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INITIAL PUBLIC OFFERINGS AND THE FAILED PROMISE OF DISINTERMEDIATION

CHRISTINE HURT*

This Article argues that although the Internet works well to eliminate intermediaries formerly necessary for distribution, the Internet cannot reliably eliminate intermediaries used by the public for creating demand networks and establishing third-party certification. As those who have tried to sidestep powerful intermediaries in both the securities industry and other industries have discovered, these intermediaries play a substantial role in cultivating consumer preferences and gaining consumer trust. In this age of overwhelming numbers of consumer choices, consumers rely on demand intermediaries to make decisions for them.

I. INTRODUCTION

At the beginning of this millennium, the future of initial public offerings (“IPOs”) conducted using an Internet-based auction method in the United States seemed very bright.¹ Although the number of auction IPOs had remained small since being allowed by the Securities and Exchange Commission in 1999,² this method was experiencing a resurgence brought about in small part by the improving economy and market for IPOs and in large part by the marketing buzz surrounding the launching of the auction IPO in 2004 for Google, Inc.³ Auctions, which allocate IPO shares to anonymous buyers on the basis of sealed bids, promised to create an era in which retail investors were able to purchase IPO shares at their market-

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¹ See Mark Lewis, *Online IPO Revolution Postponed*, FORBES.COM, Mar. 14, 2001, <http://www.forbes.com/markets/2001/03/14/0314banks.html> (reporting that Walt Cruttenden, CEO of E*Offering, had predicted that by 2002, “80 % of IPOs would be [completed] online”).

² The first no-action letter issued by the SEC to an underwriter purporting to offer equity shares in an initial public auction was to Wit Capital in 1999, and it allowed online auctions in IPOs although technically SEC rules concerning the timing of offers and sales of securities did not correspond with an ongoing bidding mechanism. See Wit Capital Corp., SEC No-Action Letter, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,577 at 78,906 (July 14, 1999).

³ See Review & Outlook: *Google’s Dutch Treat*, WALL ST. J., May 3, 2004, at A20.

driven opening prices.⁴ Because IPO shares would not be pre-allocated to friends, family and employees of the issuer and, more disturbingly, to valued customers or customers-to-be of the underwriter,⁵ the public offering system would no more be a mechanism for insiders to distribute built-in-profits to cronies via underpriced IPO shares.

Although the market saw an increased number of auction IPOs in 2005, the market for online IPO auctions again stalled beginning in 2006.⁶ In addition, even the record number of 2005 auction IPOs is miniscule compared with the number of IPOs conducted in the U.S. using the traditional bookbuilding method.⁷ Proponents of these IPOs must explain why the auction IPO model has not challenged, much less replaced, bookbuilding as the dominant offering method in the U.S.

Critics of the auction IPO explain that the popularity of the auction model has stalled because it is inferior to bookbuilding.⁸ This argument asserts that auction IPOs do not live up to their marketing; auctions are neither more democratic nor more efficient. However, this argument usually centers around the idiosyncrasies of the Google auction,⁹ which was not a true auction IPO, and few other data points. From the few online IPOs for which there is data, the median first-day pop does suggest that issuers opting for online IPOs are able to capture market demand more efficiently than the bookbuilding method can. In addition, in every other online IPO besides Google, access by retail investors to original IPO shares has been handled in a democratic fashion, and even the Google auction resulted in far more widespread retail access than most IPOs. Accordingly, watchers of IPOs must develop another explanation for the anemic growth of the auction IPO industry.

⁴ See Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 769 (2005) (“The availability of online IPO auction mechanisms promises a much more democratic IPO process whereby the larger public has the opportunity to participate.”).

⁵ See Sean J. Griffith, *Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, 69 BROOK. L. REV. 583, 594 (2004) (“By granting highly profitable IPO allocations to savvy business-people who well understand that nothing in this world is free, underwriters can expect real returns on their investment in goodwill.”).

⁶ Two U.S. firms chose the online auction method for their IPOs in 2006, compared with five in 2005. In 2007, three firms chose this method. The average number of online IPOs in each year during the period 1999-2006 is 2.33.

⁷ In 2005, the record number of online IPO auctions, five, represented 2.5% of the overall IPO market. The market saw 194 companies going public that year. See Renaissance Capital’s 2006 Annual IPO Review, <http://www.ipohome.com/marketwatch/review/2006review.asp> (last visited Nov. 27, 2007) (listing the number of U.S. IPOs in 2005 as 194).

⁸ Peter B. Oh, *The Dutch Auction Myth*, 42 WAKE FOREST L. REV. 853, 875 (2007).

⁹ See *id.* at 8, 21 (analyzing the Google auction but noting that it “featured peculiarities that delimit its utility as a case study”).

Technology, and the Internet specifically, has long created expectations of disintermediation in many contexts. Just like buyers and sellers that flocked to eBay, producers and consumers have longed to harness the potential of the Internet to “cut out the middle man.” By creating new ways to distribute and market products directly to the intended audiences, markets seek efficiencies by eliminating added fees to intermediaries who add little value in the current age. In addition, producers yearn to use new technologies to bypass industry gatekeepers that rely on outdated networks to select small numbers of products to pass on to consumers who might prefer the products that were not selected. In a world in which a buyer would choose to pay a certain price (X) for a product, the producer of that product would prefer to capture as close to 100% of X as possible and not share unnecessarily with intermediaries.

The market for initial public offerings is no different from other markets. A small number of investment banks and the underwriters and brokers they employ act as intermediaries that distribute and market offerings for a substantial fee.¹⁰ In addition to underwriting fees, which are standard across Wall Street banks and much higher than in other countries, investment banks also profit from the bookbuilding system by being able to set IPO share prices much lower than market demand and allocating this built-in profit to clients and friends.¹¹ Furthermore, because of great ties between underwriters and analysts, these intermediaries may also act as gatekeepers, determining which offerings will be successful in the after-market. However, auction IPOs have the potential of allowing issuers to avoid these investment banks and sell directly to the public at the market price (X), not the bookbuilding underprice (some percentage of X), minus the substantial underwriting fee. Issuers would then capture the entire proceeds (closer to 100% of X) from their offering instead of sharing it with clients of investment banks. So, with the potential for revolution inherent in the Internet, this Article examines why the Internet’s promise of disintermediation has not been fulfilled for IPOs.

This Article argues that although the Internet works well to eliminate intermediaries formerly necessary for distribution, the Internet cannot reliably eliminate intermediaries used by the public for creating demand networks and establishing third-party certification. As those who have tried to sidestep powerful intermediaries in both the securities industry and other industries have discovered, these intermediaries play a substantial role in cultivating consumer preferences and gaining consumer trust. In this age of overwhelming numbers of consumer choices, consumers rely on

¹⁰ The industry standard in the U.S. is for underwriters to charge a flat fee of 7.0% of the total offering. See PATRICK SCHULTHEIS, ET AL., *THE INITIAL PUBLIC OFFERING: A GUIDEBOOK FOR EXECUTIVES AND BOARDS OF DIRECTORS* 27 (2d ed. Bowne 2004).

¹¹ See Griffith, *supra* note 5, at 594-97 (discussing how underwriters “maximize welfare” by underpricing offerings in order to generate goodwill with customers by allocating to them discounted IPO shares with built-in gains).

demand intermediaries to make decisions for them. Therefore, the base market price (X) of any product will be increased (X+Y) because of the actions of these demand networks. Therefore, a producer must determine whether more profit is to be made by sharing revenues with intermediaries and receiving some percentage (A) of the increased price (X+Y) than by capturing 100% of merely X. In addition, to attempt to ignore these intermediaries comes with great risk, especially when the intermediaries retaliate, as is the case with the Wall Street investment banks with regard to auction IPOs. In certain cases, those who attempt to sidestep intermediaries may find themselves capturing not 100% (X) but 100% of a depressed market price (X-Z).

II. DISINTERMEDIATION AND THE INTERNET

In both the marketplace for goods and services and the marketplace for ideas, intermediaries have been around for a long time. Intermediaries help certain goods “get to market,” and other intermediaries connect consumers with these goods. A producer of a better-tasting peanut butter can sell only to someone looking for a better-tasting peanut butter through a series of intermediaries that can place the jar and the buyer in the same location and communicate to the buyer the superiority of the product. Intermediaries have also played a part in the dissemination of, and unfortunately in the acceptance of, ideas. Besides the speaker on the platform in Hyde Park, most ideas must also travel through a series of intermediaries before reaching the general audience. The most beautiful piece of music will be heard only by a handful of listeners without intermediaries to carry it to a wider audience.

Professor Lawrence Solum divides intermediaries into two groups: source intermediaries and search intermediaries.¹² These two groups correlate roughly with the concepts of supply intermediaries, which facilitate bringing products to market, and demand intermediaries, which assist those in the marketplace looking for certain products. To bring a product or an idea to market, supply intermediaries work through distribution networks unknown or inaccessible to the producer. On the other end, demand intermediaries convey information to consumers, who are either passively or actively acquiring information with which to make purchasing decisions. Although Professor Solum’s search (demand) intermediaries seem objectively neutral and may exclude certain products indirectly,¹³ in some industries demand intermediaries are associated with

¹² See Lawrence B. Solum, *Download It While It’s Hot: Open Access and Legal Scholarship*, 10 LEWIS & CLARK L. REV. 841, 850 (2006).

¹³ For example, Professor Solum cites Westlaw and LexisNexis as examples of demand intermediaries that assist legal scholars to find relevant source materials. *Id.* at 853. However, these databases, while enormous, are not exhaustive, and some secondary journals, smaller publications, or publications in nonlegal fields will not be accessible

supply intermediaries and work intentionally to increase connections between consumers and certain products. Whether this screening is intentional or not, or even valuable or not, these helpful and unhelpful intermediaries increase the price of goods and services to consumers and may eliminate some product choices by increasing transaction costs for producers.

The Internet has helped immensely to free some producers and consumers from these intermediary costs. Technology has enabled producers to inform consumers of their products at much less cost, decreased the costs of distribution, and increased the speed of distribution. Instead of scouring shelves in bookstores for a certain book, consumers can purchase from a volume dealer on the Internet at discount prices in the time it takes to search for the book by title. In addition, purveyors of news and commentary now have the ability to reach wide audiences through blogs and on-line magazines at a fraction of the cost of creating a printed periodical or selling a piece to a printed periodical.

However, this disintermediation has been anything but complete. Although technology has greatly decreased the cost of distributing products and ideas, technology has not been able to eliminate intermediaries entirely. Both source intermediaries and demand intermediaries provide functions beyond mere connection of buyers and sellers. Some intermediaries function as reputational intermediaries¹⁴ that vouch for the value of the product or the idea being distributed. These reputational intermediaries may be source intermediaries, such as high-end clothing boutiques that feature certain brands of clothing, or demand intermediaries, such as real estate buyers' brokers who show their clients properties they believe meet their selective criteria. In fact, the Internet has created new reputational intermediaries to replace those that have been eliminated.¹⁵ Buyers may be able to bypass a storefront when purchasing a particular appliance, but websites such as Epinions.com¹⁶ may perform the same function as a

using these tools. In addition, because of individual contracting, some popular sources are available full-text using one source but not the other. This is the case with the *Wall Street Journal*, which is available only in abstract form on Westlaw.

¹⁴ See Clayton P. Gillette, *Reputation and Intermediaries in Electronic Commerce*, 62 LA. L. REV. 1165, 1166-67 (2002) (describing the ongoing need for reputational intermediaries as important to the future of e-commerce because "[n]otwithstanding expectations that the Internet would vaporize boundaries, the need for buyers and sellers to trust each other where compliance with contractual terms cannot readily be verified ex ante or enforced ex post diminishes the likelihood of trade").

¹⁵ See Mark S. Nadel, *The Consumer Product Selection Process in an Internet Age: Obstacles to Maximum Effectiveness and Policy Options*, 14 HARV. J.L. & TECH. 183, 185-87 (2000) (discussing the emergence of online "infomediaries" and "selection assistants" to guide consumers "overwhelmed by the multitude of choices and abundance of data about those choices").

¹⁶ www.Epinions.com ("At Epinions, you can read and write reviews on millions of products and services.").

salesman in attempting to give the buyer information and reviews of certain products. In a perfect cyber world, these new intermediaries do not add costs to the purchase, as does paying the mark-up the storefront charges, but when the producers are advertising on these websites¹⁷ or paying a fee to be evaluated,¹⁸ the price of the product must eventually reflect those producer costs.

Part of the failure of auction IPOs is explained by the inability of the online auction to eliminate the need for demand intermediaries generally and reputational intermediaries specifically. When reputational intermediaries are objective and rent their reputations to those valuable products and services that deserve the vouching, then the cost of those intermediaries is warranted. However, sometimes reputational intermediaries use their position to create the value that they are vouching for. Those intermediaries come at a substantial cost to consumers and producers alike. This Article contends that a greater part of the failure of auction IPOs comes from the danger of avoiding the demand intermediary's ability to create its own demand network for products it has chosen to declare valuable. In industries in which consumer choices are virtually dependent on these demand networks, those who bypass the intermediaries will suffer. This Article argues that the securities industry is such an industry.

