need not disclose the fact that a recipient of hot IPO shares is also the

Under the Securities Exchange Act of 1934, Rule 10b-5 might serve as a basis for spinning liability. The rule makes it unlawful for any person

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
> in connection with the purchase or sale of any security.[165]

Clearly spinning satisfies the "in connection with the purchase or sale of any security" element, but 10b-5 generally requires something more than a simple spinning transaction.[166] Consider, for example, the 1998 cease and desist action that the SEC brought against investment advisor Monetta Financial Services.[167] Monetta had received an allocation of hot IPO shares as a result of its past business with the underwriter.[168] It then redistributed these shares to the personal accounts of three directors of mutual funds for which Monetta provided investment counseling.[169] Neither Monetta nor the directors disclosed this transaction to the mutual funds' shareholders, and the SEC subsequently brought an action for nondisclosure of a material fact under 10b-5.[170] Ultimately, the SEC adjudged Monetta's president and the mutual fund directors liable under 10b-5, but only by finding that Monetta and the directors breached their fiduciary duties to the shareholders.[171]

Although a simple spinning transaction in the corporate context probably will not trigger 10b-5 liability, the experience of *Monetta* may suggest another potential source of liability under Rule 14a-9.[172] Rule

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CEO of a major client. Cross & Roberts, *supra* note 49, at 600.

[165] 17 C.F.R. § 240.10b-5 (2003).

[166] *See* Coffee, *supra* note 104 (discussing Rule 10b-5 and stating, "The simple truth is that investors are unlikely to consider commercial bribes paid to corporate executives to be material to their own investment decisions—or may even regard such information as bullish").

[167] *In re* Monetta Fin. Serv., Inc., 66 S.E.C. Docket 1221, 1998 WL 80239 (1998).

[168] *Id.* at *4.

[169] *Id.* Professor Coffee has pointed out that the funds were legally permitted to purchase the hot IPO shares for themselves, thus suggesting a cause of action for usurpation of corporate opportunity. Coffee, *supra* note 104.

[170] *In re Monetta*, 1998 WL 80239, at *5.

[171] *See In re* Monetta Fin. Serv., Inc., 72 S.E.C. Docket 77, 2000 WL 320457, at *15-17 (2000).

[172] 17 C.F.R. § 240.14a-9 (2003).

14a-9 generally prohibits management from making false or misleading statements or omitting to state material facts in communications to shareholders.[173] Alluding to *Monetta*, Professor John C. Coffee, Jr. has argued that "[i]f a mutual fund's shareholders have the right to know about such conflicts under Rule 10b-5 (as they should), so should the shareholders of a Silicon Valley corporation have a similar right under Rule 14a-9."[174] A search of federal securities cases and administrative decisions, however, turns up no decisions that have adopted this theory of liability.

The NASD has weighed in with its "Free-Riding and Withholding" interpretation of Rule 2110.[175] This rule places a number of limitations on the underwriter's discretion in allocating hot IPO shares; for example, it forbids the underwriter from keeping the shares for itself[176] or selling shares to employees or family members of employees.[177] It also prohibits IPO share distributions to any senior officer of another investment bank.[178] Although the last prohibition comes closest to addressing spinning, it ultimately does not foreclose spinning to corporate fiduciaries outside the financial services industry.[179] Yet, as noted above, this is the NASD rule that the New York Attorney General and the SEC have identified as being violated by "preferential allocations of shares in initial public offerings to [corporate fiduciaries] of existing or potential investment banking clients."[180] To be sure, nothing in the wording of Rule 2110 would lead one to that conclusion, and regulatory authorities have not historically interpreted it as such.

After the IPO scandal of the summer of 2002, the NASD unveiled its newest attempt at curbing spinning abuses: proposed rule 2712.[181] This rule would "expressly prohibit," among other activities, "the allocation of IPO shares to an executive officer or director of a company *on the condition that* the officer or director send the company's investment banking business to the [underwriter], or *as*

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[173] *Id.*

[174] Coffee, *supra* note 104.

[175] NASD Manual, *supra* note 50, at IM-2110-1.

[176] *Id.* at IM-2110-1(b)(1). This is withholding, as defined in note 50 and the accompanying text.

[177] *Id.* at IM-2110-1(b)(2).

[178] *Id.* at IM-2110-1(b)(4).

[179] *Id.*

[180] SSB Final Judgment, *supra* note 141, at 3; *see* text accompanying *supra* note 149.

[181] *See* NASD Requests Comment on Proposed New Rule 2712 (IPO Allocations and Distributions) and on an Amendment to Rule 2710 (Corporate Financing Rule); Comment Period Expires September 9, 2002, NASD Notice to Members 02-55 (Aug. 2002).

consideration for investment banking services previously rendered."[182] However, the proposed language incorporates the same quid pro quo element[183] that renders existing commercial bribery statutes ineffective against spinning.[184] Rule 2712 would likely still allow underwriters broad discretion to place hot IPO shares with executives of corporate clients.[185]

Like the NASD, the NYSE has also promulgated rules governing the conduct of its members. In the recent global resolution, the SEC identified two rules in particular as bearing on the issue of spinning. Rule 401 requires that all NYSE members adhere to "principles of good business practice" when transacting business.[186] Likewise, Rule 476(a)(6) prohibits conduct contrary to "just and equitable principles of trade."[187] Given their largely indefinite nature, it is difficult to conceive of either of these rules as forming the gravamen of a complaint for alleged spinning. Indeed, they stood as no obstacle to spinning in its heyday, and their chief value seems to be as make-weight provisions in a suit premised upon some other theory of liability.[188]

With the foregoing standing as examples of regulations that do not adequately prohibit spinning, what form should any future SEC regulation take? It is critical that any attempt by regulatory authorities to implement a ban on spinning across the industry must surmount the quid pro quo obstacle. The SEC might accomplish this by taking its example from New York's Martin Act.[189] The Martin Act confers broad enforcement power on the New York Attorney General to prosecute fraudulent sales of securities; critically, it does not

[182] *Id.* (emphasis added).

[183] Terms such as "on the condition that" and "as consideration for" fall within the ambit of a quid pro quo, defined as "a thing that is exchanged for another thing of more or less equal value." BLACK'S LAW DICTIONARY 1261 (7th ed. 1999).

[184] *See supra* notes 101-07 and accompanying text.

[185] *See* Letter from Kenneth L. Josselyn, Chair, Capital Markets Committee of the Securities Industry Association, to Barbara Z. Sweeney of the Office of Corporate Secretary of NASD 3 (Sept. 24, 2002) [hereinafter Josselyn Letter] (emphasizing that the proposed rule does not prohibit placement of IPO shares to a corporate executive except on the condition that the executive direct future underwriting business to the underwriter), *available at* http://www.sia.com/2002_comment_letters/pdf/ipo.pdf (last visited Feb. 26, 2004).

[186] 2 NYSE Guide (CCH) ¶ 2401.

[187] 2 NYSE Guide (CCH) ¶ 2476.

[188] See, for example, the final judgments in the global resolution, where the NYSE rules appear lumped together with NASD Rule 2110, the paramount rule for purposes of spinning. *See supra* text accompanying note 143.

[189] N.Y. GEN. BUS. LAW §§ 352, 352(c), 353, 353-a, 359(g) (McKinney 2002).

require the showing of a quid pro quo.[190] And, as recent experience has shown,[191] it is an effective weapon against spinning. But the SEC cannot content itself to rely on the Martin Act for all spinning enforcement. For one, only the New York Attorney General can enforce the Martin Act; the Act has no provision for a private right of action.[192] It is perhaps unrealistic to expect the New York Office of the Attorney General to be the sole sentinel against spinning.[193] Thus, the SEC should enact regulations with the flexibility and utility of the Martin Act, but which would allow the SEC, or even private attorneys general, to take enforcement action against spinning violations. This objective could be relatively simple to achieve: a regulation flatly forbidding an underwriter from allocating IPO shares to a corporate fiduciary in his or her personal capacity. To be sure, underwriters would likely chafe at such a prophylactic restriction on their otherwise broad discretion to allocate IPO shares.[194] Yet, the New York Attorney General's initial announcement of the global resolution promised just such a restriction, declaring, "Brokerage firms will not allocate lucrative IPO shares to corporate executives and directors who are in the position to greatly influence investment banking decisions."[195] This simple language promises what the final judgments and existing regulations cannot deliver: an

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[190] *See supra* note 124.