A. Distribution Networks

The most obvious impact of the Internet on eliminating the need for intermediaries has come in the form of bypassing distribution networks. The Internet fulfills the cliché of cutting out the middleman. Residents all over the globe, in small towns and big cities, can order products over the Internet directly from manufacturers or large-scale merchants without having a distributor nearby. Through the magic of electronic commerce and competition in parcel shipping, producers do not need to enter into numerous agreements with various intermediaries in the chain of distribution. Without the costs of maintaining duplicative storefronts and personnel, sites such as Amazon.com have revolutionized retail shopping. Even shoe shopping, which may seem particularly suited to face-to-face service, has been transformed by Zappos.com, which offers free shipping for both orders and returns.

The same phenomenon has occurred in the dissemination of ideas as well as products. Blogs and online magazines have changed the marketing of news and commentary completely, with even major

¹⁷ On a recent visit to Epinions, the "Digital Cameras" page in "Electronics" was "Sponsored by Panasonic: Ideas for Life." See http://www.epinions.com/Digital_Camera (last visited Nov. 27, 2007).

¹⁸ See, Gillette, *supra* note 14, at 1172 (describing the costs of sending reputation signals through intermediaries).

newspapers and magazines being forced to provide at least free limited content on the Internet to compete. Consumers of information no longer need to subscribe to numerous expensive cable news programs, newspapers and magazines to receive current information. On the other hand, any individual who wants to disseminate important news can do so rather quickly, without having to be selected as one of a handful of opinion writers that appear in a major newspaper.

B. Demand Networks

The Internet has not been as successful in eliminating the need for demand intermediaries that either use their reputation to vouch for certain products or ideas, or who cultivate increased demand for those products or ideas. Online news sites hosted by major newspapers and magazines generally get more traffic than sites created from whole cloth by unknown authors. Online retail outlets generally succeed by offering the same branded products found in stores, only at lower prices. Few success stories exist of unknown producers selling a new product over the Internet without demand intermediaries.

C. Success Stories: eBay, Stephen King, & SSRN

1. eBay

The poster child for disintermediation on the Internet is eBay, Inc., “the world’s online marketplace,” an internet swap meet where sellers pay a fee to eBay to list and sell merchandise directly to sellers. Although eBay itself acts as a functional intermediary by providing the website, it insists that it is merely a forum. Since its inception in 1995, eBay has grown to dominate the online auction market. In 2006, eBay reported consolidated net revenue of \$6 billion and net income of \$1.1 billion.¹⁹ This revenue comprises earnings from eBay, PayPal and other holdings. eBay’s revenue is derived mainly from fees eBay charges sellers who use the eBay auction site. In the last quarter of 2006, eBay boasted a “confirmed registered user base” of 222 million users, and 610 million products were listed on eBay, generating \$14.4 billion in sales revenue to the sellers.²⁰

The success of eBay lies mainly in its disintermediation of distribution networks and in its ability to capitalize on existing demand networks. Primarily, sellers of goods on eBay are able to locate interested buyers easily without the added costs of consigners and advertising and

¹⁹ See eBay Inc. Announces Fourth Quarter and Full Year 2006 Financial Results, http://investor.ebay.com/financial_releases.cfm (the follow “eBay Inc. Announces Fourth Quarter and Full Year 2006 Financial Results”) (last visited Nov. 27, 2007).

²⁰ See *id.*

without the geographical limitations of flea markets and yard sales. The original model of eBay seemed to be aimed at these types of sellers: sellers of collectibles and other items not always commercially available.²¹ However, many of the popular products on eBay are products that either are currently available at local retail stores or that were available recently.²² These sellers also benefit from being able to sell directly to interested customers without search costs on either side. Theoretically, consumers should be able to obtain goods at a cost less than they would otherwise, and sellers should be able to obtain a price higher than they would otherwise. How these gains are distributed between the buyer and the seller will differ in each transaction.²³

However, eBay users do not eliminate demand networks, nor do they need to. Sellers do not have to create demand for their products; they simply respond to existing demand by selling items they have bought and used or by selling items that they specifically purchased to resell at a profit. Many eBay sellers even use pictures of items copied from online sites hosted by original manufacturers or retailers, capitalizing on investments previously made in creating demand. Sellers create niches where demand currently exists.

Many legal scholars have studied the ways in which commerce on eBay seems to flow without the true presence of reputational intermediaries.²⁴ eBay has gone to great lengths to describe itself as “only a venue.”²⁵ Although eBay itself does not investigate or vouch for the

²¹ See Steven Anderson et al., *Seller Strategies on eBay 2* (U.C. Santa Cruz Dept. of Econ., Working Paper No. 564, Apr. 2004, available at <http://ssrn.com/abstract=531702> (“The image of online auctions has expanded beyond that of a web-based garage sale or swap meet, focusing on collectibles or unique items, to one where entrepreneurs are seeking to launch or enhance ‘e-tail’ businesses in direct competition with traditional retail markets.”).

²² On May 21, 2007, the ten most popular searches on eBay were “webkinz,” “apple ipod,” “xbox 360,” “wii,” “ps3,” “louis vuitton,” “nintendo wii,” and “cars.” See eBay, *eBay Pulse*, <http://pulse.ebay.com> (last visited Nov. 27, 2007).

²³ See Ravi Bapna, Wolfgang Jank & Galit Shmueli, *Consumer Surplus in Online Auctions* (Nov. 1, 2005), <http://ssrn.com/abstract=840264> (quantifying consumer surplus on eBay as an average of \$15.59 per transaction in their sample of 4514 eBay auctions using a web based tool to measure successful winning bids against the highest bid the winner made). Seller surplus would be harder to measure, although many auctions have a “reserve” price. See *id.* (assuming that the resulting auction price reflects some seller surplus, given the reservation price and the assumption that sellers behave rationally in choosing to list products on eBay).

²⁴ See Gillette, *supra* note 14, at 1177-92 (evaluating eBay’s feedback mechanism as a substitute for reputational intermediaries and finding that although the mechanism “has overcome significant costs in generating reputational information that facilitates trade,” positive signals of seller trustworthiness are noisy given that “more than 99 percent of registered comments are positive”).

²⁵ See Mary M. Calkins, *My Reputation Always Had More Fun Than Me: The Failure of eBay’s Feedback Model to Effectively Prevent Online Auction Fraud*, 7 RICH. J.L. &

creditworthiness of either the seller or the buyer,²⁶ the website does have an important feedback function whereby buyers and sellers are encouraged to leave positive, neutral or negative feedback regarding a specific transaction. This feedback is aggregated to give each user a score, which is shown to prospective transaction parties. However, studies have shown that this feedback mechanism is probably flawed, creating a system where most users have entirely positive feedback or almost entirely positive feedback.²⁷ Because of the reduced incentives of participants to warn others compared with the incentives to increase their own feedback score,²⁸ almost all

TECH. 33, at ¶ 28 (Spring 2001), *available at* <http://law.richmond.edu/jolt/v7i4/note1.html> (quoting the user agreement as of 2001 as stating “eBay acts as a link between the buyer and seller. We just provide the automated bidding system. We do not authenticate users, we do not verify items, we do not guarantee that you will receive payment or the item.”).

The eBay User Agreement as of June 28, 2007 reads:

You will not hold eBay responsible for other users' actions or inactions, including things they post. You acknowledge that we are not a traditional auctioneer. Instead, the Sites are a venue to allow anyone to offer, sell, and buy just about anything, at anytime, from anywhere, in a variety of pricing formats and venues, such as stores, fixed price formats and auction-style formats. We are not involved in the actual transaction between buyers and sellers. We have no control over and do not guarantee the quality, safety or legality of items advertised, the truth or accuracy of listings, the ability of sellers to sell items, the ability of buyers to pay for items, or that a buyer or seller will actually complete a transaction. *See Your User Agreement*, <http://pages.ebay.com/help/policies/user-agreement.html> (last visited Nov. 27, 2007).

²⁶ In response to buyer complaints, eBay, which has historically responded to its fee-paying clients, sellers, has recently announced long-awaited reforms, including requiring all sellers to register with PayPal, a subsidiary of eBay Inc., which will retain either credit card information or bank account information for each seller. *See Brad Stone, EBay Says Its Crackdown on Fraud Is Showing Results*, N.Y. TIMES, June 14, 2007, at C1.

²⁷ eBay has recently revamped the feedback mechanism to require buyers to rate the transaction on four dimensions: item description, communication, shipping and shipping charges. *See id.* (reporting that the more complex feedback mechanism has resulted in feedback being given in 10% fewer transactions).

²⁸ In a quick survey of the 19 items listed that were retrieved under the search “indygo artwear,” of the ten sellers represented, three had explicit instructions regarding leaving feedback. One seller, “punkietmama” of the eBay store Princess Punkie-T’s Closet, included the following under “About Us”: “Please leave me positive feedback to let me know that you have received your item(s) and most importantly that you are happy with your purchase. I will conclude our transaction by doing the same for you.” (Item # 320131964861). The other two’s instructions were less explicit. Sashablue13 simply stated “Feedback left after buyer leaves feedback.” (Item # 110143769763). Spendingurmoney was also straightforward: “Feedback will be left for buyer after feedback is left for me.” (Item #230147155620). Interestingly, fact-based feedback by the seller on the buyer’s performance could be provided as soon as the seller receives payment, which is prior to delivery. No reason exists for the seller to wait until the buyer has received delivery and posted feedback before leaving seller’s feedback except to (1) incentivize buyer to leave feedback at all; (2) incentivize buyer to leave positive

feedback is positive and therefore, probably worthless. Regardless, users continue to consummate transactions on eBay without the presence of either third-party monitoring or easy enforcement mechanisms.²⁹

However, this is not to say that eBay has eliminated the need for reputational intermediaries to certify the quality of products. Because the vast majority of products sold on eBay have an existing market outside of eBay, others vouch for the substantive quality of those products. Buyers of iPods on eBay do not need eBay to vouch for the quality of a “new in the box” iPod. Those consumers can get information from the Apple website, trade magazines, and countless review websites. Consumers may rely merely on the Apple brand to vouch for quality.³⁰ In each transaction, the eBay user must trust that (1) the buyer will pay the purchase price within a certain amount of time, (2) the seller will send the product upon payment within a certain amount of time, and (3) the product will match the description, whether “new in the box,” “gently used,” “plays great,” or something similar. When feedback is negative, the substance of the remark generally reveals that the transaction was not consummated because of either nonpayment or nondelivery. However, negative feedback does not correspond to the substantive quality of the new or used product, such as the fact that the iPod seems to break shortly after the warranty expires or that iTunes is a complicated and limiting music service.

Although eBay does represent a breakthrough in the reselling of branded merchandise, it does not predict much about the ability of the Internet to eliminate the need for intermediaries in the initial dissemination of original or one-of-a-kind products. Because IPO shares are not branded commodities, the lessons of eBay, even though it is an auction market, may not be analogous.

2. Stephen King

As stated earlier, the Internet holds promise for direct dissemination of not only products but also, and possibly more importantly, ideas. Many

feedback; and (3) tailor feedback on buyer’s performance (payment) to the tone and substance of buyer’s feedback on seller’s performance (delivery of conforming product).

²⁹ See Susan Block-Lieb, *E-Reputation: Building Trust in Electronic Commerce*, 62 LA. L. REV. 1199, 1206-08 (2002) (arguing that the eBay feedback mechanism works in “forgiv[ing] minor deviations in performance obligations” and in highlighting the relatively rare, but much more substantial, deviations that amount to fraud or nonperformance).

³⁰ Unfortunately, this type of unrelated reputational mechanism also works to reward sellers of fake goods. eBay has recently implemented reforms aimed at screening out sellers of counterfeit goods in categories such as clothing and handbags. See Stone, *supra* note 26, at C1 (positing that eBay was incentivized to change its hands-off approach after the percentage of active users participating in auctions fell from 41 percent in 2005 to 36 percent in 2006).

people desire easy publication of original ideas in the forms of both scholarly commentary and original works of art such as books, poetry, music, and the visual arts. Anyone who has ever tried to have a book published will have stories of the numerous go-betweens who reject, stall, or ruin the book, or who collectively take so much of the revenues that the author feels as if she writes for free.³¹ If the Internet could help authors avoid some of these intermediaries, then more books would be available and authors would recoup more of the proceeds from those works.³² In addition, readers would spend less per book without intermediary fees, printing, and binding, so the public might purchase more books from various authors.³³ Theoretically, both the producer and the consumer would win in a disintermediated world of book publishing.³⁴

On the other hand, in a world where a thousand (or million) literary flowers bloom on the Internet, consumers must find a way to sort through to find books that fit their tastes. Although one should not judge a book by its cover, judging books without covers, or even strategic product placement at book stores, is very hard to do. In the world of publishing, publishers and bookstores act as reputational intermediaries to both vouch for the literary

³¹ See David D. Kirkpatrick, *With Plot Still Sketchy, Characters Vie for Roles; The Struggles Over E-Books Abound, Though Readership Remains Elusive*, N.Y. TIMES, Nov. 27, 2000, at C1 (“Whenever two or more authors are in the same room, the conversation eventually turns to the failings of publishers: low advances, stingy marketing, hasty editing and, most of all, rejection letters.”).

³² In addition, each intermediary would like to avoid the others: publishers would like to avoid printers, bookstores and agents; booksellers would like to avoid publishers, printers and agents, etc. See *id.* at C1 (describing how “[a]fter decades of bruising battles among agents, publishers and booksellers over the stagnant revenue from slow-growing book sales, no one wants to see their rivals get a jump on them” in the nascent electronic book industry).