[191] *See supra* note 133.

[192] *See, e.g.*, CPC Int'l v. McKesson Corp., 514 N.E.2d 116, 118 (N.Y. 1987).

[193] Indeed, the New York Attorney General's recent enforcement efforts against spinning were included within a much broader campaign against analyst misconduct. *See, e.g.*, State Suit Seeks Repayment, *supra* note 78 (stating that enforcement efforts by the New York Attorney General against telecommunications executives who reaped spinning profits "grew out of a broad conflict of interest investigation into Wall Street brokerage firms"). But there is no reason why analyst misconduct must accompany spinning; spinning can occur on a much more modest scale, unaccompanied by the type of lurid analyst conduct that provoked the New York Attorney General's investigation. *See, e.g.*, Siconolfi, *supra* note 58, at A1 (describing the 1995 IPO of Pixar Animation Studios, which predated the analyst misconduct that provoked Attorney General Spitzer's recent Martin Act complaint); *see also* Complaint, *supra* note 125. Thus, one might fairly ask whether the New York Office of the Attorney General, faced with competing demands, will have the resources and interest to prosecute small-scale, plain-vanilla spinning transactions. It would seem more appropriate that such enforcement responsibility should fall upon an authority dedicated to the regulation of financial markets, namely, the SEC. *See* Deborah Solomon & Randall Smith, *Donaldson Asserts SEC Authority on Markets*, WALL ST. J., July 16, 2003, at C1 (describing efforts by the SEC to "retain its standing as the nation's top cop" in financial markets).

[194] *See, e.g.*, Josselyn Letter, *supra* note 185, at 3 ("Broker-dealers built on a full service model aspire to offer brokerage services to all employees of companies with whom they do business.").

[195] Global Resolution Press Release, *supra* note 1.

absolute ban on spinning that does not rely on formal proof of a quid pro quo.

B. *COMMON-LAW ALTERNATIVES FOR AGGRIEVED SHAREHOLDERS*

1. The Corporate Opportunity Doctrine.

In a May 2002 article published in the *William and Mary Law Review*, Professor Therese H. Maynard recounted the story of Joseph Cayre, the former CEO of GT Software Interactive, who in 1995 realized a $2 million profit on shares he held in the IPO of Pixar Animation Studios.[196] Professor Maynard pointed to the unfavorable media coverage that followed this and similar transactions, arguing that a director or officer who trades in spun IPO shares subverts the public's "legitimate expectations . . . as to acceptable standards of business ethics."[197] She urged courts to adopt and enforce a robust view of fiduciary duties that would require the director or officer who receives spun IPO shares to disclose this fact to the board before the board selects an underwriter for its own IPO or investment banking business.[198] But, as Professor Maynard subtly conceded, such after-the-fact disclosures do little to prevent the occurrence of spinning in the first place.[199] Thus, to prevent spinning, Professor Maynard called for courts more rigorously to apply the common-law doctrine of corporate opportunity, as articulated by the Delaware state courts.[200]

In light of the recent agreements on spinning, one might believe initially that Professor Maynard's argument no longer bears any relevance to the retail investor. However, state fiduciary duty law may yet play a role in the spinning saga. Even if the recent global resolution proves effective in stemming the tide of spinning, it provides little consolation to aggrieved investors who lost their savings in 2000 and 2001 thanks, in large part, to the mismanagement of those who profited from spinning in 1998 and 1999. One must assume, for example, that WorldCom stockholders and bankruptcy trustees would gladly accept an opportunity to recover, through legal action, the $11 million in personal profits that CEO Bernard Ebbers

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[196] Maynard, *supra* note 22, at 2025-26; *see supra* notes 69-70 and accompanying text.

[197] Maynard, *supra* note 22, at 2061-62.

[198] *Id.* at 2061.

[199] *Id.* at 2064.

[200] *Id.* at 2079.

made on spinning transactions between 1998 and 2002.[201]

Furthermore, the "global" settlement is much less ambitious than its name implies, binding only ten brokerage firms.[202] It is not clear that those brokerages not bound by the agreement are currently under any obligation to curtail their spinning practices.[203] For those investment banks that are bound, it remains to be seen how well the final agreed-upon language will foreclose all of the variations on spinning that flourished in the late 1990s.[204] In view of these caveats, potential litigants may yet find a review of state fiduciary duty law profitable.[205]

* * *

In its broadest sense, the corporate opportunity doctrine seeks to prevent a corporate fiduciary from usurping an opportunity for his or her own personal benefit that properly belongs to the corporate beneficiary.[206] Such a "corporate opportunity" will constitute an asset of the corporation as against corporate fiduciaries.[207] A fiduciary who improperly usurps a corporate opportunity holds any resulting profits in constructive trust for the benefit of the corporation.[208]

Along with interested director transactions,[209] the corporate opportunity doctrine is a subset of a director's broader duty of loyalty to the corporation.[210] Unlike interested director transactions, however, which are now generally governed by state statutes,[211] the

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[201] *See* Smith, *supra* note 136 (noting that the details of the settlement "may be fodder for private lawsuits and arbitration cases by investors who lost money in the market bubble").

[202] *See supra* note 155 and accompanying text.

[203] *See* Julavits, *supra* note 157.

[204] *See supra* Part III.

[205] *See* Julavits, *supra* note 157 (quoting Seth Taube of the law firm of McCarter & English as noting that the threat of investor litigation will ultimately compel those firms who did not participate in the settlement to undertake many of the same reforms).

[206] *See* Note, *Corporate Opportunity*, 74 HARV. L. REV. 765, 765 (1961).

[207] Victor Brudney & Robert Charles Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 999 (1981).

[208] 3 FLETCHER CYC. CORP. § 861.50 (2002).

[209] Eric G. Orlinsky, *Corporate Opportunity Doctrine and Interested Director Transactions: A Framework for Analysis in an Attempt to Restore Predictability*, 24 DEL. J. CORP. L. 451, 463 (1999) ("[A]n interested director transaction occurs when a director transacts business with the corporation and by the terms of the transaction takes advantage of the corporation."). By definition, spinning arises between the director and a third-party underwriter, rather than between the director and the corporation. *See supra* note 63 and accompanying text. Interested director transactions are therefore beyond the scope of this Comment.

[210] Orlinsky, *supra* note 209, at 453.

[211] *Id.* at 453 n.5 (noting that forty-eight states have enacted interested director

corporate opportunity doctrine remains uncodified in every state but one.[212] Perhaps owing in part to this common-law character, the doctrine has historically defied precise definition, with two commentators characterizing it as being "among the least satisfactory limbs of doctrine in the corpus of corporate law."[213] Nevertheless, state courts have created several tests to guide their analysis in determining whether an opportunity properly belongs to the corporation.[214]

The earliest expression of the doctrine is known as the "interest or expectancy" test, arising from the 1900 Alabama Supreme Court decision of *Lagarde v. Anniston Lime & Stone Co.*[215] This test lives on in some states, but only in narrowly defined instances in which the corporation has some previously established right or interest in the opportunity.[216] For example, in *Lagarde*, the corporation had been leasing land for its mining operations and had negotiated a contract to purchase a two-thirds interest in this land, when several of the directors purchased a full interest in the same land for their own competing enterprise.[217] Construing the directors' fiduciary duties to the corporation very narrowly, the court held that the corporation had a "reasonable expectancy" in the two-thirds interest, but not the remaining one-third interest.[218] Thus, the directors had improperly usurped a corporate opportunity.[219] As to the one-third interest that the corporation had not negotiated to purchase, the court found no usurpation of corporate opportunity, noting "[g]ood faith to the

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statutes and providing statutory citations).

[212] *Id.* ("Curiously, no state has yet adopted a statute designed to provide guidance or a safe harbor for corporate opportunities."). The North Carolina Legislature has, in fact, codified the doctrine of corporate opportunity at N.C. GEN. STAT. § 55-8-31 (2003). *See* Meiselman v. Meiselman, 307 S.E.2d 551 (N.C. 1983) (citing the predecessor to N.C. GEN. STAT. § 55-8-31).

[213] Brudney & Clark, *supra* note 207, at 998. The corporate opportunity doctrine does not appear to have achieved any greater degree of precision in other common-law jurisdictions. *See, e.g.*, Lisa Peters, *Corporate Opportunity—A Primer* 2 (2001) (noting that "[t]here is no accepted statement of the doctrine"), *at* http://www.lawsonlundell.com/resources/CorporateOpportunityPaper.pdf (last visited Feb. 26, 2004). The primer goes on to note a similar lack of precision in Canada and Australia. *Id.* at 4.

[214] *See, e.g.*, Matthew G. Dore, *The Duties and Liabilities of an Iowa Corporate Director*, 50 DRAKE L. REV. 207, 258 (2002) (citing five tests in American jurisprudence).

[215] 28 So. 199 (Ala. 1900).

[216] *See* MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 492 (concise 8th ed. 2000) ("Insofar as the meaning of the *Lagarde* test can be determined, it is unduly narrow.").

[217] *Lagarde*, 28 So. at 200.

[218] *Id.* at 201.

[219] *Id.*

corporation does not require of its officers that they steer from their own use to the corporation's benefit, enterprises, or investments which, though capable of profit to the corporation, have in no way become subjects of their trust or duty."[220]

Addressing the need for a broader construction of corporate opportunity, the Delaware Supreme Court formulated the next, and arguably the most important, test in its 1939 decision of *Guth v. Loft, Inc.*[221] Guth was President of Loft, Inc., a candy and soda distributor.[222] He also owned a soda distribution company, Grace, on the side.[223] At the same time that Loft was searching for a cheaper alternative to Coca-Cola, Guth and a business associate purchased the Pepsi secret formula and trademark.[224] Because he was short on funds, Guth tapped into Loft's resources by directing Loft's chemist to prepare the Pepsi concentrate for shipment to Grace.[225] Grace then added sugar and water, and sold the syrup back to Loft at a considerable profit.[226] Guth also utilized Loft's money and credit to further the Pepsi venture and caused Loft to pay the settlement in a breach of contract suit between Guth and his partner in the Pepsi enterprise.[227] Loft's shareholders subsequently brought suit against Guth, and the trial court found that Guth had improperly usurped corporate opportunities belonging to Loft when he purchased the Pepsi formula and trademark, and again when he tapped into Loft's assets to fund the Pepsi enterprise.[228] The Delaware Supreme Court affirmed, applying what would come to be known as the "line of business" test. Broadly, the line of business test states that a director or officer may not take advantage of any opportunity which lies within the ambit of the corporation's existing or prospective business activities.[229] Specifically, the Delaware high court wrote:

> Where a corporation is engaged in a certain business, and an opportunity is presented to it embracing an activity as to which it has fundamental knowledge, practical experience and ability to pursue, which, logically and naturally, is adaptable to its business having regard for its financial position, and is one that is

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[220] *Id.* at 202.
[221] Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939).
[222] *Id.* at 505.
[223] *Id.*
[224] *Id.* at 505-06.
[225] *Id.* at 506.
[226] *Id.*
[227] *Guth*, 5 A.2d at 507.
[228] *Id.* at 507-08.
[229] *See* Orlinsky, *supra* note 209, at 459-60.

> consonant with its reasonable needs and aspirations for expansion, it may be properly said that the opportunity is in the line of the corporation's business.[230]

Many state courts have adopted a modified, or expanded, version of the line of business test that combines the *Guth* line of business test with the *Lagarde* interest or expectancy test.[231] One commentator, by way of example, has represented the test employed by Iowa courts thus:

> [I]f there is presented to a corporate . . . director a business opportunity which [1] the corporation is financially able to undertake, [2] is, from its nature, in the line of the corporation's business and is of practical advantage of it, [3] is one in which the corporation has an interest or a reasonable expectancy, and [4] by embracing the opportunity, the self-interest of the . . . director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.[232]

Whether this is in fact an expansion of the *Guth* line of business test is questionable, however, as the *Guth* ruling seemed to imply inclusion of the interest or expectancy test.[233]

In 1948, the Massachusetts Supreme Judicial Court proposed a third, equity-based test known as the "fundamental fairness test" in the case of *Durfee v. Durfee & Canning, Inc.*[234] Canning, a director of Durfee & Canning, also secretly controlled the Pacific Gas Corporation.[235] Between 1942 and 1944, Canning caused Durfee & Canning to purchase large quantities of "natural gasoline" from Pacific Gas at a substantial markup.[236] Upon learning of Canning's secret profit, Durfee & Canning's shareholders sued Canning, alleging breach of duty of loyalty to the corporation and seeking restitution.[237] Canning argued that Durfee & Canning had no interest

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[230] *Guth*, 5 A.2d at 514.

[231] *See, e.g.*, Southeast Consultants, Inc. v. McCrary Eng'g Corp., 273 S.E.2d 112, 117 (Ga. 1980) (discussing the "expanded 'line of business' test"); Dore, *supra* note 214, at 259 (describing the "modified" line of business test that Iowa courts apply).

[232] Dore, *supra* note 214, at 259 (quoting Lange v. Lange, 520 N.W.2d 113, 120 (Iowa 1994)). It must be noted, however, that *Lange* quotes this very language from *Schildberg Rock Prods. Co. v. Brooks*, 140 N.W.2d 132, 137 (1966), which in turn quotes it from *Guth*, 5 A.2d at 511.

[233] *See Guth*, 5 A.2d at 510-11 ("It is true that when a business opportunity . . . *is one in which* [the corporation] *has no interest or expectancy*, the officer or director is entitled to treat the opportunity as his own . . . .") (emphasis added).

[234] 80 N.E.2d 522 (Mass. 1948).

[235] *Id.* at 526. Canning had transferred all stock in Pacific Gas to his wife and daughter. *Id.*

[236] *Id.*

[237] *Id.* at 527.

or expectancy in the gasoline,[238] but the court expressly rejected the interest or expectancy test, writing:

> [T]he true basis of the governing doctrine rests fundamentally on the unfairness in the particular circumstances of a director, whose relation to the corporation is fiduciary, "taking advantage of an opportunity [for his personal profit] when the interests of the corporation justly call for protection. This calls for the application of ethical standards of what is fair and equitable [in] particular sets of facts."[239]

Applying this fairness standard, the court found Canning liable on the grounds that "Durfee & Canning was entitled to have the defendant as a director use his best skill in forwarding the interests of that corporation, and to refrain from making the secret undisclosed profit in question at its expense."[240] Recently, the Massachusetts Supreme Judicial Court reaffirmed the fundamental fairness test,[241] and courts in Alaska,[242] New Hampshire,[243] and North Carolina[244] have taken similar approaches.[245]

In the 1974 case of *Miller v. Miller*,[246] the Minnesota Supreme Court applied a novel two-prong test, combining the line of business test with the fundamental fairness test "[i]n an effort hopefully to ameliorate the often-expressed criticism that the doctrine is vague and subjects today's corporate management to the danger of

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[238] *Id.*

[239] *Id.* at 529 (quoting BALLANTINE ON CORPORATIONS 204-05 (rev. ed. 1946)).

[240] *Durfee*, 80 N.E.2d at 529.

[241] *See* Demoulas v. Demoulas Supermarkets, Inc., 677 N.E.2d 159, 180 (Mass. 1997).

[242] Alvest Inc. v. Superior Oil Corp., 398 P.2d 213, 215 (Alaska 1965).

[243] Rosenblum v. Judson Eng'g Corp., 109 A.2d 558, 562 (N.H. 1954).

[244] Meiselman v. Meiselman, 307 S.E.2d 551, 567-69 (N.C. 1983). North Carolina presents an interesting case study because its corporate opportunity doctrine is statutory. *See* N.C. GEN. STAT. § 55-8-31 (2003). The *Meiselman* court, interpreting the predecessor statute to N.C. GEN. STAT. § 55-8-31, ruled that a fiduciary charged with usurping a corporate opportunity bears the burden of showing that his or her actions were "just and reasonable" to the corporation, and that the corporation would not have wanted the opportunity for itself. *Meiselman*, 307 S.E.2d at 569.