³³ Self-publishing may take two forms. An author may print and bind the book herself, then sell directly to readers through websites or other direct marketing, or an author may sell electronic copies of the book directly from a website. The former type of self-publishing may eventually involve other intermediaries, such as bookstores or online booksellers. Online publishers provide a hybrid form of publishing whereby authors contract with the electronic publisher to distribute and market their books electronically, for a higher royalty than traditional publishing. See Mary B.W. Tabor, *Big Advance? No, Thanks, He'll Publish It Himself*, N.Y. TIMES, Sept. 24, 2000, § 3, at 4 (reporting that “while e-publishing sites typically offer no advance, they give more generous royalties – often about 40 percent” than the typical 10-15 percent royalty offered by major publishers).

³⁴ One of the early champions of electronic publishing was Jason Epstein, former Random House editor and inventor of the quality paperback, which revolutionized and democratized reading. In a 2001 book, Epstein published a series of lectures he gave in October 1999 at the New York Public Library on the unlimited possibilities for authors that the Internet could hold. See generally JASON EPSTEIN, *BOOK BUSINESS: PUBLISHING PAST, PRESENT AND FUTURE* (2001); see also Dinita Smith, *A Vision for Books That Exults in Happenstance*, N.Y. TIMES, Jan. 13, 2001, at B19.

quality of works and create demand networks for new works.³⁵ Substantial sums are spent on marketing at various levels: publishers buy advertising, bookstores create special displays, authors are sent on book tours, and even online discount booksellers like Amazon try to steer repeat buyers to new works that may be similar. The lone book sold through a single website may be merely crying in the cyber-wilderness.

Therefore, only an established author would be able to avoid these demand networks of publishing and have success selling directly to the public. Interestingly, only a small few have tried.³⁶ The most famous attempt was made by Stephen King. King is arguably one of the most well-known contemporary authors in the United States and has written over 50 bestselling horror novels, many of which have been made into feature films and television mini-series. King has a pre-existing demand network of devoted fans who know with some certainty that any new offering will be substantially similar in tone, quality and plot development to earlier works, and this entices them into reading. King also has a popular website and newsletter that enables him to communicate directly with his fan base.

In March 2000, King made his first foray into selling electronic books directly to readers by offering *Riding the Bullet*, a 16,000 word story, online for \$2.50.³⁷ Notably, King allowed Simon & Schuster to sell the book online, spreading some of the technological hassles to the publisher. The book sold over 500,000 copies, much more than the 10,000 copies that an extremely successful electronic book might sell³⁸ or the 20,000 that a respectable “midlist” hardback would sell,³⁹ but many readers also received copies for free from other downloaders or from hackers. Technology made it simply too easy to distribute original works online, even copyrighted works. However, the success of *Riding the Bullet* prompted King to try e-publishing again later that year, this time with a serialized work of fiction called *The Plant* and this time without a publisher.⁴⁰ King promised readers

³⁵ See Shira Boss, *The Greatest Mystery: Making a Best Seller*, N.Y. TIMES, May 13, 2007, § 3, at 1 (describing how publishing houses have to pick and choose which books to publish and market heavily due to low profit margins in the industry).

³⁶ Although this section of the Article focuses on individual authors, several sites have emerged that aim to electronically publish multiple authors' works directly to readers, such as Hard Shell Word Factory, Booklocker.com and Xlibris. See *id.*

³⁷ See M. J. Rose, *Stephen King, the E-Publisher*, WIRED, June 11, 2000, <http://www.wired.com/print/culture/lifestyle/news/2000/06/36915>.

³⁸ See David D. Kirkpatrick, *A Stephen King Online Horror Tale Turns Into a Mini-Disaster*, N.Y. TIMES, Nov. 29, 2000, at C1.

³⁹ See Boss, *supra* note 35, § 3, at 1 (describing one best-seller, *Prep*, as selling 133,000 copies in hardback and 329,000 copies in paperback, while a midlist book will capture “respectable sales of 15,000 to 20,000 copies”).

⁴⁰ See Rose, *supra* note 37. King was quoted at the time of the announcement of his first self-publishing venture that it would be “Big Publishing’s worst nightmare.” *E-fiction: A Sensitive Plant?*, THE INDEPENDENT (LONDON), Dec. 23, 2000, at 8. King was well aware that he might be taking a giant leap for authors everywhere. See *id.* at

that new chapters would appear on his website as long as the readers kept paying for the chapters and not downloading for free.⁴¹ The first chapters were \$1 each, and the first chapter sold more than 120,000 copies in its first week.⁴² By the fourth chapter, however, less than 50% of users downloading paid the fee, and King announced a hiatus, leaving devoted readers without an ending.⁴³ The book has never been finished, as of almost seven years later.

Commentators struggled to determine whether King's experiment was a success or a failure.⁴⁴ One obvious criticism of even King's electronic publishing was the ability of determined readers to download and disseminate works for free. Another criticism questioned whether readers have long enough attention spans for serialized works, although King has written successful serials before.⁴⁵ Some critics argued that even Stephen King could not bypass the marketing value of a publisher.⁴⁶ Still others implied that a publisher could have added value other than marketing,⁴⁷ presumably pressure to complete the book and satisfy fans.

Whether King's experiment was successful or not, it still has little relevance for the future of electronic publishers and for the vast majority of authors without the name recognition and established fan base of Stephen King.⁴⁸ By analogy, his experiment was so unique as to provide little guidance for other unseasoned and unknown producers of ideas or products

8. ("If I could break some trail for all the midlist writers, literary writers and just plain marginalised writers who see a future outside the mainstream, that's great.").

⁴¹ See Kirkpatrick, *Horror Tale*, *supra* note 38, at C1 (explaining that under King's downloading honor system, he promised to keep writing chapters as long as 75% or more of users downloading paid a \$1 for each download).

⁴² See *id.*

⁴³ See *id.* (noting that the fourth installment, which was longer, cost \$2, an unexpected increase that may have frustrated readers).

⁴⁴ Financially, *The Plant* was a success by most authors' standards, earning \$500,000 in revenues with fewer costs and all profits going to the author. See David D. Kirkpatrick, *Stephen King's E-Tale Didn't Do Too Shabbily*, N.Y. TIMES, Dec. 4, 2000, at C11.

⁴⁵ See Kirkpatrick, *Horror Tale*, *supra* note 38, at C1.

⁴⁶ See *id.* (quoting King's own assistant as explaining that "Even for Stephen King, making people aware that this is out there is a challenge. . . . That is one reason why I am sure that Stephen King would never give up traditional publishing. They provide a huge service, actually selling the work.").

⁴⁷ See *id.* (quoting Jane Friedman, chief executive of Harper Collins Publishers as saying "a publisher brings quite a lot to the table – starting with the editing process and including marketing and publicity and all the advice and wherewithal").

⁴⁸ Shortly after King began his self-publishing experiment, but before he announced *The Plant's* hiatus, best-selling novelist Frederick Forsyth announced that he would electronically publish five short stories through Online Originals. The author of such books as *The Day of the Jackal*, who notably did not use computers, soon became frustrated with the medium and the new electronic intermediaries and abandoned electronic publishing. See Stuart Wavell, *A Jackal Among the Geeks*, TIMES (LONDON), Nov. 19, 2000 ("I don't think these young geeks know how to promote a product. The conventional publishers, of course, have been doing it for years.").

looking to avoid demand networks on the Internet. However, if Stephen King was unable to avoid publishing houses' demand networks, as some critics charge, then ultimately no other author will be able to do it, either. If King was successful, or is successful in the future with a non-serialized novel,⁴⁹ then the success will be more attributable to King's stature in the world of horror fiction than to the power of the Internet to disintermediate book publishing.⁵⁰

3. SSRN

In the academic world, online scholarship databases have revolutionized the field of social science research. Instead of relying on physical or electronic libraries that purchase subscriptions to scholarly journals, researchers can now access free databases that compile working and final papers of scholars in several disciplines. Although a few papers that are published elsewhere are available only for a fee, their abstracts are freely available. In addition, most papers are available in their entirety without a fee. One of these databases is the Social Science Research Network ("SSRN"), which was created in 1994.⁵¹

SSRN not only bypasses the expense of traditional scholarship intermediaries such as academic publishers and libraries, but it also increases the volume and pace of distribution to other scholars. Professor Solum describes the publishers such as journals and academic presses as source intermediaries and the library services and online subscription

⁴⁹ See Mark Chadbourn, *Online Publishing Puts a Chill Down Book World's Spine*, THE INDEPENDENT (LONDON), Nov. 29, 2000, at 2 ("King is just having some fun, scaring the publishers. He hasn't even tried to market his best work. He described *The Plant* as an update of some old work he had lying around, and left it outside his yard with an honesty box for donations. He's having a great time, and he can't lose. But what would happen if he went full-on?").

⁵⁰ A slightly different example of a successful venture into self-publishing is the story of Benjamin Kaplan, a high-school student who amassed \$90,000 in college scholarships to the university of his choice. After graduating in 1999 from Harvard University debt-free, Kaplan self-published *How to Go to College Almost for Free: The Secrets of Winning Scholarship Money*. Kaplan's parents used their untapped college savings to help Kaplan print and bind the niche book, which he then marketed himself. The first edition sold more than 25,000 copies, with the assistance of retailers such as Amazon.com. See Tabor, *supra* note 33, § 3, at 4. Although at the time, Kaplan resisted efforts from publishing houses to re-launch his book and capitalize on his success, the 2002 edition was published by Harper Collins. Although his self-publishing efforts resulted in a respectable number of copies sold, Kaplan did not divulge the profits received from his experiment. See *id.* at 4 ("Quite frankly, I've been too busy and haven't had a chance to figure out how much money we have or have not made so far").

⁵¹ Other such databases include the National Bureau of Economics Research (NBER) and Berkeley Electronic Press (BEPRESS).

databases such as Westlaw and LexisNexis as search intermediaries.⁵² The source intermediaries, or supply intermediaries, inhibit distribution by acting as somewhat imperfect gatekeepers, selecting certain articles and books for publication while rejecting others. Some journals, such as law reviews run by law students, may not act as competent gatekeepers.⁵³ In addition, peer-reviewed journals have their own biases and politics.⁵⁴ As a result, some undeserving works are chosen for publication while deserving works may go unpublished.⁵⁵ Previously, rejected works were not accessible to other scholars until they were finally published, if at all. With the rise of SSRN, these works are stored with all other works and are equally accessible. Therefore, a notable work will not languish in true obscurity, as often times others will publish later works that supplant its original ideas.⁵⁶

In addition to inefficient sorting of articles, traditional supply intermediaries have also distributed articles at an inefficient pace. Although student-run journals make publication decisions more quickly than peer-reviewed journals, publication time remains between six and twelve months from submission. Articles in peer-reviewed journals appear in press even later. Through SSRN, articles can be accessible to readers almost instantaneously upon uploading by the author.

Although research scholars are generally in a better position than purchasers of consumer goods to identify useful products, scholars have relied on search intermediaries and demand intermediaries, to help match their known preferences with a catalogued body of scholarship. These demand intermediaries range from the crude, such as the card catalog and the index to legal periodicals, to the sophisticated (and more costly), such as Westlaw, LexisNexis and Hein Online. Through author and word searches, researchers can eventually find their way to the full text of useful scholarship. Although SSRN does not have the sophisticated capability for Boolean searching that subscription databases do, SSRN does have a fairly efficient system for matching users with products. Authors of articles

⁵² See Solum, *supra* note 12, at 851-53.

⁵³ See *id.* at 850 (hypothesizing that because law students are not experts in the breadth and depth of legal literature, they “rely on ‘proxy variables,’ e.g. the institutional affiliations of authors or their prior record of publication” when making publication decisions).

⁵⁴ See *id.* at 850-51 (“[A]nyone who has knocked around academia knows that there is a seamy underside to the world of peer review.”).

⁵⁵ See Joshua S. Gans & George B. Sheperd, *How Are the Mighty Fallen: Rejected Classic Articles by Leading Economists*, 8 J. ECON. PERSP. 165, 171 (1994) (chronicling the rejection of now seminal articles, such as George Akerlof’s *Market for Lemons: Quality, Uncertainty and the Market Mechanism*, which was rejected by economics journals for four years before being published).

⁵⁶ See *id.* at 169 (describing one of Gary Becker’s works as being rejected and unread due to the comments of one editor until it was published several years later, after other interceding works had used the same methodology).

prepare an abstract, which is searchable by users, and these same authors can choose key words that also aid users in searching.

Authors in various disciplines and countries have uploaded over one hundred thousand working papers and abstracts.⁵⁷ In return, users of SSRN downloaded approximately three million documents in 2005 from the SSRN database.⁵⁸ This revolution in disintermediation greatly improves scholars' ability to both disseminate and access works in "Internet time."⁵⁹ The question remains whether SSRN and other repositories have found a way to circumvent the reputational intermediary function that seems to be necessary for other producers of goods. In a way, SSRN is much like eBay; although individual authors could post papers on their own websites for distribution, an aggregator with search capabilities makes it easier for consumers to find and retrieve useful scholarship. Although branded products resold on eBay rely on pre-existing demand networks, most articles have a productive life with a very small demand curve. Demand may be restricted to a small handful of researchers that rely not on taste or style but on a specific need to access each original work. The cost of making a mistake in researching and finding an irrelevant article is fairly low to an academic researcher; she merely throws the article back without finishing reading. Unlike consumers who have limited attention and resources to spend obtaining a specific good, thorough academic researchers are used to lengthy projects with many rabbit holes, and a few minutes spent reading a non-useful abstract is no hardship. While a consumer needs to find the one toaster that fits his needs, a researcher needs to find all the scholarship on point and also to know where the boundaries of that scholarship lie.