[245] A number of commentators would include Maryland in this category. *See* 3 FLETCHER CYC. CORP. § 861.40 n.2 (2002) (citing Indep. Distributors, Inc. v. Katz, 637 A.2d 886 (Md. Ct. Spec. App. 1994)); Orlinsky, *supra* note 209, at 485-86 (discussing *Katz*). A subsequent decision by the Maryland Court of Special Appeals, however, states unequivocally that Maryland courts follow the interest or expectancy test. *See* Shapiro v. Greenfield, 764 A.2d 270, 278 (Md. Ct. Spec. App. 2000) ("In determining whether an opportunity is a corporate opportunity, Maryland follows the 'interest or reasonable expectancy' test.").

[246] 222 N.W.2d 71 (Minn. 1974).

unpredictable liability . . . ."[247] *Miller* was a shareholder derivative suit against the directors of Miller Waste, a waste packing business.[248] During World War II, in order to meet the government's specific requirements for "packing and wiping waste," the defendants organized a side business which purchased waste from Miller Waste, processed it, and sold it back at a modest profit.[249] In the years following the war, defendants started a number of additional side businesses, with each business renting property from Miller Waste at higher than market rentals and purchasing materials from Miller Waste at better than fair market price.[250] At trial, the court noted that although the market for its products had declined since World War II, these rentals and purchases ensured a steady increase in Miller Waste's net income.[251] Nevertheless, plaintiffs alleged that creation of these side businesses represented a usurpation of opportunities belonging to Miller Waste.[252] Applying its novel twofold test, the Minnesota Supreme Court disagreed. The first prong of the *Miller* test inquires whether there was a corporate opportunity, as defined by a flexible application of the *Guth* line of business test.[253] If satisfied, the court then considers whether the fiduciary's appropriation of the opportunity violated equitable standards of ethics.[254] In *Miller*, the court found that the trial court did not err in finding that defendant's side businesses were not within Miller Waste's line of business as defined by *Guth*.[255] Additionally, the court found that the defendants had acted in fairness and good faith and did not violate their duty of loyalty to Miller Waste.[256] Numerous courts, however, have criticized the *Miller* approach for failing to bring precision and predictability to the corporate opportunity doctrine, arguing that *Miller* instead compounds the vagueness of the line of business test with the unpredictability of the fairness test.[257] Therefore, in addition to Minnesota, only Georgia[258] and Wisconsin[259]

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[247] *Id.* at 81.
[248] *Id.* at 72-73.
[249] *Id.* at 74-75.
[250] *Id.* at 77.
[251] *Id.*
[252] *Miller*, 222 N.W.2d at 78.
[253] *Id.* at 81.
[254] *Id.*
[255] *Id.* at 82.
[256] *Id.* at 83.
[257] *See, e.g.*, Northeast Harbor Golf Club v. Harris, 661 A.2d 1146, 1150 (Me. 1995).
[258] Southeast Consultants, Inc. v. McCrary Eng'g Corp., 273 S.E.2d 112, 117 (Ga. 1980) (limiting the *Miller* approach to current fiduciaries only, while reserving the

have expressly followed *Miller*.

The most recent variation on the corporate opportunity doctrine is the ALI test, so-named because it forms part of the American Law Institute's Principles of Corporate Governance.[260] Under the ALI test, a corporate opportunity may arise in one of three scenarios: (1) where a director or officer learns of an opportunity through his or her position with the corporation, or under circumstances that reasonably should cause the director or officer to believe that the opportunity was intended for the corporation; (2) where a director or officer learns of the opportunity through use of corporate assets; or (3) where a senior officer learns of an opportunity closely related to the corporation's existing or prospective business.[261] If an opportunity qualifies under one of the above circumstances, a director or officer may not take the corporate opportunity for himself without first disclosing the pertinent facts of the opportunity to the board and securing the approval of a majority of the disinterested board members.[262] Currently, courts in just three states have adopted the ALI approach.[263]

Leading decisions in a plurality of the states,[264] most notably

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interest and expectancy test for former fiduciaries).

[259] Racine v. Weisflog, 477 N.W.2d 326, 330 (Wis. Ct. App. 1990).

[260] AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE § 5.05 (1992).

[261] *Id.*

[262] *Id.*

[263] These states are Arizona (AMERCO v. Shoen, 907 P.2d 536 (Ariz. Ct. App. 1995)); Maine (Northeast Harbor Golf Club v. Harris, 725 A.2d 1018 (Me. 1999)); and Oregon (Klinicki v. Lundgren, 695 P.2d 906 (Or. 1985)). The Tennessee Court of Appeals has applied the ALI test on at least one occasion. *See* Tenn. Bearing & Supply, Inc. v. Parrish, App. No. 88-118-II, 1988 Tenn. App. LEXIS 724, at *6 (Tenn. Ct. App. Nov. 16, 1988). More recently, however, the Tennessee Court of Appeals has applied the line of business test. *See* Schwegman v. Howard, No. M2001-00845-COA-R3-CV, 2002 WL 31247084, at *5 (Tenn. Ct. App. Oct. 8, 2002).

[264] A survey of state case law reveals at least seventeen states whose leading decision employs some variation of the line of business test. *See* Morad v. Coupounas, 361 So. 2d 6 (Ala. 1978); Ostrowski v. Avery, 703 A.2d 117 (Conn. 1997); Broz v. Cellular Info. Sys., Inc., 673 A.2d 148 (Del. 1996); Cohen v. Hattaway, 595 So. 2d 105 (Fla. Dist. Ct. App. 1992); Lussier v. Mau-Van Dev., Inc., 667 P.2d 804 (Haw. Ct. App. 1983); Jenkins v. Jenkins, 64 P.3d 953 (Idaho 2003); Kirtley v. McClelland, 562 N.E.2d 27 (Ind. Ct. App. 1990); Lange v. Lange, 520 N.W.2d 113 (Iowa 1994); Urban J. Alexander Co. v. Trinkle, 224 S.W.2d 923 (Ky. 1949); SCD Chem. Distrib., Inc. v. Medley, 512 N.W.2d 86 (Mich. Ct. App. 1994); Hill. v. Southeastern Floor Covering Co., 596 So. 2d 874 (Miss. 1992); Chem. Dynamics, Inc. v. Newfeld, 728 S.W.2d 590 (Mo. Ct. App. 1987); Grato v. Grato, 639 A.2d 390 (N.J. Super. Ct. App. Div. 1994); Prodan v. Hemeyer, 610 N.E.2d 600 (Ohio Ct. App. 1992); A. Teixeira & Co. v. Teixeira, 699 A.2d 1383 (R.I. 1997); Schwegman v. Howard, No. M2001-00845-COA-R3-CV, 2002 WL 31247084, at *5 (Tenn. Ct. App. Oct. 8, 2002); Noble v. Lubrin, 60 P.3d 1224 (Wash. Ct. App. 2003).

Delaware, currently follow some form of the line of business test,[265] although many courts have struggled over how broadly to construe a corporation's line of business.[266] For instance, it is not immediately clear that the purchase of securities falls within a corporation's line of business.[267] Some courts have held that a director or officer who purchases shares of outstanding stock in the corporation may be liable for usurpation of an opportunity properly belonging to the corporation.[268] By contrast, some courts have declined to find liability under similar facts.[269] Most legal authorities draw a distinction between a director or officer purchasing stock in the corporation as opposed to purchasing stock in outside investment opportunities,[270] although many large corporations do regularly invest corporate funds in equities markets.[271]

The Delaware Supreme Court has recently provided some guidance with its 1996 decision of *Broz v. Cellular Information Systems, Inc.*[272] Reaffirming the basic principle underlying the *Guth* line of business test, the court elucidated several factors which must be

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[265] *Accord* PAT K. CHEW, DIRECTORS' AND OFFICERS' LIABILITY 99 (1994) ("The most widely used test is the line of business test, as described in *Guth v. Loft, Inc.*").

[266] *See, e.g.*, Northeast Harbor Golf Club, Inc. v. Harris, 661 A.2d 1146, 1149 (Me. 1995) (noting that "the question whether a particular activity is within a corporation's line of business is conceptually difficult to answer").