That being said, publishers and academic presses have not been eliminated for the reputational intermediary functions that they serve in authenticating certain works as worthy of their attention.⁶⁰ A paper published in a top journal or top academic press will always have additional value to the author for career purposes and possibly to casual researchers who need to quickly access "seminal works" in a field without lengthy research.

⁵⁷ See Bernard S. Black & Paul L. Caron, *Ranking Law Schools: Using SSRN to Measure Scholarly Performance*, 81 IND. L.J. 83, 95 (2006) (giving statistics as to data and use).

⁵⁸ *Id.* at 96.

⁵⁹ See Legal Theory Blog, http://lsolum.blogspot.com/archives/2006_01_01_lsolum_archive.html#113683990156732487 (Jan. 9, 2006, 17:20 CST).

⁶⁰ See Solum, *supra* note 12, at 861-62 (listing as one of the functions of publication intermediaries that of "certification," which both "reduce[s] search costs" and "enhances professional reputation").

D. Not-So-Success Stories

Although businesses or individuals that harness technology to subvert traditional hierarchies are few and notable, those who try and fail are many and not as highly publicized. In a parallel universe in which the Internet has made this revolution possible, new authors would sell directly to readers, as would songwriters and recording artists, filmmakers, inventors and fashion designers. Worthy political candidates could appeal to the public without the need for political parties' fundraising machines. The list could go on and on. However, this world does not exist in our universe, and much of the reason lies in the necessity of reputational intermediaries in our complex society with the unlimited choices it offers.

Some instances of individuals or groups who have actively questioned and opposed reputational intermediaries know how dangerous visibly avoiding intermediary hierarchies can be. These examples may have more salience for the failure of online IPOs. For example, during Google's online IPO, rumors existed that institutional investors were boycotting the auction. The world outside the securities industry has other examples. One such example occurred in the music industry.

At the 2006 Grammy Awards, a singing trio called the Dixie Chicks won Record of the Year, Album of the Year, Country Album of the Year, and Country Performance by a Duo or Group for their album *Taking the Long Way* and the song *Not Ready to Make Nice*. However, songs from this critically acclaimed album were not played on most radio stations. In March 2003, the Dixie Chicks were one of the most popular recording groups in the U.S.⁶¹ Their first two albums had sold over 10 million copies each, and their third album had sold more than 6 million copies in its first nine months.⁶² The first day of ticket sales for their U.S. tour was a complete success, with over \$49 million in tickets sold.⁶³ One of the songs from that record, *Travelin' Soldier*, was the number one country song, and another, a remake of Fleetwood Mac's *Landslide*, was a top ten pop song.⁶⁴

However, on March 10, 2003, lead singer Natalie Maines, originally from Lubbock, Texas, ad libbed from a stage in London that "we're ashamed that the President of the United States is from Texas."⁶⁵

⁶¹ Ironically, in 2002, programming directors gave their third album, *Home*, airplay even though one single bashed country radio, due to the vast appeal of the unconventional group. See Bill Friskics-Warren, *The Dixie Chicks Keep the Heat on Nashville*, N.Y. TIMES, Aug. 25, 2002, at B1 (quoting a program director for Infinity Broadcast Network as saying in 2002 "Do we have a choice not to play the Dixie Chicks? Sure, we have a choice, but one also has a choice to cut off one's nose to spite their face. The Dixie Chicks are the biggest of the big right now. We play their music as often as we can get it on the air.").

⁶² Chris Willman, *Stars and Strife*, ENTERTAINMENT WEEKLY, May 2, 2003, at 22.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

This statement referred to preparations by the U.S. to invade Iraq, a move that occurred on March 20 that began the Iraq War, which is ongoing almost five years later. This statement stopped the group's commercial success in its tracks. Almost immediately, songs from their hit album were pulled from radio playlists throughout the U.S.⁶⁶ and *Travelin' Soldier* dropped 62 spots to number 63.⁶⁷

The almost instant unpopularity of the group might be attributable to mere backlash from irate listeners. However, the power of the radio stations in creating and destroying demand for a particular song or group cannot be ignored. The songs that are played on the radio are determined by the program director, who is extensively lobbied by the record companies that produce albums and choose singles.⁶⁸ The program director determines what songs will be on the playlist (that the DJ may not deviate from at most stations) and how many times that song will be played in a week.⁶⁹ These decisions may change as a song is added, depending on listener requests and telephone research that asks listeners to listen to song clips and tell which songs sound familiar.⁷⁰ Obviously, if a song is put into high rotation from the beginning, then more requests will follow and more survey respondents will find the song familiar, feeding on the initial determination by the program director. In the best case scenario, songs are added to playlists weeks before the launch of the album, building up demand. However, if a song is not added to many playlists and gets weak rotation, then the debut of the album may go unnoticed. Program directors can also pull songs from rotation, causing demand for the album to dwindle,⁷¹ which is what happened to the Dixie Chicks' fourth album.

The ripple effects of alienating the conglomerates that own multiple stations are pronounced: no air play, no promotion of tour dates, no giveaways of concert tickets, no mention at all. When a documentary⁷²

⁶⁶ See Jennifer 8. Lee, *Musicians Protesting Monopoly in the Media*, N.Y. TIMES, Dec. 18, 2003, at E1 (discussing the consolidation of radio stations under conglomerates such as Clear Channel and noting that Cox Radio and Cumulus banned its member stations from playing Dixie Chicks songs after Maines' statements).

⁶⁷ See Jeff Leeds, *Chicks Sing New Song? Who Needs Airplay?*, N.Y. TIMES, June 10, 2006, at B5.

⁶⁸ See generally JACOB SLICHTER, *SO YOU WANNA BE A ROCK & ROLL STAR* (2004) (chronicling the rise and fall of Semisonic and giving a detailed primer on the power of radio stations, their program directors and the prevalence of legal and illegal "payola").

⁶⁹ See *id.* at 82.

⁷⁰ See *id.* at 86-87.

⁷¹ See *id.* at 82. Writing of his own situation, Slichter says: "The right PD could 'break' us, turning thousands of listeners on to us and thereby launching our album and career. Or, even in the face of building momentum, an influential PD could kill our single by dropping it from the station's playlist, sending our stock plummeting."

⁷² SHUT UP AND SING (Cabin Creek Films 2006).

about the Dixie Chicks' 2003 experience was released, major television broadcasters would not carry paid advertisements for the film.⁷³

Even with the current power of the Internet, when the group released their next album, in 2006, the group did not forego intermediaries and simply sell their new album straight from their own website without a record company. Instead, the Dixie Chicks and their producers sought out new demand networks other than the ones commanded by country radio stations.⁷⁴ Although some radio programming directors were willing to hear the new album, the theme of the album, which focused on how unfairly the band was treated by both the industry and listeners, actually inspired more directors to keep the Dixie Chicks off their playlists.⁷⁵ Through new marketing strategies, and with positive critical acclaim, the album was a respectable hit, although its pre-Grammy Award sales of 1.9 million copies⁷⁶ paled in comparison to their earlier albums and competing albums whose songs were played on country radio.⁷⁷ News of its Grammy success immediately boosted sales to 103,000 the following week, seven times what its anemic sales were the week before.⁷⁸

Although one could expect that an established recording artist or group with a pre-established fan base could avoid intermediaries and sell its product directly to buyers, the necessity for a demand network appears to be strong in the recording industry. In a cyberworld in which anyone can offer music for sale, listeners tend to depend on established demand networks to signal value to them.⁷⁹ Because of this tendency, initial decisions by

⁷³ See David M. Halbfinger, *Negative Publicity is the New Hot Hype*, N.Y. TIMES, Oct. 28, 2006, at B7.

⁷⁴ See Leeds, *supra* note 67 at B5 (describing how the 2006 album *Taking the Long Way* was not played on radio stations but benefited in its first few weeks by a promotional push on *60 Minutes* and morning television shows, as well as partnering with Target).

⁷⁵ See *id.* (quoting one sympathetic programmer as being frustrated that the new album rehashed old wounds instead of moving on to less political themes).

⁷⁶ Bill O'Reilly, the conservative host of the Fox News show *The O'Reilly Factor*, predicted on-air that the album would be a commercial failure and wouldn't sell more than two million copies. See Jon Pareles, *America Catches Up With Them*, N.Y. TIMES, May 21, 2006, at B1 (describing an incident where Maines reminded O'Reilly of this statement after O'Reilly told her that he liked the first single, *Not Ready to Make Nice*).

⁷⁷ See Jeff Leeds, *Grammy Sweep by Dixie Chicks is Seen as Vindication*, N.Y. TIMES, Feb. 13, 2007, at E1.

⁷⁸ See Ben Sisario, *Pop Charts: Lovers and Grammys*, N.Y. TIMES, Feb. 22, 2007, at E2.

⁷⁹ See Duncan J. Watts, *Is Justin Timberlake a Product of Cumulative Advantage?*, N.Y. TIMES, April 15, 2007, at 22 (“[P]eople almost never make decisions independently – in part because the world abounds with so many choices that we have little hope of ever finding what we want on our own; in part because we are never really sure what we want anyway; and in part because what we often want is not so much to experience the ‘best’ of everything as it is to experience the same things as other people and thereby also experience the benefits of sharing.”).

demand intermediaries become powerful determinants of what music consumers buy.⁸⁰

III. DISINTERMEDIATION AND INITIAL PUBLIC OFFERINGS

Much like other industries, the initial public offering industry in the U.S. in the late 1990s seemed ripe for a technological revolution. Issuers wanting to sell shares of their companies into the market must interact with many intermediaries along the way, including investment banks, accountants, lawyers, and printers.⁸¹ Each of these intermediaries requires a fee, thus decreasing the net amount of capital that an issuer can yield from a public offering. Some of these intermediaries are required by law and cannot be bypassed entirely, such as accountants and lawyers. However, advances in the Internet have made it possible to bypass traditional investment banks. These banks launch public offerings using the bookbuilding method, a very expensive method for issuers. After the end of the technology boom in 2001, the bookbuilding process became scrutinized for the conflicts of interest between underwriters, analysts and brokers employed by the investment banks and the issuers that were their clients.⁸² These conflicts, which seemed to be inherent in the bookbuilding process, increased the costs for issuers and reduced the amount of capital they could raise.⁸³

⁸⁰ See *id.* (describing a study in which more than 14,000 listeners were asked to rate unfamiliar songs and were given the option of downloading their favorites, and one set of participants was able to see the download rate of the songs before deciding. The authors of the study found that songs that became popular were different among the groups, and in the groups that were able to see the downloads, the difference between the popular songs and the unpopular grew steadily as the study continued.).

⁸¹ See CARL W. SCHNEIDER, JOSEPH M. MANKO & ROBERT S. KANT, *GOING PUBLIC: PRACTICE, PROCEDURE, AND CONSEQUENCES* (1997) (listing legal fees, accounting fees, and printing costs as the three largest costs of IPOs after the underwriting fee).

⁸² In 2003, the SEC settled with ten major investment banks in a lawsuit primarily regarding analysts touting the stock of issuers who were clients of the analysts' own investment banks. See Press Release, SEC, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), available at <http://www.sec.gov/news/press/2003-54.htm>. In the complaint, both Credit Suisse First Boston and Salomon Smith Barney were charged with spinning IPO shares in "hot" IPO offerings. See *SEC v. Credit Suisse First Boston, LLC*, Litigation Release No. 18110, 2003 SEC LEXIS 1010 (Apr. 28, 2003); *SEC v. Citigroup Global Markets, Inc.*, Litigation Release No. 18111, 2003 SEC LEXIS 1009 (Apr. 28, 2003). In the global settlement of these claims, CSFB and Salomon neither admitted nor denied these claims.

⁸³ In 2002, Harvey Pitt, the now former SEC Chairman, asked Dick Grasso, then New York Stock Exchange Chairman, and Robert R. Glauber, then NASD Chairman, to convene a committee of leaders in both the business and academic communities to assess problems in the IPO process. In May 2003, the NYSE/NASD IPO Advisory Committee released a document entitled "Report and Recommendations," which

Just as the Internet created many opportunities to democratize other processes, such as the election process, the corporate director nominating process, the purchasing of goods, and the acquisition of information, it had great potential to democratize and streamline the IPO process. If the promise of the Internet were fulfilled, the IPO revolution would mean the obsolescence of the bookbuilding mechanism and the emergence of the IPO auction, a transparent and accessible system open to the participation of all U.S. investors. However, this revolution did not happen; although the Internet held the technical capabilities of avoiding traditional Wall Street intermediaries, it could not duplicate the necessary demand network of brokers, analysts and institutional investors those intermediaries controlled.

A. *Bookbuilding Method*

In an IPO, the issuing company sells its shares at the offering price. If the offering price increases in the first day, even dramatically, the issuer does not profit from any share price increase. The resellers of shares either allocated prior to the offering or bought early in the offering capture this price increase. However, some company insiders who sell shares in the aftermarket may be able to sell at the higher price, depending on any restrictions placed on them by the issuer or underwriter to hold their shares for a certain amount of time. Primarily, persons that are able to buy IPO shares at the original offering price will capitalize on the spread between the offering price and the market price. In almost all IPOs conducted in the U.S. using the bookbuilding method, the vast majority, almost 80%, of original IPO shares are pre-allocated by the underwriters of the offering.⁸⁴ The recipients of those shares are usually institutional investors known to the underwriters and regular customers of the underwriters.⁸⁵ As a

acknowledged some problems with the bookbuilding process but nevertheless concluded that the method should not be eliminated or disfavored but should compete on equal footing with online auctions). See NYSE/NASD IPO ADVISORY COMMITTEE, REPORT AND RECOMMENDATIONS OF A COMMITTEE CONVENED BY THE NEW YORK STOCK EXCHANGE, INC. AND NASD AT THE REQUEST OF THE U.S. SECURITIES AND EXCHANGE COMMISSION 9 (May 2003) [hereinafter IPO ADVISORY COMM. REPORT], available at

http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p010373.pdf.

⁸⁴ See Beatrice Boehmer et al., *Do Institutions Receive Favorable Allocations in IPOs with Better Long-Run Returns?*, 41 J. FIN. & QUANTITATIVE ANAL. 809, 814 (2006) (studying a sample of IPOs and determining that 79% of all original IPO shares in the sample were allocated by the underwriter).

⁸⁵ See Reena Aggarwal et al., *Institutional Allocation in Initial Public Offerings: Empirical Evidence*, 57 J. FIN. & QUANTITATIVE ANAL. 1421, 1422 (2002) (finding that institutional investors receive approximately 75% of original IPO shares in an average offering).

consequence of the institutional investor and “friends and family”⁸⁶ allocations, no more than 20% of an offering will be available for sale at the opening of trading. Those retail investors interested in investing in a new issuer must buy shares from original recipients at a higher price in the aftermarket. Generally, institutional investors are the recipients of IPO shares at the offering price, and later sell their shares within days to retail investors at a higher price, pocketing the difference.⁸⁷ In this method, the result is either that the issuer receives less than the full value of its shares, the retail investor overpays for its shares, or a combination of the two.

The unwarranted costs of the investment bank intermediary are almost entirely due to the bookbuilding method.⁸⁸ The bookbuilding method gives the lead underwriter full control of the IPO offering. The underwriter controls how the offering is marketed, how the offering is priced, who receives the IPO shares, and when share recipients may sell their shares in the secondary market. Additionally, the underwriter solicits “indications of interest”⁸⁹ from investors during road shows that take place after the company has filed its registration statement, but before the SEC has declared the statement “effective.” Not surprisingly, the only investors invited to road shows are large, institutional investors and extremely wealthy individuals.⁹⁰ Based on the indications of interest received at the road shows, the underwriter sets the price for the original IPO shares, determines which road show attendees will receive shares at the original IPO price, and determines the number of shares each attendee will receive.

Although the bookbuilding method seems designed to assist underwriters in determining the market price of the shares, thus capturing market demand in the highest price at which the issuer may sell the original

⁸⁶ In an IPO, the issuer may receive an allocation from the underwriter that may be sold to employees, relatives, friends and business partners. See Renee Deger, *IPO Directed Share Plans Pose Risks*, NAT’L L.J., Sept. 13, 1999, at B5 (describing how before the 1999-2000 Boom, directed share plans generally accounted for 10% or less of the total offering but grew during this time period).

⁸⁷ See Alexander P. Ljungqvist et al., *Hot Markets, Investor Sentiment, and IPO Pricing* 33, Nov. 6, 2003, <http://ssrn.com/abstract=282293> (stating that 92% of shares sold by institutional investors on the first day of trading are bought by retail investors).

⁸⁸ See Shawn Tully, *System Failure; Corporate America Has Lost Its Way. Here's a Road Map for Restoring Confidence*, FORTUNE, June 24, 2002, at 74 (reporting that due to investment banking fees and underpricing, startups paid 58 cents for every dollar raised in a public offering and stating that “[t]he main source of corruption in America’s financial markets is the sordid, antiquated world of initial public offerings”).

⁸⁹ See Francesca Cornelli & David Goldreich, *Bookbuilding & Strategic Allocation*, 56 J. FIN. 2337, 2337 (2001).

⁹⁰ See Adam Lashinsky, *It’s Time to Open Up the Road Show: What the SEC Doesn’t Want You to Know*, FORTUNE, Nov. 8, 1999, at 338; The Regulation of Securities Offerings, Securities Act Release No. 7606A, Exchange Act Release No. 40, 632A, Investment Company Act Release No. 23,519A, 63 Fed. Reg. 67,174,67,214 (proposed Dec. 4, 1998) (acknowledging that investment banks generally invite only selected broker-dealers and large investors to road shows).

IPO shares, in practice the resulting price is systematically less than market demand. During the first day of trading in an IPO, most issuers see their shares increase in price throughout the day, reflecting the fact that the offering price was less than the market price. From 1980-2001, the average IPO share price increased during the first day by 18.8%.⁹¹ This first-day “pop” will also be pronounced during “hot” IPO markets,⁹² such as the market that existed during the technology boom, specifically in 1999 and the first half of 2000. During this period, the average first-day increase was 65%.⁹³ Technology issuers had even more dramatic first-day share price increases, with one-third of those issuers seeing the share price double in the first day.⁹⁴ Even in lethargic market environments, the investment bank that determines an offering price seems to fix that price at a substantial discount from the price the market will bear. Although many scholars have developed economic hypotheses of why IPO shares are underpriced,⁹⁵ an agency cost hypothesis explains in the simplest terms why an underwriter would underprice IPO shares. In doing so, the underwriter rewards loyal customers, including institutional investors and investment banking clients, by allocating them shares with a built-in gain. This reward, though given by the underwriter, is financed by the issuer, who may not benefit from this practice.⁹⁶

The bookbuilding process, complete with the underpricing and pre-allocation of shares, does not run afoul of any state or federal laws, including securities laws and rules of the National Association of Securities Dealers. In recent years, however, some regulators have attempted to investigate the most extreme abuses. For example, a few powerful Wall Street investment banks were investigated and charged by the SEC, the Department of Justice and the New York Attorney General for allocating

⁹¹ Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795, 1795 (2002).

⁹² Francois Derrien & Kent L. Womack, *Auctions vs. Bookbuilding and the Control of Underpricing in Hot IPO Markets*, 16 REV. FIN. STUD. 31, 44 (2003).

⁹³ See Ritter & Welch, *supra* note 91, at 1796.

⁹⁴ Melanie Warner, *Friends and Family: Sycamore Gave Lots of “Directed Shares” to a Key Customer*, FORTUNE, Mar. 20, 2000, at 104.

⁹⁵ Ann E. Sherman & Sheridan Titman, *Building the IPO Order Book: Underpricing & Participation Limits With Costly Information*, 65 J. FIN. ECON. 3, 4 (2001) (arguing that underpricing is necessary to compensate investors who disclose their valuation of the firm pre-IPO and assist the underwriter in assessing market value); Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings are Underpriced*, 41 UCLA L. REV. 17, 19 (1993) (arguing that because damages in securities lawsuits based on disclosure fraud are based on price declines from the offering price, underwriters are inclined to set the offering price artificially low).

⁹⁶ See John C. Coffee, Jr., *The IPO Allocation Probe: Who is the Victim?*, N.Y.L.J., Jan. 18, 2001, at 5 (describing as dysfunctional an IPO system that sees up to 75% of the market value of the IPO shares going to either underwriters or institutional investors and not the issuer).

shares to investors in return for excessive brokerage fees.⁹⁷ In addition, the SEC has shown some willingness to prosecute “laddering schemes” whereby underwriter require allocates of hot IPO shares to buy more shares in the aftermarket of either the same issuer or a different issuer.⁹⁸ Private lawsuits by investors alleging that the bookbuilding method is similar to a “pump-and-dump” scheme have not been as successful under either antitrust laws⁹⁹ or securities laws.¹⁰⁰ In 2002, the NASD proposed Rule 2712, which would prohibit investment bankers from allocating IPO shares

⁹⁷ See Press Release, SEC., *supra* note 82. In addition, The NASD announced in May 2004 that it had fined Bear Stearns & Co., Inc., Morgan Stanley & Co. and others for churning excessive fees on the day of the IPO for the accounts of allocates. See NASD News Release, NASD Charges Invemed Associates with Sharing in Customers’ Profits from Hot IPOs (Apr. 15, 2003), available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002942; see also NASD News Release, Thomas Weisel Partners to Pay \$1.75 Million to Settle NASD Charges of IPO, E-Mail Retention Violations (Mar. 30, 2005), http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013698 (determining that Thomas Weisel partners received excessively high commissions (\$1 per share compared to the normal six cents per share) on highly liquid trades within 24 hours of allocating hot IPO shares to the same customers during 1999-2000). For example, a customer may be granted an opportunity to buy hot IPO shares on a certain day, but during that day, the broker will buy and sell a liquid security for the same customer and charge a fee of \$100,000 instead of a \$3000 fee.

⁹⁸ *SEC v. J.P. Morgan Securities Inc.*, No. 03-2028 (D.D.C. Oct. 1, 2003) (entering settlement agreement for \$25 million for requiring customers receiving IPO allocations in an oversubscribed “hot” IPO, IPIX, to participate in a “cold” IPO for Biopure in violation of Rule 101 (Regulation M) of the 1933 Act, NASD Rule 2110, and the Free-Riding and Withholding Interpretation).

⁹⁹ *Billing v. Credit Suisse First Boston Ltd.*, 426 F.3d 130 (2d Cir. 2005) (holding that litigation under antitrust laws could continue in case in which “[p]laintiffs allege an epic Wall Street conspiracy. . . . Through these contracts and by other illegal means, the underwriter firms allegedly executed a series of manipulations that grossly inflated the price of the securities after the IPOs in the so-called aftermarket.”). This decision was reversed by the U.S. Supreme Court on procedural grounds, ending the litigation. *Credit Suisse Sec. (USA) LLC v. Billing*, 127 S. Ct. 2383, 2397 (2007) (holding that the antitrust laws do not apply to these actions, which are allowed by the federal securities laws, and that the SEC is a better governmental agent to monitor these types of activities than the federal courts applying antitrust law).

¹⁰⁰ Similar cases under securities laws have also generally been unsuccessful. Although the district court initially held that the laddering and market manipulation allegations against investment banks in six of over 300 consolidated cases could stand and certified the plaintiff class, the Second Circuit reversed that finding. *In re Initial Public Offering Sec. Litig.*, 227 F.R.D. 65 (S.D.N.Y. 2004), *rev’d* by 471 F.3d 24 (2d Cir. 2006). Likewise, a group of these 300 cases alleging price inflation via underpricing was dismissed by both the U.S. District Court for the Southern District of New York and the Second Circuit. *Tenney v. Credit Suisse First Boston Corp.*, 2006 WL 1423785 (2d Cir. May 19, 2006), *cert. denied* *Liu v. Credit Suisse First Boston Corp.*, 127 S. Ct. 733 (2006).

to executives of clients or potential clients in a quid pro quo transaction.¹⁰¹ However, proposed Rule 2712 was still pending as of July 2007, although public comments were closed in January 2005, indicating that the Rule is unlikely to be accepted.¹⁰²

B. *OpenIPO*

Alternatively, IPO shares could be distributed through an open auction process conducted over the Internet. In an Internet auction, bidders place orders based on the number of shares that they would purchase at given prices. The highest price at which all shares would be purchased becomes the offering price. Successful bidders are allocated shares based on the offering price, and if the offering is oversubscribed at the offering price, then bidders receive a pro rata allocation of shares. No shares would be pre-allocated to either individuals or institutions. In this process, the underwriter is more of a facilitator, like eBay, than an intermediary. The underwriter has no discretion or very little discretion in determining the price of the IPO shares or the recipients of the distribution in the purest form of an online auction. Because the resulting offering price should reflect the full market demand for the IPO shares (100% of X), the online auction process should eliminate underpricing and allow the issuer to obtain the maximum amount of capital to be raised in the offering.

Although several investment banks developed online auction systems during the late 1990s, currently only W.R. Hambrecht + Co. maintains an online IPO auction platform.¹⁰³ Beginning in 1999, Hambrecht began launching companies using an online IPO auction process called OpenIPO. Although the completed OpenIPO auctions suggest that the auction offering prices do more closely resemble the market prices for

¹⁰¹ See National Association of Securities Dealers, Notice to Members 02-55 (Aug. 22) (requesting comment on Proposed New Rule 2712 (IPO Allocations and Distributions)). This proposed rule was amended in September 2003 and in November 2003 to incorporate some of the recommendations of the IPO Advisory Committee and comments were solicited on “requiring underwriters to . . . [u]se an auction or other system to collect indications of interest to help establish the final IPO price”). See National Association of Securities Dealers, Notice to Members 03-72, 778-79 (Nov. 2003).

¹⁰² In 1998, the SEC proposed rule 7606A, which would have made numerous changes to the IPO process. Dubbed the “Aircraft Carrier” proposal for its breadth, rule 7606A languished for years without being accepted.