[267] *See generally* Annotation, *Purchase of Shares of Corporation by Director or Officer as Usurpation of "Corporate Opportunity,"* 16 A.L.R. 4th 784 (1982).

[268] *See, e.g.*, Farclas v. City Vending Co., 194 A.2d 298 (Md. 1963) (finding liability where the corporation has declared a policy to buy back outstanding stock); Kelly v. 74 & 76 W. Tremont Ave. Corp., 146 N.E.2d 795 (N.Y. 1956) (finding liability where president, whose job it was to negotiate corporate buy back of stock, acquired shares for himself at a time when the corporation did not have sufficient capital to do so itself); Lash v. Lash Furniture Co., 296 A.2d 207 (Vt. 1972) (finding liability where director voted at a board meeting to reject the opportunity to buy back stock but later purchased it for himself).

[269] *See, e.g.*, Northwestern Terra Cotta Corp. v. Wilson, 219 N.E.2d 860 (Ill. Ct. App. 1966) (declining to find liability where director had purchased, for $7 per share, shares for which the corporation had previously bid $5 per share); Zidell v. Zidell, Inc., 560 P.2d 1091 (Or. 1977) (declining to find liability where plaintiff shareholder failed to prove that corporation had contemplated purchasing stock or had done so in the past).

[270] *See, e.g.*, Recent Case, *Director's Liability Broadened to Include Usurpation of Opportunity Merely Advantageous to Investment Trust*, 104 U. PA. L. REV. 424, 426 (1955) (noting that a decision to hold the director of an investment trust liable for usurpation of corporate opportunity when he purchased for himself outside patent rights represented an extension of the traditional doctrine that "merely advantageous" investment opportunities were not corporate opportunities).

[271] *See, e.g.*, MCLEODUSA, INC., 2000 ANNUAL REPORT F-3, F-12 (2002) (describing a $64.7 million "investment in available-for-sale securities" in 2000 and a $934.1 million investment in liquid securities in 1999).

[272] 673 A.2d 148 (Del. 1996).

satisfied for an opportunity to qualify as a corporate opportunity:

> (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.[273]

But even where a corporate opportunity exists, a corporate fiduciary may take the opportunity as his or her own if

> (1) the opportunity is presented to the director or officer in his individual and not his corporate capacity; (2) the opportunity is not essential to the corporation; (3) the corporation holds no interest or expectancy in the opportunity; and (4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity.[274]

In her recent article, Professor Maynard suggested that the *Broz* factors translate to the spinning context with little difficulty.[275] Specifically, she argued that a trier of fact could find that the allocation of hot IPO shares to a CEO's personal trading account was a result of the CEO's position in a company known widely within the investment banking community to be a significant consumer of financial services.[276] Although conceding that investing in a hot IPO is probably not essential to the corporation,[277] Professor Maynard did argue that the corporation's interest in the opportunity trumps that of the corporate fiduciary, since the corporation ultimately will be the consumer of subsequent investment banking business.[278] Thus, a trier of fact "balancing the equities of [the] individual case"[279] could reasonably find a corporate fiduciary's spinning transaction to be a usurpation of corporate opportunity under the *Broz* line of business analysis.[280]

Professor Maynard's analysis certainly bears merit, but its greatest weakness lies in the need for a trier of fact to find what essentially amounts to a quid pro quo. Specifically, the jury must find that the recipient of the hot IPO shares received those shares

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[273] *Id.* at 155.

[274] *Id.*

[275] Maynard, *supra* note 22, at 2078 (noting that the *Broz* decision is "quite helpful" in the spinning context).

[276] *Id.* at 2079-80.

[277] *Id.* at 2080.

[278] *Id.* at 2081.

[279] *Broz*, 673 A.2d at 155.

[280] Maynard, *supra* note 22, at 2081.

precisely *because* he or she was a fiduciary of a potential corporate client—not because he or she, in an individual capacity, was a favored client of the underwriter. Thus, using the Joseph Cayre example mentioned earlier, Professor Maynard asserts that "[b]ecause the opportunity came to Mr. Cayre as a result of his position within the company, this is powerful evidence that this investment opportunity constituted a corporate opportunity."[281] But this assumes that the opportunity did in fact devolve to Mr. Cayre because he was the CEO of GT Software Interactive. Certainly, however, Mr. Cayre would argue in litigation that he received the opportunity in his individual capacity as a wealthy investor and potential customer of the underwriter.[282] Professor Maynard suggests that a trier of fact "balancing the equities of an individual case" could surmount this obstacle.[283] This may indeed pose a lower hurdle than formal proof of a quid pro quo under a commercial bribery statute,[284] but it nevertheless suggests a loophole through which spinning could slip unabated.

2. Agency Principles.

One may also think of spinning as a type of kickback.[285] This characterization is particularly apt in light of a variation on spinning that CSFB allegedly practiced. In early 2002, the SEC and NASD charged CSFB with underpricing IPOs and allocating shares to select hedge funds.[286] The hedge funds would then flip the shares in the aftermarket and pay a percentage of the resulting profits back to CSFB through inflated commissions on unrelated stock trades.[287] CSFB ultimately settled the charges and paid a $100 million fine without admitting any wrongdoing.[288] Nevertheless, the scenario

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[281] *Id.* at 2079-80.

[282] *See* Siconolfi, *supra* note 58, at A1 (recounting how Sanford Robertson, principal of the underwriter that allocated Pixar IPO shares to Mr. Cayre in 1995—an allocation that generated a $2 million profit for Mr. Cayre—claimed that the underwriter had made the allocation because Mr. Cayre was a "very, very good client").

[283] Maynard, *supra* note 22, at 2081 (internal quotation marks omitted).

[284] *See supra* notes 101-07 and accompanying text.

[285] *See* Letters to the Editor, *supra* note 122 ("It is obvious that spin shares amount to a high-tech pre-emptive kick-back at best . . . .").

[286] *See* Smith & Pulliam, *supra* note 80. A hedge fund is "[a] specialized investment group—usu. organized as a limited partnership or offshore investment company—that offers the possibility of high returns through risky techniques such as selling short or buying derivatives." BLACK'S LAW DICTIONARY 727 (7th ed. 1999).

[287] Smith & Pulliam, *supra* note 80.

[288] *Id.*

vividly illustrates a kickback in practice.[289]

In the CSFB example, the hedge funds allegedly paid the kickback to the underwriter. But a kickback may also occur when an agent of the principal receives secret remuneration. The Maryland Court of Appeals decision in *Green v. H & R Block, Inc.*[290] illustrates this concept. Green was a taxpayer who solicited H & R Block ("Block") to prepare her taxes.[291] She elected to take advantage of Block's "Rapid Anticipation Loan" program, whereby Block would arrange for her to receive a loan from a third-party lender in the amount of her anticipated tax refund.[292] Block, however, neglected to disclose that it received a fee, or "kickback," from the lender for each loan the lender made as a result of Block's referral.[293] Thus, Green sued Block for breaching its fiduciary obligations to its customers by failing to disclose its secret profit.[294]

The court found that Block was Green's agent for purposes of preparing Green's taxes.[295] Accordingly, fiduciary duty law required that Block disclose the side payments it received from the lender.[296] Because it failed to make the necessary disclosures, allowing its customers reasonably to believe that it was acting as their "broker" in securing the most favorable loan terms,[297] Block breached its fiduciary duty to Green.[298] Moreover, the court noted that where the agent breaches its principal-agent relationship, it is not necessary for the principal to allege that she had suffered actual harm.[299]

As it turns out, the *Green* analysis translates well to the standard spinning context. Just as the court found that Green was the principal and Block the agent, so too is a CEO an agent of the

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[289] *See* Coffee, *supra* note 30 (arguing that this general scenario involves an illegal side payment that rises to the level of a commercial bribe).

[290] 735 A.2d 1039 (Md. 1999).

[291] *Id.* at 1043-44.

[292] *Id.* at 1044.

[293] *Id.* at 1045.

[294] *Id.* Green was actually the named plaintiff in a class representing all of Block's Maryland customers. *Id.* at 1043.

[295] *Id.* at 1049.

[296] *Green*, 735 A.2d at 1056.

[297] *Id.* at 1054.

[298] *Id.* at 1057.

[299] *Id.* (quoting *Mechem Outlines Agency* as stating, "It makes no difference that the principal has not been injured, or that the agent has given him as good terms as anybody would, or even perhaps better terms, or that the sale or purchase has been at the price fixed by the principal; or that there was no bad faith or intention to defraud . . . .").

corporate principal.[300] And just as Block owed to Green a duty to disclose any side profits it received arising from the scope of its agency, the CEO must also disclose to the board any profits it receives within the scope of agency.[301] But herein lies the problem, for it is not immediately evident that a CEO who receives a hot IPO allocation does so in his or her capacity as an agent of the corporation. Indeed, most CEOs would argue that they received the shares in their capacity as an individual investor (who just happened also to be a corporate fiduciary). On the other hand, a large body of circumstantial evidence suggests that a reasonable jury could indeed find that the CEO received a personal allocation of hot IPO shares in his or her capacity as a corporate decision maker.[302] The inaccessibility of hot IPO shares to ordinary retail investors, coupled with the free availability of these same shares to certain individuals, such as WorldCom and Qwest executives, adds weight to this argument.

C. THE DUTCH AUCTION APPROACH TO INITIAL PUBLIC OFFERINGS AS AN ALTERNATIVE TO FIRM COMMITTMENT UNDERWRITING

This Comment has described a species of underwriting commonly known as the "firm commitment" method[303] and has explained how unscrupulous participants may abuse this method to perpetrate the practice of spinning. Firm commitment underwriting is only one of several possible offering methods,[304] however, and some commentators of late have questioned whether it is truly the best one.[305] One alternative in particular, the "Dutch auction" method,

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[300] *See* JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS § 8.01, at 117 (2003) ("The officers of a corporation are in legal theory the agents of the corporation."); 2 FLETCHER CYC. CORP. § 266 (1998) (distinguishing between officers and "mere agents," but stating that officers do have agent status).

[301] 3 FLETCHER CYC. CORP. § 884 (2002) (stating that directors and officers "cannot, either directly or indirectly, in their dealings on behalf of the corporation with others, or in any other transaction in which they are under a duty to guard the interests of the corporation, make any profit, or acquire any other personal benefit or advantage, not also enjoyed by the other shareholders").

[302] *See, e.g.*, Mills, *supra* note 36, at H1 (admitting that some investors get hot IPO shares "as a kind of favor, to get them to continue doing more long-term business with Merrill [Lynch]").

[303] *See supra* notes 29, 31.

[304] *See generally* 1 LOSS & SELIGMAN, *supra* note 31, at 322-85 (describing strict underwriting, firm commitment underwriting, best efforts underwriting, competitive bidding, and shelf registration).

[305] William R. Hambecht, principal of W.R. Hambrecht & Co., has been a vocal supporter of the Dutch auction method and currently offers the service through his

has garnered new interest in recent years[306] as a possible challenger to the more traditional—and arguably more abuse-prone—firm commitment method.

1. The Dutch Auction Defined.

The Dutch auction is an open bidding process in which the issuer announces its intention to offer a fixed quantity of shares and solicits bids from investors who are interested in participating.[307] Each potential investor submits a bid specifying how many shares he or she is willing to buy and at what price, and these bids become irrevocable and binding at the close of the bidding period.[308] At that time, the issuer will have received a range of bids, some offering to buy large quantities of shares at very low prices, and others offering high prices for just a few shares.[309] Next, the issuer will arrange the bids in descending order of price and will accept the highest bid first, then the next highest bid, and so forth.[310] Eventually, the issuer will arrive at the bid that depletes the shares in the offering.[311] This bid determines the "clearing price,"[312] which is the price that the accepted bidders will pay for their shares.[313] The issuer rejects all bids below the clearing price and accepts all higher bids at the clearing price.[314]

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firm. *See infra* note 341; *see also Auctioning New Issues*, *supra* note 43, at 1381 ("[C]orporations should be encouraged to experiment with securities auctions.").

[306] *See* McNamee, *supra* note 98 (discussing Hambrecht's Dutch auction method); Nick Wingfield, *Deals & Deal Makers: Hambrecht's IPO Method Is in Dutch*, WALL ST. J., July 31, 2002, at C1 (describing Hambrecht's method of conducting Dutch auctions via the Internet).

[307] *See* JAMES D. COX ET AL., SECURITIES REGULATION 218 (1997). Bidders may be individuals, institutional investors, or broker-dealers. *See* Exxon Corp., SEC No-Action Letter, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,171, at 88,006 (May 5, 1977) [hereinafter Exxon No-Action Letter].

[308] COX ET AL., *supra* note 307, at 218.

[309] Although most authorities on the subject do not expressly address such situations, it is theoretically possible that a bidder may bid a low price for a small number of shares, or a high price for a large number of shares. In the former instance, the bid will likely have no effect on the auction, as it will fall below the clearing price. *See infra* note 312. Conversely, the bidder in the latter situation can expect that its bid will be successful, as its bid likely will fall above the clearing price. *Id.*

[310] COX ET AL., *supra* note 307, at 218.

[311] *Id.*

[312] Wingfield, *supra* note 306, at C1 (stating that the "clearing price" is the highest price at which all of the shares in the offering may be sold).

[313] *Id.*

[314] *Id.* ("The lowest price accepted by the issuer through this process is the price paid by all the bidders whose bids were accepted through the process.").

The idea of using a Dutch auction for public offerings of corporate securities is a relatively recent idea in the United States.[315] A subsidiary of Exxon first drew attention to the method in 1977 when it proposed to issue debt securities (bonds) using a Dutch auction.[316] The SEC gave its blessing in the form of a no-action letter,[317] thus paving the way for the successful 1982 auction of $135 million in debentures.[318] Similar auctioning methods have enjoyed broader use in Great Britain in the form of "offers for sale by tender,"[319] as well as in France.[320]

2. Theoretical Justifications for the Dutch Auction IPO.

In the aftermath of recent IPO allocation scandals, the theoretical appeal of the Dutch auction method is obvious. First, the Dutch auction greatly simplifies the job of the underwriter,[321] to the extent the issuer even requires an underwriter at all. Some commentators have suggested, for example, that the issuer itself would be perfectly capable of soliciting and evaluating bids, perhaps by appealing directly to potential investors through advertising media.[322] Direct investor solicitation raises the specter of a registration violation,[323] so the issuer may still need an intermediary to communicate with individual investors.[324] Even so, the Dutch auction removes one of the underwriter's most time-consuming and error prone tasks, namely, valuation.[325] A 1996 Practicing Law Institute publication described firm commitment underwriting thus: "During

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[315] The U.S. Treasury, however, regularly auctions government securities. *See Auctioning New Issues*, *supra* note 43, at 1381, 1386 n.23.

[316] Exxon No-Action Letter, *supra* note 307; *see* COX ET AL., *supra* note 307, at 218.

[317] Exxon No-Action Letter, *supra* note 307.

[318] *See Auctioning New Issues*, *supra* note 43, at 1388 (stating that the auction obtained a better price than comparable Treasury securities).

[319] *Auctioning New Issues*, *supra* note 43, at 1389.

[320] *See* Benveniste & Busaba, *supra* note 37, at 385.

[321] *See Auctioning New Issues*, *supra* note 43, at 1389-90.

[322] *See, e.g.*, *id.* at 1391 ("[A]uctions bypass the process of negotiating the price with an underwriter and allow the issuer to poll the market directly to see what the securities are worth.").

[323] Specifically, § 5(b)(1) of the Securities Act of 1933 generally prohibits investor solicitation by means of any writing that may be deemed an offer to sell a security before a registration statement has been filed for that security. *See* 15 U.S.C. § 77e(b)(1) (2002).

[324] *See* Yi, *supra* note 34, at 246 (discussing the general prohibition on direct solicitation of individual investors during the waiting period, the period between the filing of a securities registration statement with the SEC and the time at which the registration becomes effective); *supra* note 36.