¹⁰³ Hambrecht + Co. was launched in 1998 by Bill Hambrecht, a former investment banker at his own San Francisco firm, Hambrecht & Quist. See Christian Berthelsen, *Investment Banker Fights the System: Plan for Cutting IPO Conflicts Gets Attention, but Wall Street Dubious*, S.F. CHRON., Sept. 22, 2002, at G1 (describing OpenIPO as “an alternative open-bidding process modeled on Dutch flower auctions to eliminate secretive IPO pricing strategies and what many experts consider allocation favoritism”).

the shares, as reflected in the closing prices for the first day of trading, very few companies have opted for the online auction route.

Issuer Name	Date of IPO	Size of Offering	Offering Price	Closing Price	Percent Change
NetSuite Inc.	12/20/2007	\$161,200,000	\$26.00	\$35.50	0.3654
Clean Energy Fuels Corp.	5/25/2007	\$120,000,000	\$12.00	\$12.04	0.333
Interactive Brokers Group, Inc.	5/4/2007	\$1,200,400,000	\$30.01	\$31.30	4.298
FortuNet, Inc.	1/31/2006	\$22,500,000	\$9.00	\$9.05	0.555
Traffic.com, Inc.	1/25/2006	\$78,600,000	\$12.00	\$12.01 ¹⁰⁴	0.083
Dover Saddlery, Inc.	11/17/2005	\$27,500,000	\$10.00	\$10.25 ¹⁰⁵	2.500
Avalon Pharmaceuticals, Inc.	9/28/2005	\$28,875,000	\$10.50	\$9.49	-9.619
CryoCor, Inc.	7/14/2005	\$40,799,990	\$11.00	\$10.87	-1.181
Morningstar, Inc.	5/2/2005	\$140,831,250	\$18.50	\$20.05 ¹⁰⁶	8.378
Boff Holding, Inc.	3/15/2005	\$35,100,001	\$11.50	\$11.50	0.000
Google, Inc. ¹⁰⁷	8/18/2004	\$1,666,429,400	\$85.00	\$100.34	18.047
New River Pharmaceuticals, Inc.	8/5/2004	\$33,600,000	\$8.00	\$7.50	-6.250
Genitope Corporation	10/30/2003	\$33,300,000	\$9.00	\$10.00	-11.111
RedEnvelope, Inc.	9/25/2003	\$30,800,000	\$14.00	\$14.55	3.928
Overstock.com	5/29/2002	\$39,000,000	\$13.00	\$13.03	0.231

¹⁰⁴ According to the Wall Street Journal's market company research tool on its website, closing prices for this stock were only available for January 27, 2006 and later, even though its initial public offering is listed as occurring on January 25, 2006.

¹⁰⁵ According to the Wall Street Journal's market company research tool on its website, closing prices for this stock were only available for November 18, 2005 and later, even though its initial public offering is listed as occurring on November 17, 2005.

¹⁰⁶ According to the Wall Street Journal's market company research tool on its website, closing prices for this stock were only available for May 3, 2005 and later, even though its initial public offering is listed as occurring on May 2, 2005.

¹⁰⁷ Technically, Google was not an OpenIPO because it was not hosted on Hambrecht's IPO platform and was executed according to its own guidelines. However, because so many people associate the Google IPO with the Hambrecht IPO system, it is included here.

Briazz, Inc.	5/2/2001	\$16,000,000	\$8.00	\$8.03	0.375
Peet's Coffee & Tea	1/25/2001	\$26,400,000	\$8.00	\$9.38	17.250
Nogatech, Inc.	5/17/2000	\$42,000,000	\$12.00	\$9.41	-21.583
Andover.net	12/8/1999	\$82,800,000	\$18.00	\$63.38	252.111
Salon.com	6/22/1999	\$27,300,000	\$10.50	\$10.00	-5.000
Ravenswood	4/9/1999	\$11,550,000	\$10.50	\$10.88	3.600

As the table suggests, only a handful of companies have chosen the online auction for their IPOs. Roughly no more than two companies choose this option a year, with 1999, the height of the technology boom, seeing three online IPOs and 2005, the year following Google's online auction, seeing five. However, the online auction does appear to capture full market demand in the offering price much better than the bookbuilding system. Out of the twenty-one companies that have chosen this option, only four companies have seen first-day share price increases of over 10%, and only two companies' shares increased over the average bookbuilding price increase of 18.8%. Including Andover.net's nonrepresentative jump of over 252% in its first day of trading, the mean first-day return is skewed to 13.960%, an increase that does not seem substantially more efficient than the traditional bookbuilding increase. Because the dataset contains an outlier, and the mean is not robust to the outlier, the median first-day increase is a better measure. In fact, the median first-day return using the OpenIPO system is 0.375%, which comes close to approximating the theoretically perfect first-day pop of zero. In the median case, the issuer would capture 99.625% of the market price X.

If online auction IPOs are more efficient in getting necessary capital to issuers, then proponents of auctions must explain why they seem to be unpopular with issuers. Many reasons that may affect decision-making on the margins come to mind: some issuers may believe that going public with a Wall Street firm has more cachet than an auction;¹⁰⁸ some issuers may believe that a first-day pop creates positive media buzz that either advertises their products and services¹⁰⁹ or increases goodwill for a follow-on offering;¹¹⁰ some issuers may themselves benefit from the bookbuilding method by receiving allocations of original IPO shares in

¹⁰⁸ See Tully, *supra* note 88, at 74 (positing that issuers choose the inefficient bookbuilding method because "gilded names like Goldman Sachs and Morgan Stanley provide a comfort factor").

¹⁰⁹ Griffith, *supra* note 5, at 601 ("A substantial pop on the first day of trading may be valuable for its ability to signal to other market participants that the issuer is a quality company.").

¹¹⁰ *Id.* at 601 ("Aftermarket performance may also have an impact on future equity offerings in which issuers may recoup the capital foregone in initial underpricing.").

future offerings;¹¹¹ and some issuers may use pre-IPO allocations to their own advantage by granting allocations to business partners, vendors, employees and friends.¹¹²

However, one explanation holds true in all cases: in the U.S., online IPOs that avoid Wall Street intermediaries also suffer from the loss of demand networks that those intermediaries create.¹¹³ Just as brilliant novels and inspiring music can be sold directly to consumers over the Internet, these products will not be sold to a substantial number of consumers without being part of a demand network (or having amazing luck).

C. *The Wall Street Demand Network*

Investors have a dazzling array of choices when it comes to purchasing equity securities in publicly-traded companies. Almost 7,000 companies are traded on the New York Stock Exchange, the NASDAQ, and the American Stock Exchange. This number does not include companies traded on foreign exchanges or companies publicly traded but not on exchanges. And of course, investors may also choose to invest in bonds,

¹¹¹ See John C. Coffee, Jr., "Spinning" for Dollars: IPOs and Allocation of Hot Issues, N.Y.L.J., Mar. 26, 1998, at 5 (describing a hypothetical scenario in which founders are inclined to protest because the share price jumped the first day but are placated both by their newly created personal wealth and by receiving IPO shares of another client of the investment banker); see also Tully, *supra* note 88, at 74 (suggesting that "the SEC should ban all officers of startups and their venture capitalists from accepting any other firm's IPO shares from investment banks within a year of their own company's filing to go public").

¹¹² See, e.g., Gretchen Morgenson, *Sweetheart Stock Deals Common in Telecom*, TULSA WORLD, Sept. 1, 2002, at E1 (describing transaction in which ONI Systems Corp. offered two executives for Williams Communications pre-IPO shares for \$6.32 each a few months prior to the announcement that Williams and ONI had signed a \$30 million contract for ONI's fiber optic network-related products; at the time of the IPO, one Williams executive's gain was \$43 million); Jeff Smith, *N.Y. Puts Heat on Nacchio Hot IPOs*, ROCKY MTN. NEWS, June 21, 2003, at 1C (detailing another ONI transaction that rewarded Joe Nacchio, former Qwest CEO, with friends and family shares that tripled in price the first day of trading three months before the announcement of a contract between ONI and Qwest that caused the shares to soar 15 percent).

¹¹³ See Tully, *supra* note 88, at 74 (noting that one critical reason that issuers choose the inefficient bookbuilding method is because "going with a top house guarantees that a prestigious analyst will tout your stock [to] powerful institutions"). Although issuers that use pre-IPO stock to gain business advantages may not be subject to liability, the executives receiving the shares who subsequently steer business the issuer's way may be. See Kathleen Pender, *Be Cautious When Business Associates Offer Access to IPO Shares*, S.F. CHRON., Apr. 7, 2000, at B1 (considering a scenario whereby the business associate recipient of the directed shares might be charged with commercial bribery under California state law for accepting something of value "in return for using or agreeing to use his or her position for the benefit of that other person"); CAL. PENAL CODE § 641.3 (West 2007).

various types of funds and other investment vehicles. Even if an investor wanted to concentrate on companies launching IPOs, that research would be daunting. In 2006, 198 companies went public in the U.S. alone.¹¹⁴ In hot markets, this number may double; in 1999, 486 companies went public, and in 2000, 406.¹¹⁵ In addition, an investor would have to spend more time researching each company than, for example, researching a book by reading the book jacket or a review or researching an album by listening to snippets in a record store. Most retail investors, therefore, rely on third-parties to tell them the value of an upcoming IPO.

When an IPO is being considered, an issuer would like to see positive reviews in financial newspapers and magazines and on financial news television shows. In addition, analysts, some of whom are independent and some of whom are employed by investment banks, research IPOs and then issue recommendations on whether investors should invest in a particular company's shares. Hopefully, this coverage will last throughout the IPO and into the aftermarket, supporting the price for months to come. In addition, brokers, who either read the research themselves or hear about IPOs directly, will recommend the IPOs to their customers, particularly institutional investors.

In a bookbuilding IPO, the demand network is highly structured and led by the underwriter. However, if an issuer decides to avoid traditional underwriters and launch its shares in an online IPO, then the issuer must hope that financial reporters and analysts will be willing to provide coverage of their IPO and that brokers will recommend the IPO to their customers independent of the underwriter's efforts.¹¹⁶ However, these actors may not have sufficient incentives to act in that way. In addition, traditional underwriters work in syndicates, thereby expanding existing demand networks by a factor of the number of participating banks. However, few traditional underwriters have chosen to join Hambrecht in online IPOs.¹¹⁷ Therefore, although online auction IPOs may be efficient in that they capture existing market demand (X) and completely incorporate it into the offering price, the online auction IPO does not in and of itself

¹¹⁴ See Renaissance Capital's 2006 Annual IPO Review, *supra* note 7.

¹¹⁵ *Id.*

¹¹⁶ See Berthelsen, *supra* note 103, at G1 (reporting that when Overstock.com went public in 2002 using OpenIPO, "nearly every firm competing for the underwriting business said top investment houses would not provide research coverage of his company"). In fact, only one company other than Hambrecht provided research coverage for Overstock.com, even three months after the IPO. See *id.*

¹¹⁷ See Patrick Byrne, CEO of Overstock.com, IPO Reporter, available at 2002 WLNR 5011975 (Westlaw) (quoting Byrne as saying that when he was considering an auction IPO, "[A]ll the other banks told me they would not work with Hambrecht. They all let me know they would all work with each other, but none of them would work with Hambrecht.").

create increased demand ($X + Y$). Thus, issuers may be capturing close to 100% of X , but that amount may be less than 80% of $(X + Y)$.¹¹⁸

OpenIPO works somewhat like eBay, so there must be potential for it to become as popular as eBay, even without functioning as either a reputational intermediary¹¹⁹ or a demand intermediary. However, the products on eBay are generally branded products that are being resold into a market with sufficient demand for those items. In fact, one could argue that many of the items on eBay are pre-selected by the sellers for sale based entirely on the fact that market demand for those items is high. Resellers of video game systems on eBay benefit from continued advertising and marketing of those systems by the manufacturers and other retail outlets. Amazon.com benefits from marketing of books by publishers and CDs by record companies. But the issuers that are going public on OpenIPO are selling a product that is fairly unknown and for which information is hard to obtain and difficult to analyze. Particularly for unseasoned issuers with short records of earnings, the OpenIPO method may capture existing market demand in an efficient manner, but it won't generate increased demand the way the bookbuilding method can with its built-in demand network. Interestingly, one wonders if a seasoned issuer, with at least long-standing demand for its products or services, if not its equity, could use OpenIPO like eBay to sell at a higher price without losing capital to the intermediaries.

D. Google

Unlike many technology firms that have launched IPOs in recent years without lengthy track records, Google's two founders, Larry Page and Sergey Brin, announced Google's IPO in 2004 after enjoying enormous popularity for many years.¹²⁰ By design or sheer luck, Google did not go

¹¹⁸ While this article was in the editing process, NetSuite Inc. went public using Hambrecht's auction platform, but with Credit Suisse Securities (USA) LLC as lead manager of the offering. Although the timing of this offering does not allow for a thorough treatment in this article, the higher-than-expected closing price of \$26 lends some credibility to the argument that Wall Street underwriters increase demand. However, the above-average first-day pop (36.538%) suggests that underpricing may have occurred also. See Ken Schachter, *NetSuite IPO Hits Larry Ellison's Sweet Spot*, RED HERRING, Dec. 20, 2007, <http://www.redherring.com/home/23345> (last visited Jan. 30, 2008); Lynn Cowan, *NetSuite's IPO is an Ellison Winner*, WALL ST. J., Dec. 21, 2007, at C3.