[325] *Accord* Mills, *supra* note 36, at H1 (describing the wrangling that usually occurs between issuer and underwriter when setting the offer price).

the IPO process, the investment bankers refine their valuation analysis to incorporate the changing business conditions and stock market environment. Ultimately, however, investor demand determines the final IPO valuation."[326] Underwriters devote much of the roadshow to trying to read the tealeaves of market demand.[327] The Dutch auction achieves the same result—a valuation determined by investor demand—albeit in a more direct, efficient manner. By the very act of bidding in a Dutch auction, investors are explicitly *stating* their demand.[328]

With efficiencies in valuation come efficiencies in underwriter fees. At least one commentator has argued that firm commitment underwriters price their services supracompetitively.[329] Charging supracompetitive fees, the commentator argued, is equivalent to underpricing an IPO, and underpricing may in fact be symptomatic of a lack of market competition for underwriting services.[330] The Dutch auction, by simplifying the IPO process and allowing the issuer itself to assess demand, reduces the scope of the underwriter's services and introduces greater competition into the underwriter bidding process.[331] To the extent that an underwriting syndicate no longer needs to purchase the issuer's entire offering in order to effect a distribution, the underwriter's discount would also no longer be necessary.[332]

As a practical matter, issuers may want to seek out the services of an underwriter to manage the auction.[333] But even assuming the

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[326] Crocker, *supra* note 15, at 390.

[327] *See* Benveniste & Busaba, *supra* note 37, at 390.

[328] Generically stated, demand is the "intensity of buyer pressure on the availability and cost of a commodity or service." BLACK'S LAW DICTIONARY 441 (7th ed. 1999). A bid, as in a Dutch auction, manifests demand as an "offer to pay a specified price for something that may or may not be for sale." *Id.* at 153.

[329] *See Auctioning New Issues*, *supra* note 43, at 1391.

[330] *Id.* at 1390-91 (discussing the possibility that underwriters "possess some market power to extract supracompetitive fees," such as collusion or oligopolistic behavior).

[331] *Id.* at 1391.

[332] *See supra* note 53.

[333] *See* Wingfield, *supra* note 306 (using the example of W.R. Hambrecht & Co.). The 1933 Securities Act defines an underwriter as:

> [A]ny person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission.

issuer retains an underwriter to conduct the auction, the Dutch auction eliminates the conflict of interest inherent in firm commitment underwriting, namely the underwriter's incentive to underprice.[334] First, because the firm commitment underwriter agrees to purchase all of the IPO shares from the issuer and place them with (i.e., sell them to) subscribers, the underwriter runs the risk that it will not be able to resell them for a profit.[335] To minimize this risk, the underwriter has an incentive to price the offering below market demand so that complete resale is assured and the offering is oversubscribed.[336] Second, the lavish underpricing of the late 1990s suggests another factor at work, namely the intangible benefits that accrue to the underwriter through selective distributions of hot IPO shares. In the Dutch auction, these incentives are eliminated because competitive bidding determines the offering price, not the underwriter.[337] The result is a more accurate valuation of the IPO and greater capitalization for the issuer.

The Dutch auction method promotes accurate valuation in another way. Ordinarily, bidders who are influenced by a desire to pay as little as possible may understate their demand by submitting low bids. But because the issuer in a Dutch auction IPO accepts all bids *at the cutoff price*, the price that bidders pay does not necessarily correspond to the price they bid.[338] Thus, bidders have an incentive to bid what the IPO shares are actually worth to them, since understating demand lessens the likelihood that the issuer will accept their bid.[339]

Further efficiencies arise from the fact that Dutch auction IPOs generally involve more bidders than traditional IPOs.[340] Unlike firm commitment underwriting, which tends to exclude all but a handful of select investors, Dutch auctions are generally open to all qualified

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15 U.S.C. § 77b(11) (2002). As courts construe this definition broadly, a company that manages a Dutch auction probably meets the definition of an underwriter. *See* 1A FLETCHER CYC. CORP. § 222.10 (2002) (noting that the definition is broad and encompasses "any one who purchases stock from the issuer with a view to resell to the public"); *see also supra* notes 323, 324 (noting the constraints of § 5(b)(1), which may require an intermediary between the issuer and investors).

[334] *See Auctioning New Issues*, *supra* note 43, at 1390; *supra* notes 43-45 and accompanying text.

[335] *Auctioning New Issues*, *supra* note 43, at 1390.

[336] *Id.*

[337] *Id.* at 1391.

[338] *Id.* at 1385.

[339] *Id.*

[340] *Auctioning New Issues*, *supra* note 43, at 1385.

investors.[341] Allowing greater participation in the offering ensures a more competitive bidding process and should, in theory, result in a more accurate valuation.[342]

Dutch auctions also eliminate the need for underwriter discretion when allocating IPO shares.[343] Bids, not the underwriter, determine who comes away from the IPO with shares.[344] Thus, even if a Dutch auction does not operate efficiently, and an undervalued IPO results,[345] the underwriter nevertheless will be unable to spin those hot IPO shares to favored clients.

Finally, a company may auction off debt or equity entirely through electronic media, such as the Internet.[346] This is a highly relevant consideration in view of the geometric proliferation of financial services offered over the Internet since the mid-1990s.[347] The firm of W.R. Hambrecht & Co. has been the leading proponent for the use of this technology in auctioning corporate equity securities.[348] Some observers predict that its compatibility with emerging technologies will cause the Internet-based Dutch to auction eventually become the IPO method of choice.[349]

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[341] See, for example, W.R. Hambrecht & Co.'s description of its OpenIPO® process, at http://www.wrhambrecht.com/ind/auctions/openipo/index.html, which states, "Qualified investors, whether institutions or individuals, have equal access to bid on IPO shares through our OpenIPO auction."

[342] *See* Bill Hambrecht, *Fixing the IPO Process* (Sept. 2002) ("Final pricing would be based on the order information . . . ."), *at* http://www.wrhambrecht.com /ind/strategy/bill_pov/200209/index.html (last visited Feb. 26, 2004).

[343] The W.R. Hambrecht & Co. web page, *supra* note 341, alludes to this point by noting, "Shares are allocated in an equal and impartial way by the auction process. There is no preferential allocation."

[344] *See* Hambrecht, *supra* note 342 ("Final pricing would be based on the order information . . . .").

[345] This result has occurred in practice. *See infra* notes 364-65.

[346] *See, e.g.*, Bear, Stearns & Co. Inc., SEC No-Action Letter, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,887, at 77,100 (July 20, 2000) (describing Bear Stearns' Internet-based Dutch auction for investment-grade bonds); CapitaLink Securities Corp. & CapitaLink Bond Auctions, SEC No-Action Letter, 1990 WL 286361, at *1 (Apr. 10, 1990) ("Since 1986, CapitaLink has completed the development of the technology necessary to permit it to conduct electronic Dutch auctions of securities . . . .").

[347] *See* Nancy C. Libin & James S. Wrona, *The Securities Industry and the Internet: A Suitable Match?*, 2001 COLUM. BUS. L. REV. 601, 602-03 (noting that online brokerage accounts have increased from 1.5 million in 1996 to more than twenty-three million at the end of 2000, and further noting a study purporting to show that eighteen percent of all investors had bought or sold securities over the Internet by January 2000).

[348] *See* Wingfield, *supra* note 306.

[349] *See, e.g.*, *id.* (quoting Chris Mottern, chief executive of a company that went public via Dutch action, as saying, "My belief is maybe five or six years from now, this is the way IPOs are going to happen").

3. Drawbacks to the Dutch Auction IPO.

The allure of the Dutch auction IPO depends largely on perspective, and many of the same features that make it highly attractive to some make it equally repugnant to others. It is not surprising, therefore, that traditional underwriters have been less than enthusiastic about the prospect of their obsolescence, or at the very least, diminished fees.[350] Part of this resistance is cultural, as Dutch auction promoter William Hambrecht candidly admitted in a July 2002 *Wall Street Journal* article.[351] For many corporations seeking to go public, an IPO with a brand-name underwriter is a sign of prestige and status, and an important achievement in the life of the issuer.[352] Underwriters, too, share this sentiment.[353] For many investment banks, serving as lead underwriter in a public offering has long been, and remains, a matter of intense pride and competition.[354]

In addition to prestige, traditional IPOs—in particular, hot IPOs—radiate pecuniary benefits to all who participate. Beyond simply their discount, underwriters may benefit through a number of more questionable means, such as spinning. Moreover, officers and directors of the issuer may profit from large first-day trade ups through their own holdings in IPO shares and stock options.[355] Spinning aside, many view these benefits as time-honored perquisites, and a legitimate by-product of the IPO process.

Throughout the 1990s, explosive IPOs also provided invaluable media coverage for start-ups trying to establish a presence on the dot-com landscape. Commentators to this day talk, usually with a mixture of awe and revulsion, about the spectacular December 1999 IPO of VA Software Corporation, which closed up 698 percent at the end of

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[350] *See* Wingfield, *supra* note 306, at C1 (noting that "established Wall Street firms have resisted using Dutch auctions").

[351] *Id.*

[352] *Id.* (quoting William Hambrecht as saying, "When I started in this business, the ultimate thing for you as a company was to go public with Morgan Stanley. That just hasn't died").

[353] *See* LISA ENDLICH, GOLDMAN SACHS: THE CULTURE OF SUCCESS ix (1999) (describing the 1956 IPO of Ford Motor Company as "one of [Goldman Sachs's] greatest triumphs").

[354] *See* BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE 325 (1990) (describing the "powerful symbolic significance" of being designated the lead underwriter in bond offerings).

[355] *See* Alan Murray, *Let Capital Markets, Not Financial Firms, Govern Fate of IPOs*, WALL ST. J., Sept. 10, 2002, at A4 (quoting investor advocate Nell Minow as saying, "If you're 25 years old and operating out of your garage and somebody offers you tens of millions of dollars, are you going to quibble?").

its first trading day.[356] Orchestrating an *éclat* of this magnitude may provide sufficient intangible benefits to the issuer (as in the form of media attention or analyst coverage) to justify the lost capitalization. But the long-term benefits are much less assured. Consider that as of February 2004, a share of VA Linux stock, which closed at almost $240 on its first trading day in December 1999, was trading at less than four dollars.[357] Thus, the traditional mantra that firm commitment underwriters use to justify underpricing—that their goal is to "seek the highest sustainable valuation rather than the highest attainable valuation"[358]—often is not borne out in practice.

4. The Dutch Auction IPO in Practice.

How have Dutch auction IPOs fared in practice? Regrettably, the bellwether underwriter, W.R. Hambrecht & Co., has taken only nine companies public by Dutch auction since it first offered the service in 1999.[359] This rather sparse track record, however, may be more a reflection of the current market for IPOs, which is weak, than an indication of issuer disinterest. For their part, those issuers who have chosen Hambrecht's Dutch auction IPO—ranging in size from the $11.5 million April 1999 IPO of Ravenswood Winery to the $86 million December 1999 IPO of Andover.net—generally report satisfaction with the process.[360] Issuers in the United Kingdom who have offered securities through the issue for sale by tender similarly commend the more accurate valuations and lower underwriters' discounts.[361]

If markets were perfectly efficient,[362] one would expect no jump in price on the first day of trading after a Dutch auction IPO.[363] In

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[356] *See, e.g.*, Maynard, *supra* note 22, at 2024.

[357] Stock quote as of Feb. 26, 2004: $3.79.

[358] Crocker, *supra* note 15, at 390.

[359] *See Completed OpenIPOs*, web page of W.R. Hambrecht & Co., *at* http://www.wrhambrecht.com/ind/auctions/openipo/completed.html (last visited Feb. 26, 2004).

[360] *See* Kate Kelly, *Small Stocks Focus: Peet's IPO Manages a 17% Rise on Down Day for Nasdaq Stocks*, WALL ST. J., Jan. 26, 2001, at C6 (quoting Peet's Coffee & Tea CEO Chris Mottern as saying, "We're pleased with the results").

[361] *Auctioning New Issues*, *supra* note 43, at 1389 n.51 (reporting that an "average market discount is about six percent for offers for sale by tender, as compared to 17% for offers for sale").

[362] The efficient market hypothesis posits that security prices in a perfectly efficient market are instantly responsive to the introduction of new information, and therefore reflect all available information at any given time. *See* REILLY & NORTON, *supra* note 5, at 215.

[363] *See* Simon Avery & Kate Kelley, *Signs of Life: Simplex IPO Jumps 77% in Best First-Day "Pop" Since November*, WALL ST. J., May 3, 2001, at C16 (noting that the 0.37% first

practice, markets are somewhat less than efficient, and Hambrecht's actual results have varied from a twenty-two percent first-day decline for the May 2000 IPO of Nogatech, Inc.,[364] to the surprising 252 percent first-day gain for Andover.net.[365] Yet the experience of Andover.net, which went public around the time of the record-setting VA Software IPO, demonstrates that even Dutch auctions can yield inefficient results in exceptionally hot IPO markets. Indeed, this fact may help assuage those who argue that Dutch auction IPOs simply cannot garner enough media attention, nor generate enough investor profits, to pose a serious challenge to firm commitment underwriting.

CONCLUSION

Throughout the rampant IPO market of the 1990s, spinning proliferated. Spinning is a by-product of inefficiencies inherent in firm commitment underwriting, the most common form of IPO underwriting in the United States today. The often imprecise art of IPO valuation, coupled with nearly absolute underwriter discretion in allocating IPO shares to select investors, and fueled by intense public demand for IPO shares, creates an environment in which hot IPO shares become a currency for funding questionable underwriter business practices. Many commentators have argued, for example, that spinning is nothing more than a corporate bribe, and that it encourages officers and directors to breach their fiduciary duties.

Under the auspices of a global resolution of investigations into analyst conflicts of interest, the New York Attorney General and the SEC have taken an important first step toward creating an environment in which spinning is not tolerated. But vagaries in the language of the final judgments leave questions unanswered and undermine the strong condemnation that regulatory authorities purport to send. Non-signatories to the settlement may still engage in spinning, and even signatories may have colorable arguments that certain spinning activities do not violate the terms of the final judgments. Meanwhile, existing laws and regulations have proven ineffective at curbing IPO allocation abuses, New York's Martin Act standing as a possible exception. This Comment has argued that the

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day increase of the Briazz Dutch auction IPO "speaks to the theory behind the Dutch-auction system: If shares are valued accurately before the IPO, they won't skyrocket on the first day of trading").

[364] *See* Terzah Ewing, *New Focus IPO Opens Strong, Bucking Trend*, WALL ST. J., May 19, 2000, at C18.

[365] Kelly, *supra* note 360, at C6.

SEC should take a page from New York's book by enacting spinning regulations patterned after the Martin Act, requiring no quid pro quo.

Even if the SEC ultimately decides not to take the lead in regulating spinning before it occurs, courts can and should become more active in finding liability after the fact. Broader application of existing securities regulations, for instance, would require underwriters to provide greater disclosure and thereby discourage spinning. Furthermore, aggressive application of the corporate opportunity doctrine would be an effective deterrent of spinning if corporate fiduciaries were suddenly to find themselves liable for spinning profits they received in their service to the corporation. Similarly, state agency law suggests a possible remedy against agents of the corporation who receive undisclosed compensation from a third-party underwriter while acting in their official capacity.

Finally, it may be time to look beyond merely addressing the symptoms of IPO underwriting inefficiencies, such as spinning, and take a more holistic approach. Firm commitment underwriting, for all of its convolutions, is merely a process for gauging and fulfilling market demand. Dutch auction IPOs achieve the same result, but in a much more efficient manner and at lower cost to the issuer. Fees that the issuer would pay to the firm commitment underwriter for valuation and allocation services instead inure to the Dutch auction issuer as increased capitalization from the IPO. And because spinning owes its existence to inefficiencies in IPO valuation and allocation, the Dutch auction approach, to borrow a phrase from the antitrust context, catches the weed in the seed and keeps it from coming to flower.[366]

Admittedly, the Dutch auction is an idealistically sanguine approach to IPO allocations, perhaps better suited to the sensibilities of European capital markets than to the slings and arrows of Wall Street. But in the absence of further SEC regulation and more aggressive application of common-law theories of liability, it may represent the truest alternative to the prevailing culture of spinning. And amidst the fallout of IPO abuses like those of the late 1990s, mounting public, legal, and regulatory pressure may indeed tip the balance in favor of a new way of doing business.

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[366] S. REP. NO. 74-1502, at 4 (1936).