¹¹⁹ Of course, one cannot say that Hambrecht + Co. does not act as a reputational intermediary; under securities laws, it is liable to investors under certain circumstances and as such has more at stake than eBay. However, Hambrecht + Co. does not provide the types of services that a demand intermediary like a Wall Street investment bank would with its network of analysts and brokers.

¹²⁰ See *Google's Dutch Treat*, *supra* note 3, at A20 ("In a sense, this auction is the perfect IPO expression of Google's own business model. The company's success has

public during the 1999-2000 boom, although many technology companies with little or no record of earnings did choose to go public during that time, only to eventually fail. In fact, several search engine companies failed during this time or underwent massive restructuring.¹²¹ However, Google remained private and continued to prosper, choosing to go public when it was the most pre-eminent search engine website and the fifth most popular website in the world.¹²² To make this high-profile IPO even more interesting, the founders announced that the public offering would be executed via an online auction that would embody both the innovative mindset and democratic spirit of Google.¹²³

Google attempted to have the best of both IPO worlds: the Wall Street demand network plus the less costly online IPO. Although Google chose two traditional underwriters, Morgan Stanley and Credit Suisse First Boston, to lead the IPO,¹²⁴ Google chose the online IPO format. Neither Morgan Stanley nor CSFB had ever offered an online IPO auction before. This hybrid model could be similar to having an established publisher offer an author's book electronically: using an established network without losing profits through unnecessary markups. In theory, Google would be able to capture something closer to 100% of X than a traditional bookbuilding auction. In fact, using two established demand

derived from its ability to democratize access to information via the Internet, and its auction will likewise open its shares to a wide spectrum of investors.”).

¹²¹ Lycos was sold twice, once in 2000 to Terra Networks, S.A., and again in 2004 to Daum Communications Corporation. Jung-A Song, *Saturation Drives Daum to Buy Lycos: Acquisition Underlines Ambitions of South Korean Internet Companies*, FIN. TIMES (London), Aug. 3, 2004, at 23. AltaVista's parent was bought by Compaq, which spun off AltaVista stock in 1999. *CMGI Files to Spin Off Altavista*, TIMES OF INDIA, Dec. 19, 1999. Altavista was eventually bought by Overture Services, Inc., which was then bought by Yahoo in 2003. Michael Bazeley, *The Search Engine That Could: Yahoo's Crash Efforts to Build an Internet Search Engine Paid Off Handsomely for a Firm Lagging Behind Its Top Competitors. Now, Search Engine Ad Revenue is Nearly Half of Yahoo's Total Net Revenue*, SAN JOSE MERCURY NEWS, Apr. 10, 2005, at 1C.

¹²² Stating that Google chose to go public may be misleading. Because the founders had used Google shares to recruit talented employees, the firm found itself with over 300 shareholders, subjecting it to disclosure requirements of public companies under federal securities laws. See Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581, 1592 (2006) (describing how Google would soon become a “backdoor” public company regardless of whether it participated in an IPO). Google management surely realized that the firm might as well reap the benefits of being a public company, including liquidity, increased capital and a ready currency for conducting acquisitions.

¹²³ *Google's Dutch Treat*, WALL ST. J., *supra* note 3.

¹²⁴ Google Inc., Registration Statement (Form S-1), at 96 (Apr. 29, 2004) [hereinafter *Form S-1*], available at

<http://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds1.htm>.

intermediaries, Google might be able to obtain the improbable, if not impossible, 100% of (X + Y).¹²⁵

However, this model soon began to suffer. Critics noted that the two underwriters were frustrating the democratic auction model by requiring bidders to have accounts at their firms with very high minimum balances.¹²⁶ In its first amendment to its registration statement, Google added twenty-nine additional banks as underwriters, including smaller banks and online banks, with minimum balances as low as \$2000, such as E*Trade.¹²⁷ The twenty-nine additional underwriters also included traditional Wall Street firms such as Merrill Lynch and Goldman Sachs, who were in the unfamiliar position of being part of a large syndicate without having leadership roles.¹²⁸ Merrill Lynch would eventually drop out of the syndicate.¹²⁹

In addition, although Hambrecht was added to the syndicate, Google did not use the OpenIPO platform. Instead, it created a two-stage bidding process¹³⁰ that investors found confusing.¹³¹ On the day the

¹²⁵ However, one other theory suggests that the Google founders chose the auction mechanism not to maximize IPO returns but to create a marketing event. *See* Fleischer, *supra* note 121, at 1593 (arguing that because Google was prompted to go public by noneconomic events its main goal was not to obtain an increased share price, either 100% of X or 100% of (X + Y), but to use its IPO as a branding event that reflected its mantra, “Don’t be Evil”).

¹²⁶ *See Form S-1, supra* note 123, at 26 (noting that “due to each underwriter’s requirements. . . you may not be able to open an account”); *see also* John E. Fitzgibbon, Jr., *Passing Parade: Google Hype vs. History*, at <http://www.123jump.com/story/Passing-Parade:-Google-Hype-Vs.History/14842/ipo/Google> (last visited Nov. 27, 2005) (reporting the rumor that one of the two firms required a balance of \$1 million in order to participate in the auction).

¹²⁷ Google Inc., Amendment No. 1 to Registration Statement (Form S-1), at 25 (May 21, 2004), *available at* <http://www.sec.gov/Archives/edgar/data/1288776/000119312504093053/ds1a.htm>.

¹²⁸ *See id.* at 94 (noting that Morgan Stanley and Credit Suisse would act as representatives for the other underwriters).

¹²⁹ *See Bill Deener, Google IPO May Not Live Up to Its Hype*, DALLAS MORNING NEWS, Aug. 8, 2004, at 1D (hypothesizing that Google’s demand to reduce underwriting fees from seven percent to three percent drove Merrill Lynch out of the underwriting syndicate).

¹³⁰ This elaborate process is described in Google’s seventh amendment to its registration statement. *See* Google Inc., Amendment No. 7 to Registration Statement (Form S-1) at 35-38 (Aug. 13, 2004), *available at* <http://www.sec.gov/Archives/edgar/data/1288776/000119312504139655/ds1a.htm>. First, bidders were required to register on a Google website to participate in the auction and then separately open an account with a participating underwriter. Then, once the bidding process started, bidders could submit bids to any of the remaining twenty-eight underwriters listed in the seventh amendment via Internet, telephone, fax or hand delivery. However, all bidders must accept electronic delivery of all notices during the auction process. Bidders could change or withdraw bids during the auction process, but Google management retained the right to change the amount of shares sold and the

auction closed, Google also lowered the estimated price range from \$108-135 to \$85-95.¹³² After the auction closed, Google priced the shares at \$85 per share. Because Google reserved the right to deviate from the clearing price, no one outside the process could know if the clearing price was in fact \$85 or if the clearing price was above or below that amount.¹³³ In addition, shares were allocated following a rather opaque process. Google had reserved the right to allocate its shares either in a pro rata allocation or in a “maximum share allocation” based on an algorithm that seemed to indicate that smaller bids would be wholly accepted while larger bids would receive a reduced number of shares.¹³⁴ Although Google did not make the bids public, most critics believe that winning bidders received a 75% allocation.¹³⁵ Therefore, the offering would have been oversubscribed at \$85, suggesting that the clearing price was higher and that Google underpriced itself. To that end, the first-day increase in Google’s share price was 18%, roughly equivalent to the average bookbuilding IPO first-day increase. Therefore, the question remains: Was the Google IPO more efficient than a traditional bookbuilding IPO? Google did not capture 100% of the existing market demand on the day of its IPO. But, did Google capture 82% of X, 82% of (X+Y) or 82% of something else?

Many critics believe that the market demand on August 18, 2004 was not as high as it otherwise could have been. Many factors unrelated to the auction process contributed to investor confusion surrounding the Google IPO: the uncertainty in the Internet search market in the summer of 2004,¹³⁶ disclosures made by Google shortly before the registration

price range during the process. After an offering price was determined, successful bidders would be sent an electronic notice, with one hour to withdraw their bid before acceptance.

¹³¹ See Pete Barlas, *Many Thumbs Neither Up Nor Down for Google’s Auction IPO*, INVESTORS BUS. DAILY, Aug. 27, 2004, at A4 (citing a former chief economist for the SEC as saying that the web-based system was too confusing for individual investors due to its unwieldy interface).

¹³² Google Inc., Amendment No. 9 to Registration Statement (Form S-1), at ii (Aug. 18, 2004), available at <http://www.sec.gov/Archives/edgar/data/1288776/000119312504142742/ds1a.htm>.

¹³³ *Form S-1*, supra note 123, at 18 (describing how Google may set an initial public offering price that “is near or equal to the clearing price”).

¹³⁴ *Id.* at 29.

¹³⁵ Dawn Kawamoto & Stefanie Olsen, *Google Gets to Wall Street and Lives*, CNET NEWS.COM, Aug. 19, 2004, http://news.com.com/2100-1038_3-5317091.html?legacy=cnet.

¹³⁶ See, e.g., David A. Vise, *Bidding Opens New Chapter for Tech ‘God’ Google*, WASH. POST, Aug. 13, 2004, at E1; Global Agenda, *Google’s IPO Rollercoaster*, Economist.com, Aug. 20, 2004, available at http://www.economist.com/agenda/displaystory.cfm?story_id=E1_PTDPJTG.

statement was declared effective concerning an SEC investigation,¹³⁷ and disclosures regarding potential liability¹³⁸ for a *Playboy* interview published during the IPO's quiet period.¹³⁹ Critics also argue that demand was suppressed because of industry response to Google's choice of IPO format.¹⁴⁰ However, an established underwriter could have enforced discipline among analysts and brokers so that these missteps were not seized upon by the demand network. In effect, one can theorize that due to backlash from the bookbuilding demand network, Google actually captured 82% of (X-Z). One financial reporter makes this claim in this post-IPO review:

The "go it alone" method that Google used was a total fiasco, just ridiculous. The arrogance, the incompetence was beyond belief. Their own missteps and misbehavior have brought *much lower* prices than they ever would have gotten for the deal. Institutions, mutual funds and hedge funds all are boycotting the deal. So the price will be artificially *low*. These guys will have totally messed it up for themselves.¹⁴¹

One question that Google's IPO raises is why did the founders of Google choose to capture 82% of (X-Z) and not 100% of (X-Z)? If rumors are correct and successful bidders in the IPO received 75% of their bids, then the assumption must be that the IPO was oversubscribed at \$85.¹⁴² If the

¹³⁷ Google Inc., Amendment No. 8 to Registration Statement (Form S-1), at 19 (Aug. 16, 2004), available at <http://www.sec.gov/Archives/edgar/data/1288776/000119312504141762/ds1a.htm>.

¹³⁸ Amendment No. 7, *supra* note 129, at 21-22.

¹³⁹ David Sheff, *Google Guys*, PLAYBOY, Sept. 2004, at 55.

¹⁴⁰ The share price rose almost continuously from the first day, reaching close to \$300 per share in the first nine months of trading. Growing institutional demand, which may have been suppressed at the time of the auction, helped this price increase. For example, Fidelity Investments bought 15% of Google's Class A shares in the first month of trading. See Gregory Zuckerman and Kevin J. Delaney, Heard on the Street: *Google Rallies, Shakes Off Some of the Skeptics*, WALL ST. J., Sept. 29, 2004, at C4. Growing institutional investor demand both supported and followed the share price, and by December 2004, 89% of Google's float was held by institutional investors. Bambi Francisco, *Getting Google Religion: Even the Skeptics are Converting*, MARKETWATCH.COM, Nov. 30, 2004, <http://www.marketwatch.com/news/story/getting-google-religion/story.aspx?guid=%7B07901253%2DFC58%2D427B%2DB691%2D77B23B64738D%7D>.

¹⁴¹ James J. Cramer, *How to Buy Google: After the Deal*, REALMONEY.COM, Aug. 18, 2004, http://www.thestreet.com/p/_rms/rmoney/jamesjramer/10178902.html.

¹⁴² See *IPO Watch: Pop Goes the Google*, RED HERRING (Aug. 22, 2004), <http://www.redherring.com/Home/10805> ("In a nutshell, the offering price of \$85 per share had to be below the clearing price."). See also Kevin J. Delaney, Gregory Zuckerman & Robin Sidel, *Google Is Allowed to Continue Along Its Bumpy Road to IPO By Issuing Revised SEC Filing*, WALL ST. J., Aug. 16, 2004, at C1 (providing anecdotal evidence that most bids were in the \$108 to \$135 range or higher).

founders and their investment bankers had chosen an offering price that was closer to the true clearing price, the highest price at which all shares would have been subscribed, the offering price may have been closer to the market price. Assuming that on the day of the IPO the most that the issuer could have captured would have been 100% of $(X-Z)$, the decreased market demand, the issuer seemed to have made a decision to capture less. Indeed, the numbers seem to suggest that Google chose to underprice itself. If underpricing is generally thought to occur either to provide investment banks with a currency with which to reward or entice customers or, in a more generous view, to compensate first customers with providing pricing information before the offering, then the Google underpricing in its online auction seems to have no purpose whatsoever.

However, a persuasive explanation can be offered for the intentional underpricing. Most participants agree that there were not enough bids on August 18 to allocate all the shares at \$135. With only hours left in the bidding process, Page and Brin drastically lowered the price range, with the resulting \$85 per share being 58% of the highest suggested \$135 price, but they also reduced the number of shares that they personally would sell at that price.¹⁴³ Instead, they were able to sell shares 180 days later at a much higher price once they shrank the supply. Perhaps Page and Brin determined that the clearing price would not approach either the market price of Google (X) or the market price with increased demand sometimes generated in an IPO ($X + Y$). Instead of selling the bulk of their stakes at the reduced price of $(X-Z)$, they decided to let others sell at the underpriced offering price of 85% of $(X-Z)$. Perhaps they realized that because so many investors were waiting to buy in the aftermarket that a “pop” with reduced supply would attract otherwise wary investors¹⁴⁴ who would raise the price beyond $(X-Z)$ to something closer to X or even $(X+Y)$. In a traditional bookbuilding offering, the investment bank can manipulate both the price and the number of shares offered for resale to ensure that certain parties capture part of the demand curve. Likewise, Google insiders may have manipulated the share price to accomplish the same thing.

In fact, Page and Brin were able to time the sale of their stock to coincide with share price increases. Although the founders could not possibly have predicted that the share price would increase to almost \$300 per share less than one year later, they each were able to sell shares in June

¹⁴³ Amendment No. 9, *supra* note 131, at 2 (showing that the large reduction of shares from 25.7 million to 19,605,052 would be achieved by selling fewer insider shares in the offering).

¹⁴⁴ Griffith, *supra* note 5, at 605 (noting that issuers must weigh increasing investor enthusiasm for underpricing against the cost of the underpricing).

2005 worth over \$100 million at the time,¹⁴⁵ receiving about three and one-half times the value they would have if they had sold the same shares in the August 2004 IPO.

In any event, the end result of the Google auction process may be preferable to the bookbuilding system. The optimal system would have captured increased demand for the benefit of the issuer, not the founders, and perhaps Page and Brin were able to accomplish that through means other than the auction system. At least in the Google scenario, the spoils of the IPO went to the individuals who created the successful company, not the financial intermediaries. However, the online auction process alone does not seem to hold this promise for most issuers.

E. *Overstock.com*

No description of Wall Street backlash would be complete without some mention of the travails of Overstock.com¹⁴⁶ in its first five years as a public company. When Overstock.com went public in 2002, the CEO, Patrick Byrne, chose to use Hambrecht's OpenIPO platform. In Byrne's opinion, this is when Wall Street began to sour on his company, which had once been very attractive to traditional investment banks courting its public offering. Once Byrne announced his decision, the investment banks did not want any part of the IPO and refused to provide research coverage for Overstock.com shares. Since the offering, Byrne has been very public in his distaste for Wall Street banks, analysts, financial reporters, institutional investors and hedge funds.

One comparison of two Overstock.com follow-on offerings does provide a stark look at the difference between an offering with no Wall Street demand support and one with that support. In May 2004, Overstock.com conducted a follow-on offering using OpenIPO. According to Byrne, many buyers that he was counting on to bid never participated in the auction. Surprisingly, the resulting offering price was lower than the current market price for the same Overstock.com shares. In November of that same year, Overstock.com conducted a second follow-on offering of stock and convertible notes using three Wall Street firms and Hambrecht as a fourth participant in the syndicate. These shares were sold using the bookbuilding method. Notably, this offering generated coverage from analysts associated with the underwriters. The price of the shares rose 82%

¹⁴⁵ Wall Street Journal, <http://www.wsj.com> (click on "Company Research," choose "GOOG," click on "Insider Transactions") (last visited Nov. 27, 2007) (showing sales by date for all insider sales).

¹⁴⁶ According to one of Overstock.com's legal representatives, Theodore Griffinger, Jr., Overstock.com is the world's second largest online retailer with \$900 million in annual revenue. See Mike McKee, *Something Else for Analysts to Watch: Overstock.com's Libel Suit*, THE RECORDER, Mar. 28, 2007, at 1.

to a fifty-two week high in December, even though financial reports from the company were not promising.

However, beginning in 2005, Byrne had cut most ties with the Wall Street demand network and alleged that various factions were conspiring against him to depress Overstock.com's share price so that a "Sith Lord" could buy the company from him.¹⁴⁷ Obviously, statements such as these do not generate favorable press. However, just because someone is paranoid does not mean that someone is not out to get that person. Byrne has complained for years that short sellers are entering into "naked shorts" on Overstock.com stock, which puts excessive downward pressure on the stock price. These types of transactions violate SEC rules, and even though the SEC is keeping a watch list of companies whose stocks are shorted without physical delivery of the borrowed stock, the SEC has not pursued these traders. The SEC has taken no action, even though Overstock.com has been on this list for over 500 consecutive trading days, a fact that is almost unfathomable. In response, Overstock.com and several shareholders have filed a lawsuit in California state court against major Wall Street investment banks, including Morgan Stanley, Goldman Sachs, Bear Stearns, Banc of America, Bank of New York, Citigroup, Credit Suisse, and Merrill Lynch, for facilitating these illegal trades.¹⁴⁸

Whether the Morgan Stanley lawsuit will be successful remains to be seen, but Overstock.com has had success in the California state courts with another lawsuit. In 2005, Overstock.com sued Gradient Analytics, Inc. (formerly Camelback Research Alliance, Inc. ("Camelback")), Rocker Partners and its managing partners Marc Cohodes and David Rocker, and various other individuals, alleging libel, intentional interference with prospective economic advantage, and violations of various California statutes.¹⁴⁹ Overstock alleged a very sinister securities trading plot. According to the appellate court opinion, Gradient "provides analytical reporting services" for a substantial fee to subscribing customers.¹⁵⁰ However, part of the business model for this reporting service was that

¹⁴⁷ See Bethany McLean, *Phantom Menace*, FORTUNE, Nov. 14, 2005, at 187, 187-88 (quoting Byrne from an August 12 conference call when he "launched into a rant about a 'miscreants ball' in which he mentioned hedge funds, journalists, investigators, trial lawyers, the SEC, and even Eliot Spitzer. 'I believe there's been a plan since we were in our teens to destroy our stock, drive it down to \$6-\$10 . . . and even a plan for how the company would then get whacked up.'").

¹⁴⁸ Complaint at 2-5, *Overstock.com, Inc. v. Morgan Stanley & Co.*, No. CGC-07-460147 (San Francisco County Super. Ct. Feb. 2, 2007) (alleging conversion, trespass to chattels, intentional interference with prospective economic advantage, and violations of California statutes by participating "in a massive, illegal stock market manipulation scheme").

¹⁴⁹ First Amended Complaint, *Overstock.com, Inc. v. Gradient Analytics, Inc.*, 61 Cal. Rptr. 3d 29 (Cal. Ct. App. 2007) (No. CV053693) [hereinafter *Gradient Complaint*].

¹⁵⁰ *Overstock.com, Inc. v. Gradient Analytics, Inc.*, 61 Cal. Rptr. 3d 29, 34 (Cal. Ct. App. 2007).

customers could request “custom reports” on specific companies, and customers would negotiate the content of these reports.¹⁵¹ According to a former Camelback employee, subscribers of Gradient-generated custom reports were able to influence what was contained in the report by supplying the information Gradient would include in the report and by instructing Gradient to produce a positive or negative report.¹⁵² Such a relationship was common knowledge at Gradient and, in essence, facilitated customers who were involved in the practice of selling companies short. Customers would request negative reports on specific companies and even request delaying the release of these reports until the customers could acquire their short positions.¹⁵³ Gradient touted its services to prospective subscribers by tracking its ability to affect stock performance. For example, Gradient kept lists of “Blow ups,” or “companies which suffered a one-day decline of -20 percent or more in the price of their stock” as a result of the publication of a Gradient report.¹⁵⁴

The complaint specifically alleges that Rocker Partners requested numerous negative reports on Overstock.com, which Gradient provided in 2005, in order to gain profits by short selling Overstock.com shares.¹⁵⁵ Although the allegations were generally ignored by the financial media,¹⁵⁶ this suit has survived both a motion to dismiss and an appeal of the denial of that motion based on the holding that the plaintiffs established a probability of prevailing on the merits.¹⁵⁷ Any damages received by the

¹⁵¹ *Id.* at 35-36.

¹⁵² *Id.* at 35.

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 35-36.

¹⁵⁵ Gradient Complaint at 6-7 (listing no fewer than twenty-four reports between Jan. 17, 2005 and June 13, 2005).

¹⁵⁶ See McLean, *supra* note 146, at 187-88 (dismissing Byrne’s complaints against Gradient as “paranoid fantasy” and noting that “[a]ll the parties named in the lawsuit deny any wrongdoing, and David Rocker says he is preparing a dismissal motion and countersuit”). McLean may, like other financial journalists, be predisposed against suits against analysts and journalists who speak negatively about public companies. McLean wrote a seminal article in Fortune questioning Enron’s financial reports that became a key component in the revelations of accounting fraud that occurred at Enron and led to a book co-written by McLean. See Bethany McLean, *Is Enron Overpriced?*, FORTUNE, Mar. 5, 2001, at 123; BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON (2003). However, McLean presumably was not shorting Enron’s stock when she published her objective article, which tends to distinguish the Gradient reports from other analyst markets published and disseminated in the market.

¹⁵⁷ *Overstock.com, Inc.*, 61 Cal. Rptr. 3d at 38, 48 (“The malice is in the very business model and practices that preordain negative reports and provides probative evidence that Gradient acted in reckless disregard of the truth in making the false statements and implications that it did.”). Apparently, the panel was convinced by the briefs to let the lawsuit continue, as one justice stated at oral argument that even at the pleading stage there was sufficient evidence to likely substantiate Overstock.com’s claims. See Mike

plaintiffs in this case would be calculated according to the amount the stock price declined as a result of the tortious conduct.¹⁵⁸

Although blaming all of Overstock.com's woes on its not selecting a traditional underwriter for its IPO might be hyperbolic, certainly Overstock.com's journey as a public company provides a few cautionary tales for those who consider circumventing Wall Street's demand network for not only an online auction IPO but also for general investment banking needs.¹⁵⁹ Perhaps after litigation is concluded, future issuers will be able to determine whether Overstock.com did suffer an industry-wide backlash for its maverick attitude.

IV. THE FUTURE OF AUCTION IPOs

In conclusion, the future of auction IPOs in the U.S. may not be so bright after all. Although the IPO Advisory Committee reported that the auction and bookbuilding methods should compete in the marketplace to determine which is preferable,¹⁶⁰ such competition may never materialize. As long as traditional Wall Street investment banks choose not to offer the auction method, then the only auction alternative available to issuers is the one that operates outside the Wall Street demand network of analysts, brokers, and financial reporters. The future does not hold much promise for traditional investment banks to offer an online auction method because that method is not as lucrative for them as the bookbuilding method, which provides opportunities to use pre-IPO allocations to build profitable goodwill with investment banking clients and brokerage customers.

Without the option of an online auction with access to a demand network, an issuer is not choosing between the ideal auction return of 100% of X and the theoretical bookbuilding return of 80% of X. Instead, the issuer is choosing between an auction return of 100% of a reduced X, or (X-Z) or 80% of an increased X, or (X + Y). In most instances, $.80(X + Y)$

McKee, *Court's OK Likely in Overstock.com's Stock Libel Suit*, THE RECORDER, Apr. 11, 2007, No. 70, available at <http://www.law.com/jsp/article.jsp?id=1176282246984>.

¹⁵⁸ Fortunately for the plaintiffs in this case, the court did not require them to meet the higher pleading standards for securities law "fraud on the market" cases to survive a motion to dismiss. See *Overstock.com, Inc.*, 61 Cal. Rptr. 3d at 52. During the general time period that Gradient was issuing negative reports on Overstock, Overstock's stock price dropped from \$73 per share to under \$30 per share. *Id.* at 37.

¹⁵⁹ Although not the topic of this article, an interesting research study would analyze whether OpenIPO firms generally suffer from lack of Wall Street research coverage and whether this lack of coverage reduces overall returns. See Oh, *supra* note 8, at 27-28 (calculating that "66.67% of all OpenIPOs have experienced negative three-year returns," with the average OpenIPO experiencing a share price decline of 3.3%, compared with an average 20.4% three-year return for all IPOs).

¹⁶⁰ See IPO ADVISORY COMM. REPORT, *supra* note 83, at 1, 9 ("The market, and not regulators, should determine whether bookbuilding, a Dutch auction or another method is desirable for a particular IPO.").

will be greater than $1.0(X - Z)$; therefore, rational issuers will choose the bookbuilding method. The few issuers who choose the auction IPO will do so for mainly symbolic reasons.¹⁶¹ Unless regulators become inspired to forbid practices that allow underwriters to inappropriately influence market price, whether through analyst conflicts, laddering, tying agreements, or other methods, the bookbuilding underwriters will continue to have the competitive advantage.

¹⁶¹ See Fleischer, *supra* note 121, at 1605 (noting that many online auction users, including Google and Overstock.com, have created personas so that the public sees them as “contrarian, egalitarian, and user-oriented” such as Peet’s Coffee & Tea, RedEnvelope and Salon.com).